



FROM "GROWTH" TO "SUSTAINABLE GROWTH"

CENTRAL BANK OF TURKEY

June 2005

The Past: 30 Years of Fallacies

I - INFLATION vs. GROWTH

**We have inflation, but
we are able to grow
fast...**

It was thought that:

– *Disinflationary policies*



Decrease growth

– *Loose monetary policy*



Increase growth

True or False? False.

The false statement only valid:

- **In a static environment,**
- **In countries with low inflation and,**
- **In the short run.**

The Past: 30 Years of Fallacies

- In fact, in the long run;

✓ There is no such conflict.

✓ There is a strong and negative relationship between inflation and growth. →

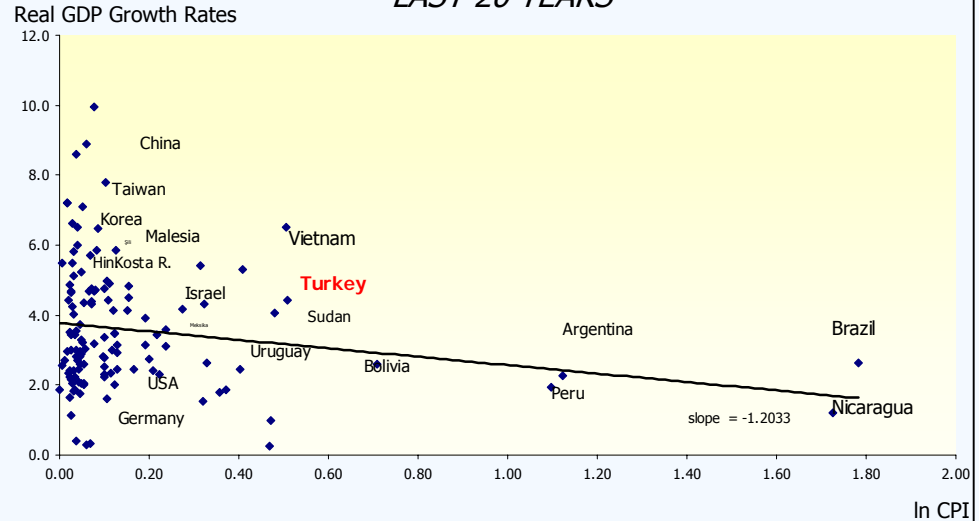


For sustainable and high growth ⇨ Price stability is a sine qua non.

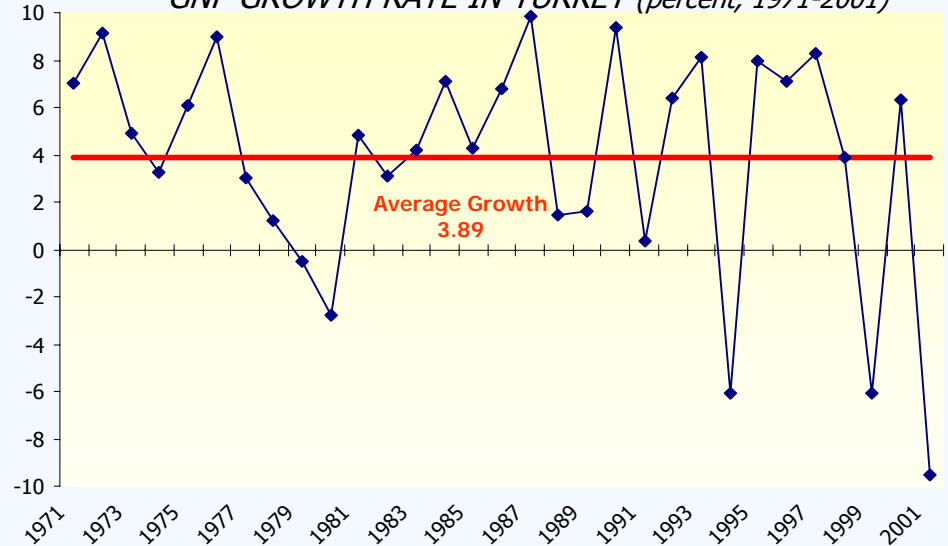
- Before 2001, in the 30 years of high and chronic inflation period, the Turkish economy followed a volatile growth path and the growth rates were low on average compared to similar developing countries. →

Tight fiscal policy →

AVERAGE INFLATION AND GROWTH IN THE LAST 20 YEARS



GNP GROWTH RATE IN TURKEY (percent, 1971-2001)



Source: CBT, SIS

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II- TIGHT FISCAL POLICY vs. GROWTH

It was thought that:

Tight fiscal policies

– *High primary surplus* → *Economy shrinks*

– Top priority is growth, so public expenditures must increase.

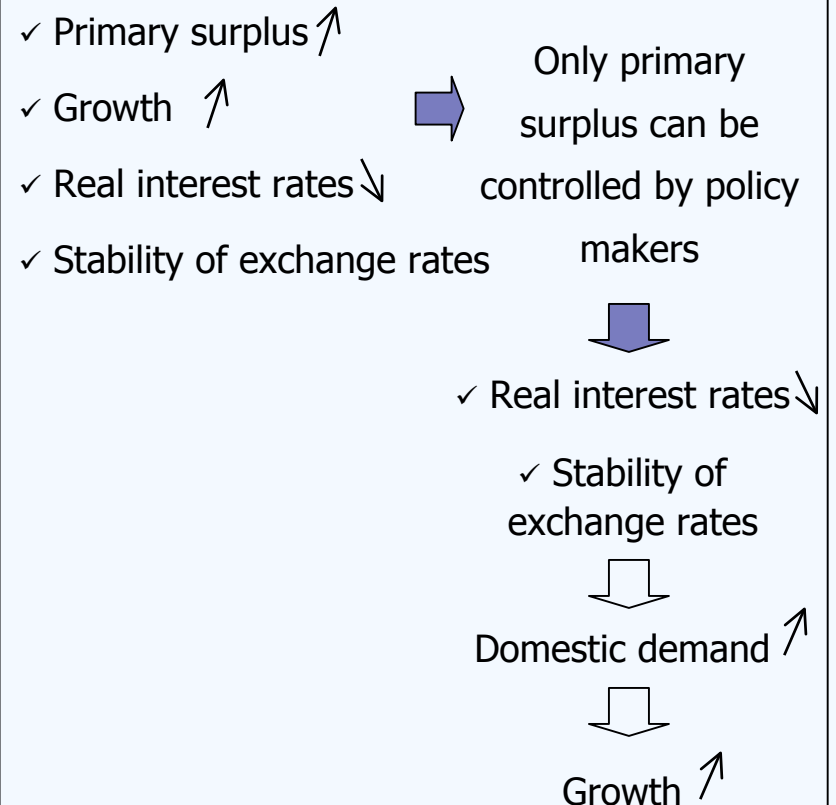
True or False? False.

Countries where the risk of public debt sustainability is high; → Expectations about the **sustainability of debt** are the determining factor behind dynamics of growth and inflation.

To have growth,

Public Debt / GNP must be reduced:

How?

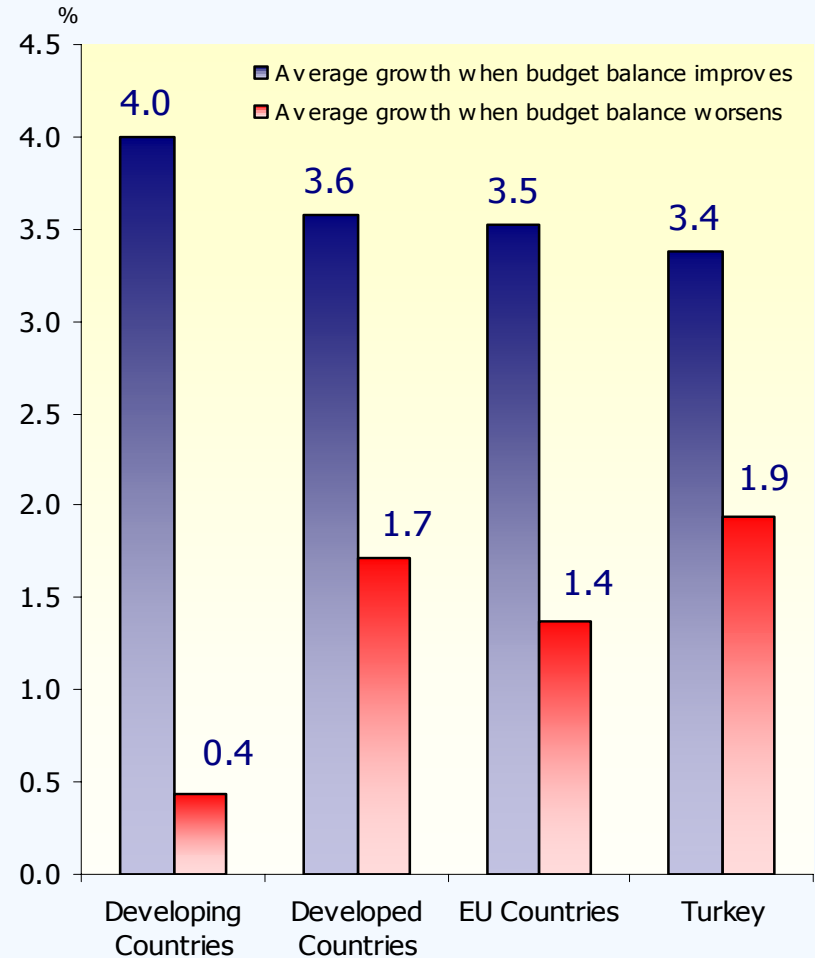


The Past: 30 Years of Fallacies

– Moreover, tight fiscal policy,

- ✓ Is an indicator of the fiscal discipline and stability.
- ✓ Is a signal of government policies.
- ✓ Shapes expectations.
- ✓ Increases confidence in policies.
- ✓ Provides a longer-term vision.

BUDGET BALANCE AND AVERAGE GROWTH

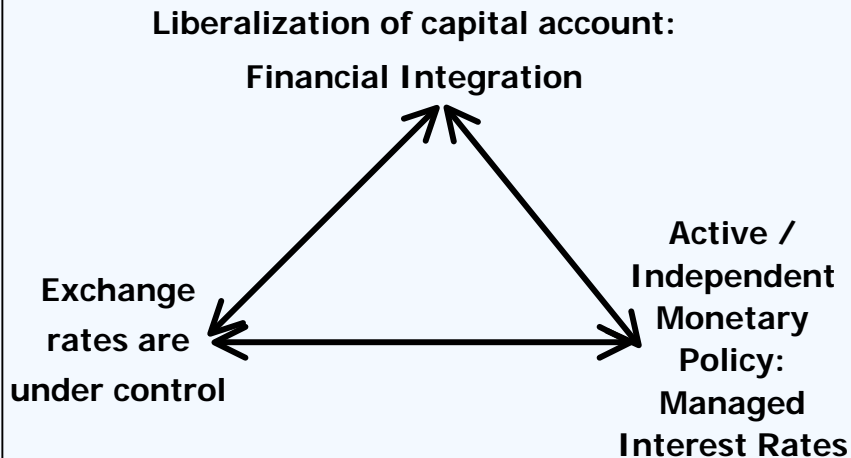


Better budget balance: Average 8 years. Worse budget balance: Average 5 years.
For Turkey 1991-1995 and 1998-2000 data used.

Changing Dynamics of the Turkish Economy

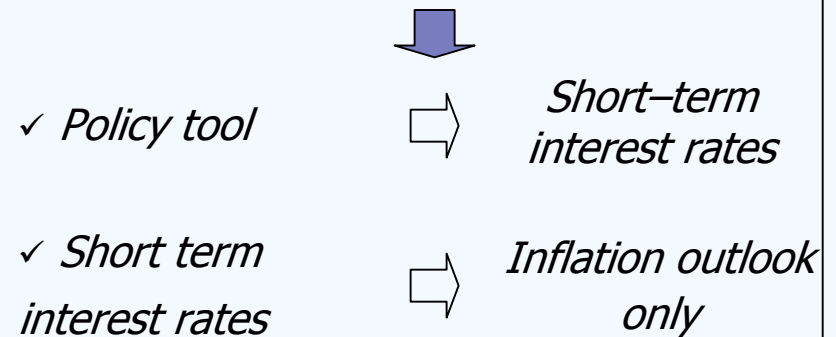
1- ACTIVE MONETARY POLICY

Impossible Trinity



When capital movements are liberalized, interest rates and exchange rates cannot be controlled at the same time.

Today, the CBT is pursuing an active monetary policy – implicit inflation targeting.



To foresee the future course of inflation:

- *Aggregate supply and demand;*
 - ✓ *Fiscal policy indicators,*
 - ✓ *Monetary indicators,*
 - ✓ *Credit aggregates.*
- *Inflation expectation surveys and the CBT's own inflation estimates,*
- *Wages, employment and unit labor costs, productivity,*
- *Pricing behaviour of public and private sectors,*
- *Exchange rates and balance of payments,*
- *External economic developments.*

Changing Dynamics Of The Turkish Economy

2- CENTRAL BANK INDEPENDENCE

May 2001:

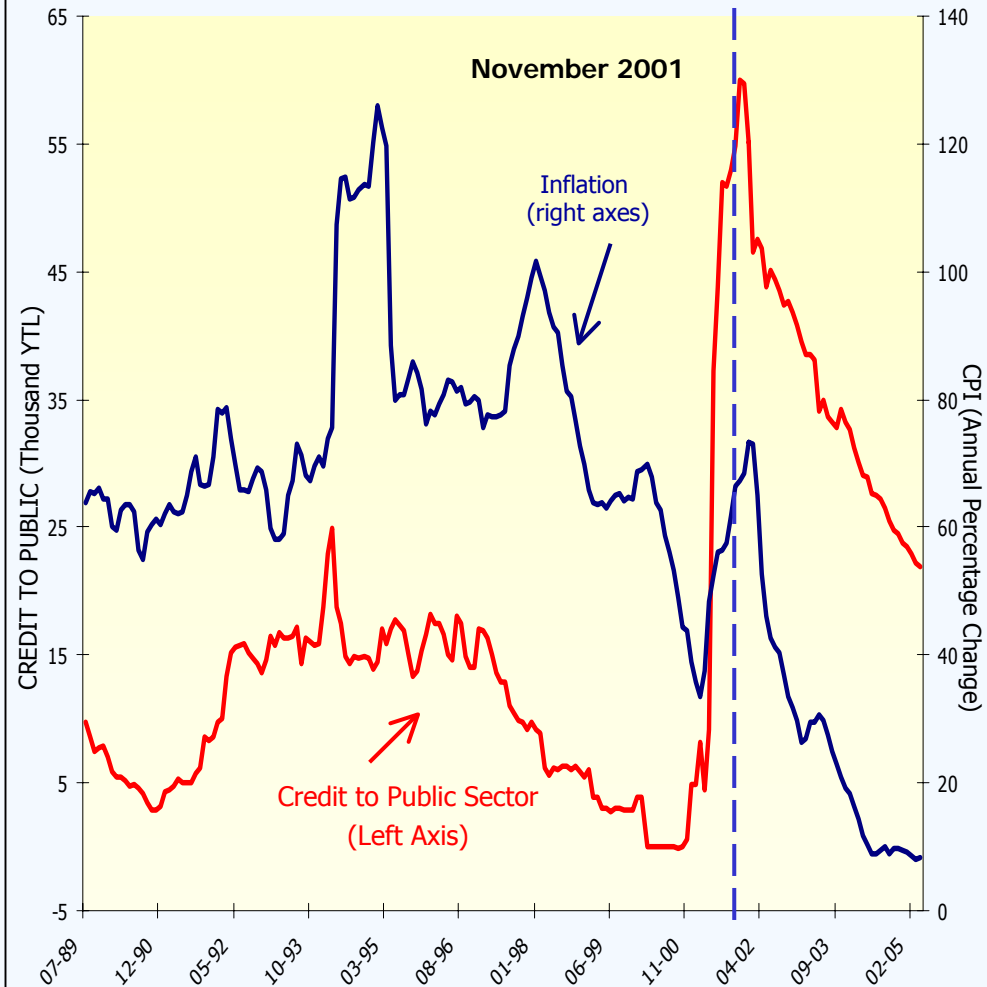
- ✓ New CBT Law
Article 4
- ✓ Clearly defined target:
Price stability.
- ✓ Target set by;
Government + CBT.
- ✓ Monetary policy and
instruments; CBT.
- ✓ Operational independence.

November 2001:

No more credit to
public sector →

*In order to preserve and safeguard the
Central Bank independence, the society
should understand its meaning ,
internalize and maintain it.*

*CREDIT TO PUBLIC SECTOR (real values)
AND INFLATION (annual percentage change, May 2005)*



Source: CBT, SIS

Inflation fell →

Changing Dynamics Of The Turkish Economy

3- INFLATION FELL. →

2002: 73.2 % (January)

2005: 8.7 % (May)

Single digit annual CPI figure after **35 years**

	2002	2003	2004	2005
Target	35	20	12	8
Realization	29.7	18.4	9.32	May 8.7

– **Currency Reform**; Six zeros were dropped from the currency as of January 1st, 2005.

✓ This is an indicator of the determination in bringing inflation down.

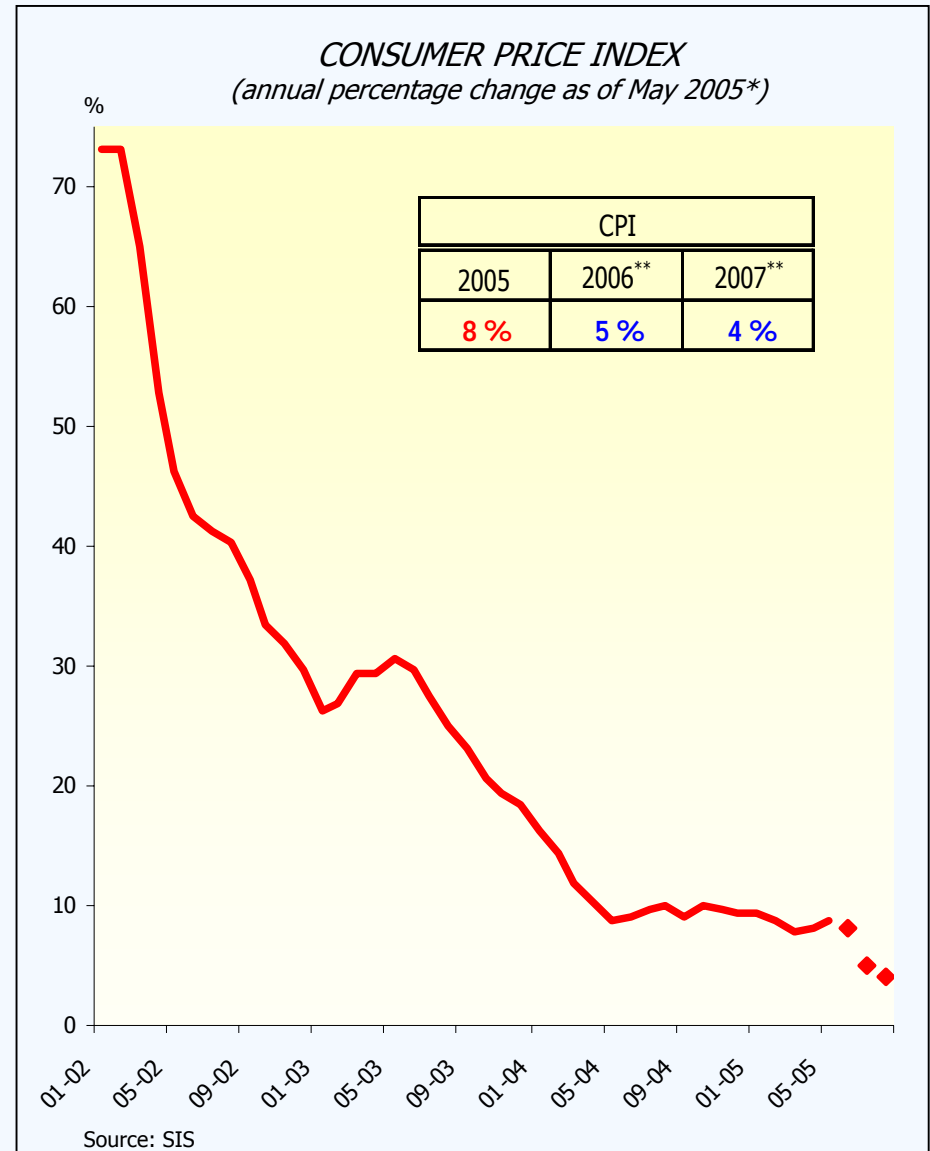
– **However:**

✓ Disinflation process has been continuing.

✓ Price stability has not been achieved yet.

✓ Fighting against inflation is an ongoing process.

Growth →



* Inflation data for the year 2005 was calculated by using the index 2003=100.

** 2006 and 2007: Program targets

Changing Dynamics Of The Turkish Economy

4- GROWTH

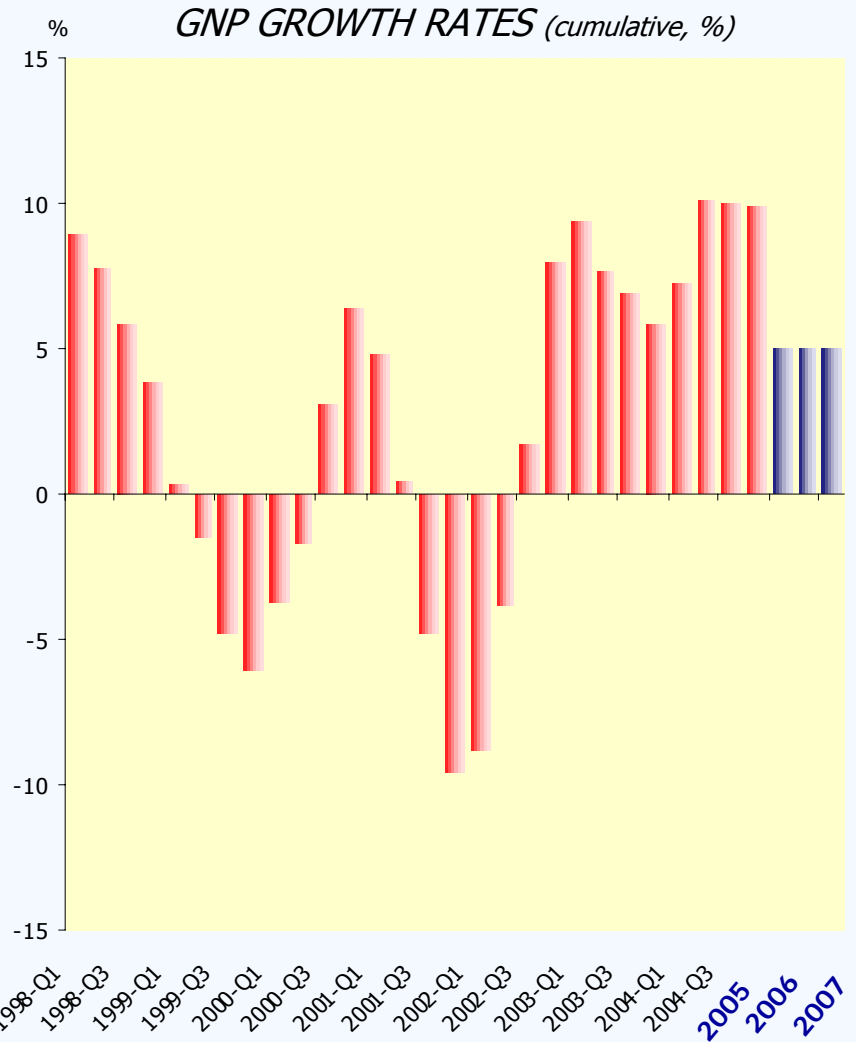
- Turkish economy has been experiencing **high growth rates since 2002.** →
- Economic growth **compared to 2001:** **25.5 %** in real terms
- Growth in **2004: 9.9 %**; one of the highest growth rates in the world.

2005

2006

2007

Growth forecasts:
5 %



Source: SIS

Changing Dynamics Of The Turkish Economy

5- GROWTH DYNAMICS ARE CHANGING.



A- High growth rates have been attained while **inflation is falling.** →

B- Highest contribution to growth came from the **increase in productivity.**

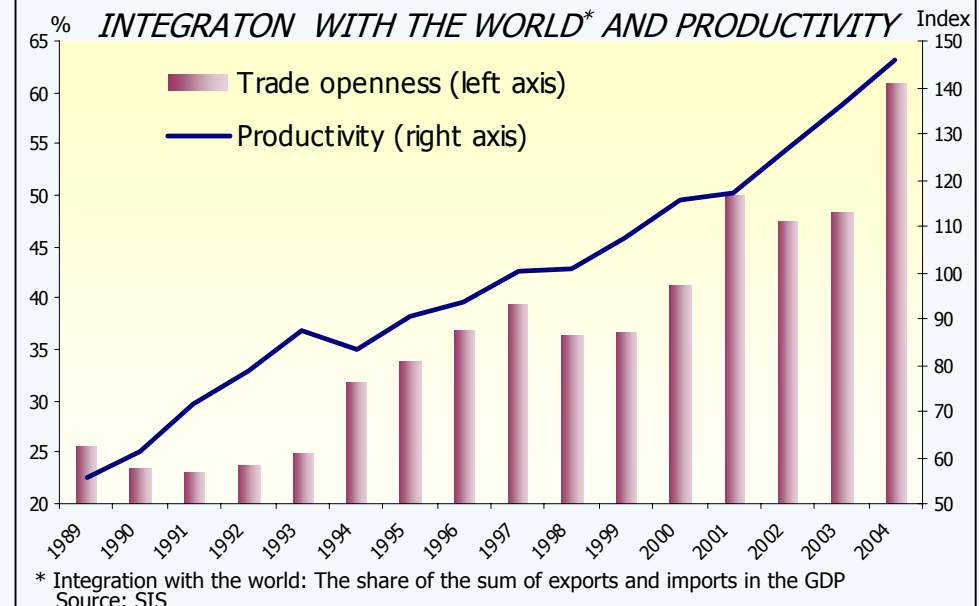
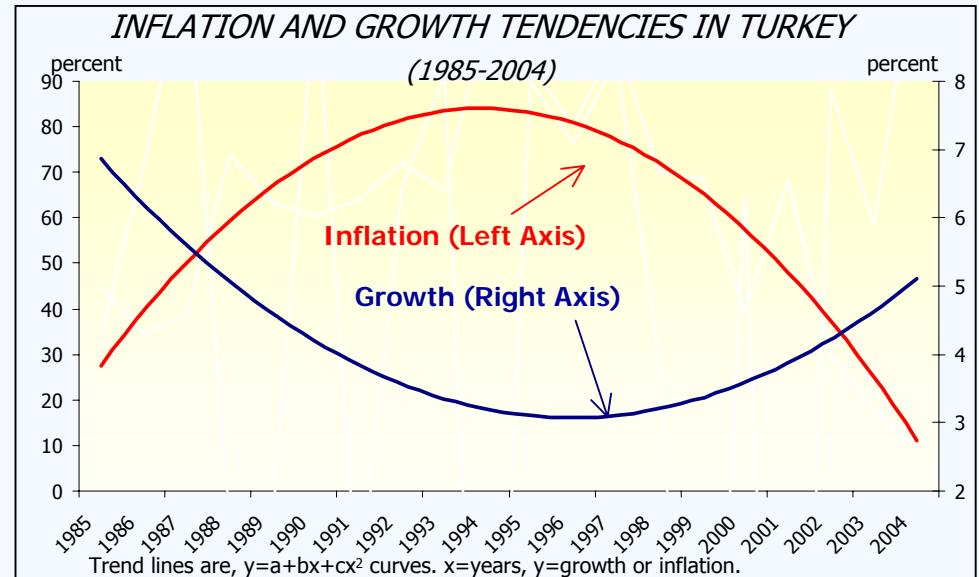
✓ *In the last three years the cumulative increase in productivity is 25 %.*

✓ *Contributed to growth jumping to a higher plateau.*

C- Exports contribute with an **increasing share:**

✓ *Since 2001, Turkey's total foreign trade volume has increased by 120 %.*

✓ *Trade openness is increasing. The Turkish economy is now more integrated with the world economy, giving rise to an increasing importance of productivity and competitiveness.* →



Changing Dynamics of the Turkish Economy

5- GROWTH DYNAMICS ARE CHANGING.



D- The private sector is the engine of growth:

✓ While the contribution of the government's final consumption and investment expenditures to GDP decreased, that of the private sector increased. →

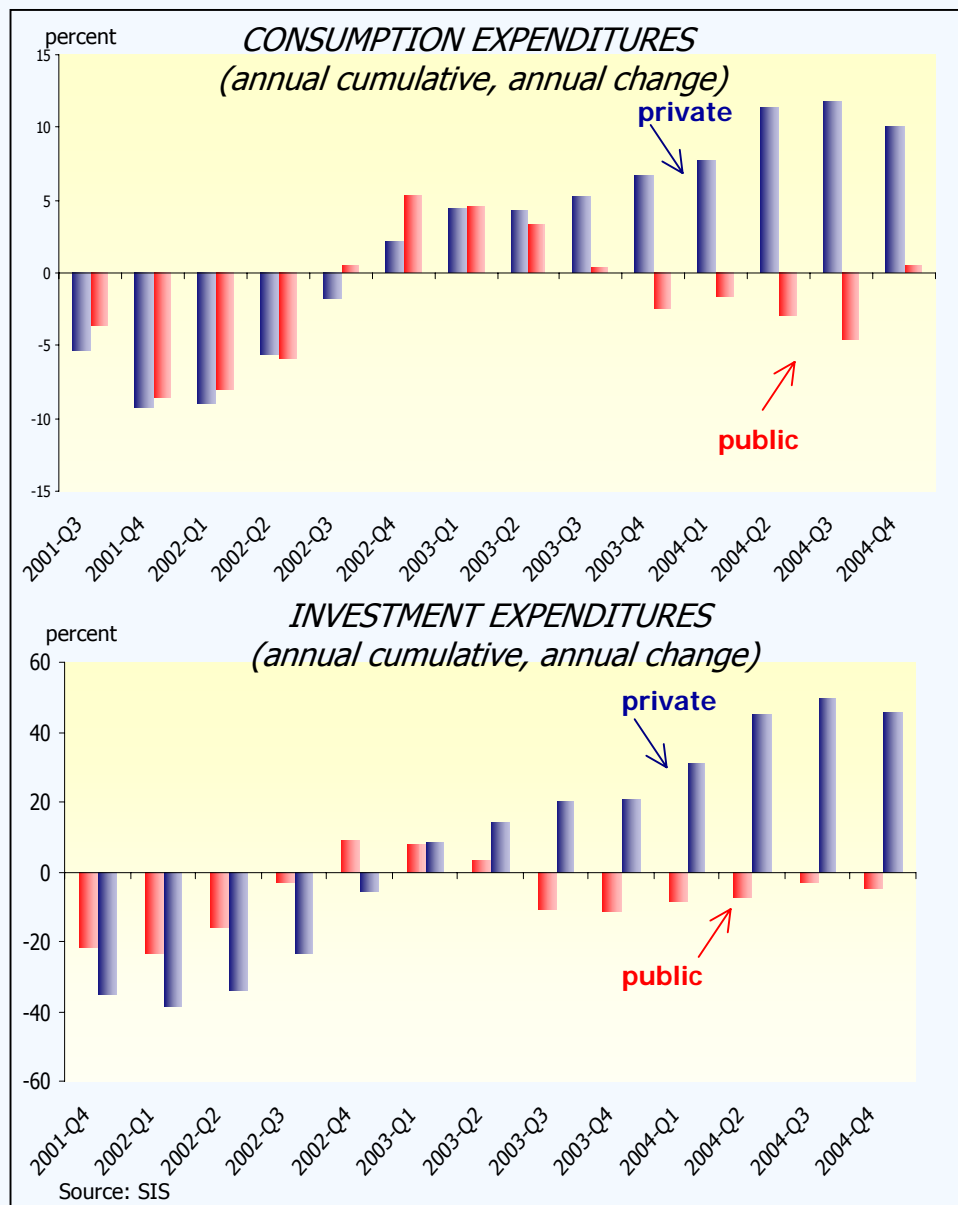
2004 GNP (%)			
Government Final Consumption	Private Final Consumption	GFCF* - Private	GFCF* - Public
0.5	10.1	45.5	-4.7

* Gross Fixed Capital Formation

✓ Changing dynamics of growth force the public sector to focus on areas that will increase the growth potential of the country in line with the principles of good governance:

Regulations to improve the quality of government's services and to enhance the transparency of fiscal policies.

Is this sustainable growth? →



From Now On; Sustainable Growth

Is this sustainable growth?

No.



– **Sustainable Growth** can be defined as:

Growth periods,

✓ *At potential growth rates,*

✓ *Lasting for 5 or more years,*

in an environment where;

✓ *Price stability is maintained,*

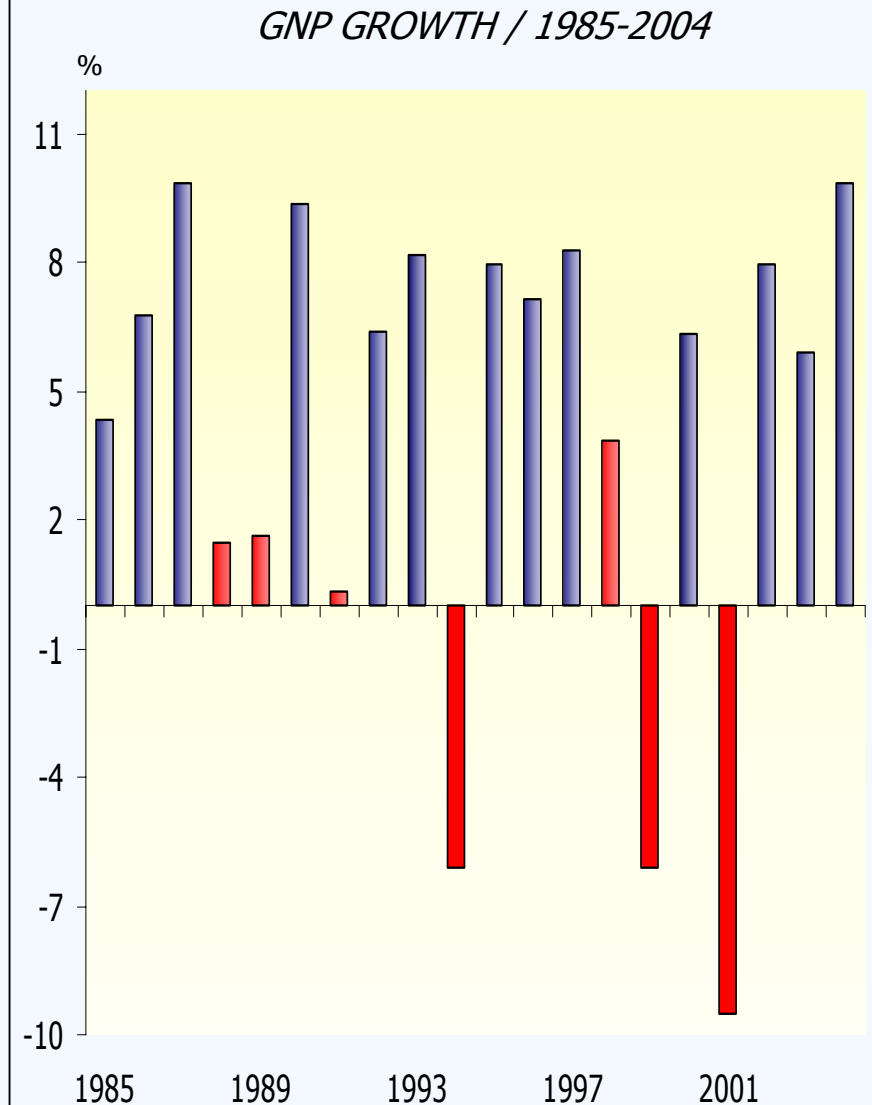
✓ *Economic indicators, including current account deficit/GNP and total demand, and macroeconomic balances are coherent.* →

– **Questions:**

✓ *What will be the **sustainable growth rate**?*

✓ *Will that level be **satisfying**?*

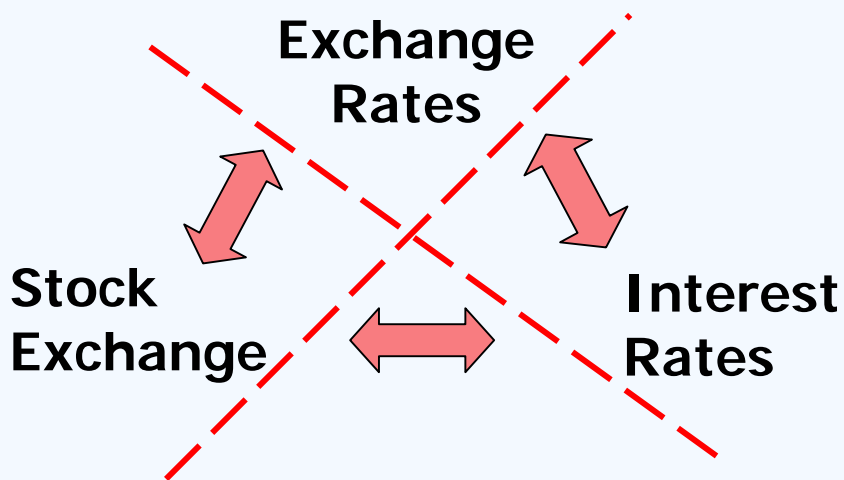
✓ *Where do we **stand** in the sustainable growth process today?*



Source: SIS

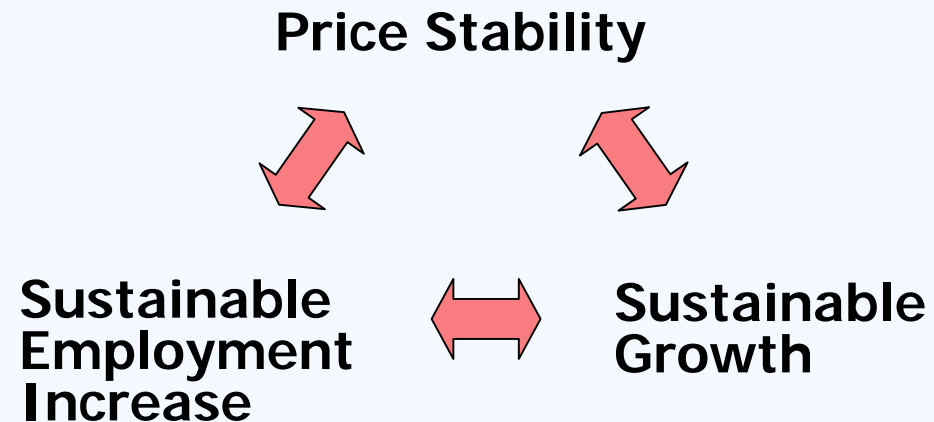
From Now On; Sustainable Growth

Hence, hereafter discussions on the economy should go beyond the narrow triangle of



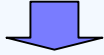
The triangle reflects only a narrow and short-term vision.

Instead, with a wider and longer vision, we should focus on where we stand and what should be done hereafter within the framework of:



From Now On; Sustainable Growth

Banking sector reform:



– There is a strong positive relationship between national **income per capita** and the banking sector **credits / GNP** ratio. →

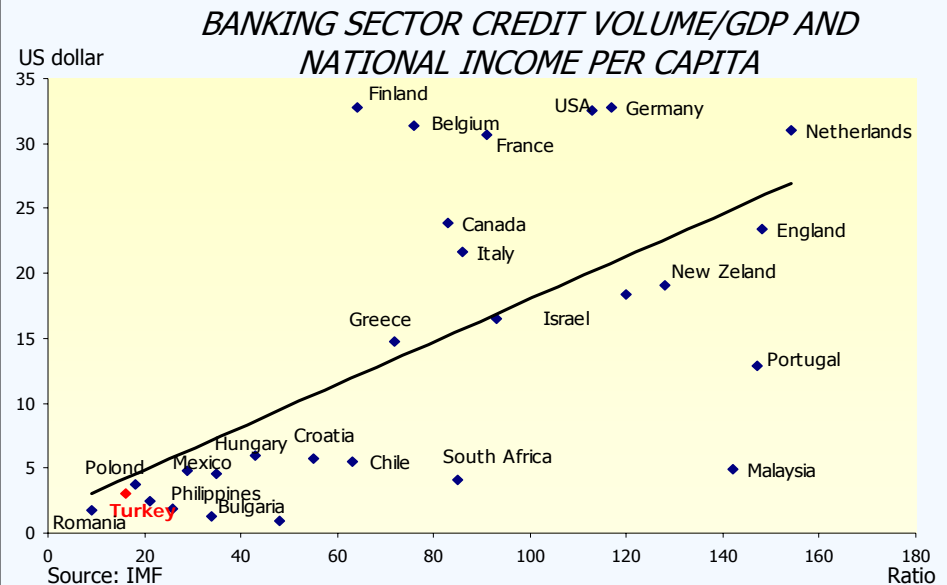
- **A strong banking sector plays a key role in providing resources to real sector and achieving high growth rates.**

- Credit volumes in Turkey, which dropped rapidly following the 2001 crisis, **started to increase after the second half of 2003.**

Credit Volume / GNP	2002	2003	2004
	0.13	0.15	0.20

- However, current achievements are not sufficient; the **ratio of total credit volume over national income** is **below that of developed countries and many developing countries.**

- Continuous implementation of the **banking sector reform** must remain a **priority** in order to be able to provide resources to the real sector in a **more efficient way.**



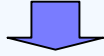
Agenda of the Real Sector

- Prepare **sound and transparent balance sheets,**
- Give importance to **risk management,**
- In terms of **corporate governance;**
 - ✓ *Equality among shareholders*
 - ✓ *Transparency*
 - ✓ *Responsibility (conformity of enterprise's activities to legislations and regulations, and openness to auditing)*
 - ✓ *Accountability*

This process will also contribute to **development of capital markets.**

From Now On; Sustainable Growth

Institutionalization and the implementation of the principles of good governance



- The **quality of the institutions** is one of the most important variables that explain why some countries manage to advance in technology and accumulate capital faster than others; that explain cross-country differences in income levels.

- The most important factors are **rule of law** and the protection of **intellectual property rights**.

✓ *Per unit improvement in the quality of institutions can increase the income per capita by 5 units. This relationship is even stronger in developing countries.**

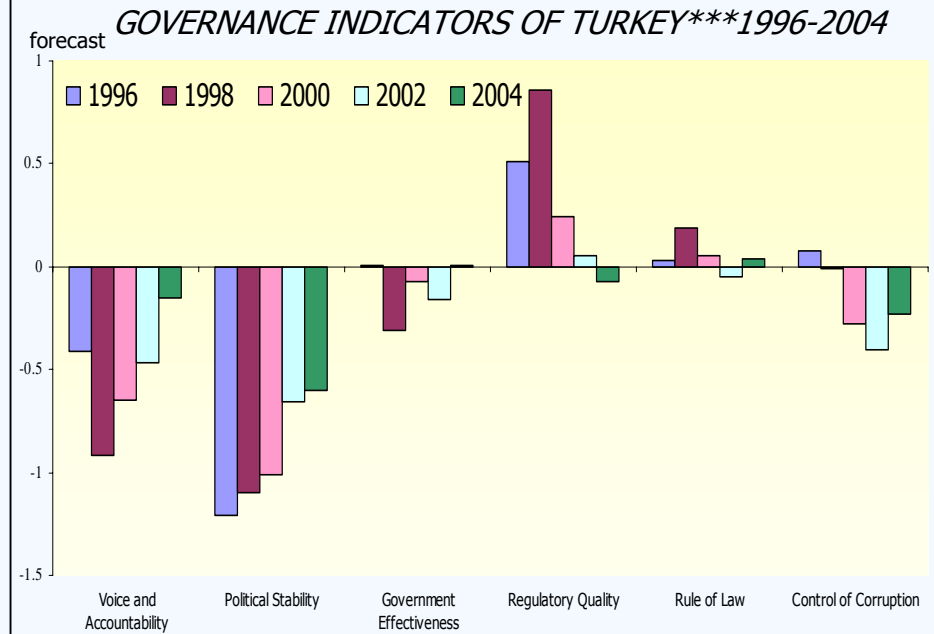
- The principles of good governance in the public sector are classified as:

- ✓ *Voice and accountability*
- ✓ *Political stability*
- ✓ *Government effectiveness*
- ✓ *Regulatory quality*
- ✓ *Rule of law*
- ✓ *Control of Corruption*

Institutional quality and good governance increase the efficiency of monetary and fiscal policies, and contribute to lower volatility of macro and micro variables.**

* Cavalcanti, Novo (2002), "Institutions and Economic Development: How Strong is the Relation?", Banco de Portugal Working Paper 13-02.

** Acemoğlu, Johnson, Robinson, Thaicharoen (2003), "Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth", Journal of Monetary Economics, 50, 49-123.



Source: World Bank

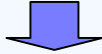
- Although Turkey shows important progress in governance indicators except for the regulatory quality, it is still behind both in absolute terms and compared to other countries.

- The achievements in these indicators will determine the place of Turkey in the world, not only in the economic area but also in all other areas.

***Governance indicators are estimated by using several hundred variables drawn from 37 data sources such as the surveys of individuals and domestic firms, perception of country analysts, NGOs and commercial risk rating agencies. Virtually all scores lie between -2.5 and +2.5, the higher scores correspond to better governance.

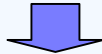
From Now On; Sustainable Growth

Tax Reform



- Broadening the Tax Base

- ✓ *In Turkey both direct and indirect effective tax rates are quite low.*
- ✓ *A certain amount of income is generated. However it cannot be taxed effectively.*
- ✓ *Due to this taxation structure, the tax burden on the registered economy is quite heavy, whereas that on the unregistered economy is insignificant.*



- Formalizing the Unregistered Economy

- ✓ *In Turkey the size of unregistered economy changes from 16% to 50%, conditional on assumptions used in studies.*
- ✓ *Unregistered economy causes government revenues to decrease, unproductive use of country resources, low levels of sustainable growth, only temporary increases in employment, and unfair competition.*

Hence, restructuring of the tax system is of critical importance.

Social Security Reform



Deficits in the social security system have reached critical levels.

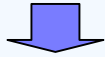
- Although the demographic structure of Turkey provides an important advantage;
 - ✓ *Small number of registered employees,*
 - ✓ *Understatement of employees' incomes,*
 - ✓ *Distortions in expenditures*

lead to imbalances in the social security system.

- Public expenditures on social security system have reached 23 % of the non-interest expenditures. It is estimated that in 2004, transfers from the budget to social security institutions is around 4.5 % of the GNP.
- Important steps have been taken already; the outcomes of the measures will only be observed in the long run.

From Now On; Sustainable Growth

Improving the Investment Environment



- In Turkey, **the level of domestic savings are very low**. Encouraging inflows of foreign capital is very important in order to achieve high growth rates.
- The **EU accession** process provides a **significant potential**.
- So, it is extremely important to remove the barriers to both **domestic** and **foreign** investment, and especially to encourage foreign direct investment (**FDI**).
- The enactment of the **FDI Law** and the law on the protection of **intellectual property rights** are important steps on the way.

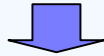
Sustaining Productivity Increases



- Increases in total factor productivity** will be one of the most important dynamics of sustainable growth in the upcoming period.
- Recent productivity increases in the manufacturing sector should be extended to all other sectors and be sustained.
 - **For sustainable productivity increase:**
 - ✓ *Research and development facilities that will enable technological advancement,*
 - ✓ *Labor force training,*
 - ✓ *Improvement in corporate governance are important.*
 - It is necessary to sustain employment increases as well as productivity increases in order to reach sustainable growth rates.

From Now On; Sustainable Employment

Where are we in terms of employment?



- The total increase in employment in Turkey throughout 2004 is much higher than that of EU member and candidate countries.
- Compared to the first quarter of 2004, there is an annual increase of 4.7 % in total employment in 2005. →
- When we look at the changes in employment by sectors;

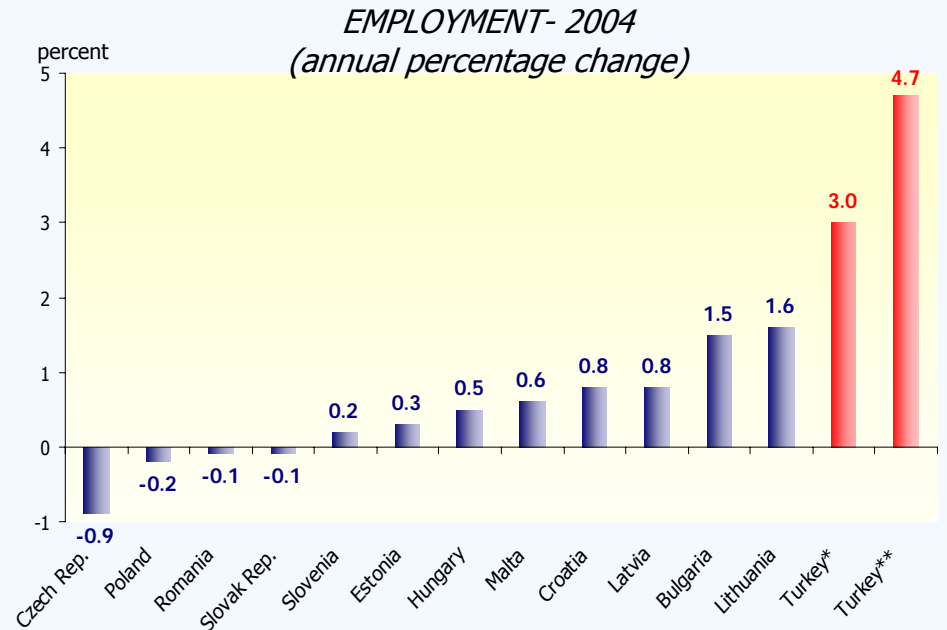


Industry	Services	Construction	Agriculture
% 5.5	% 7.9	% 27.8	%- 2.8

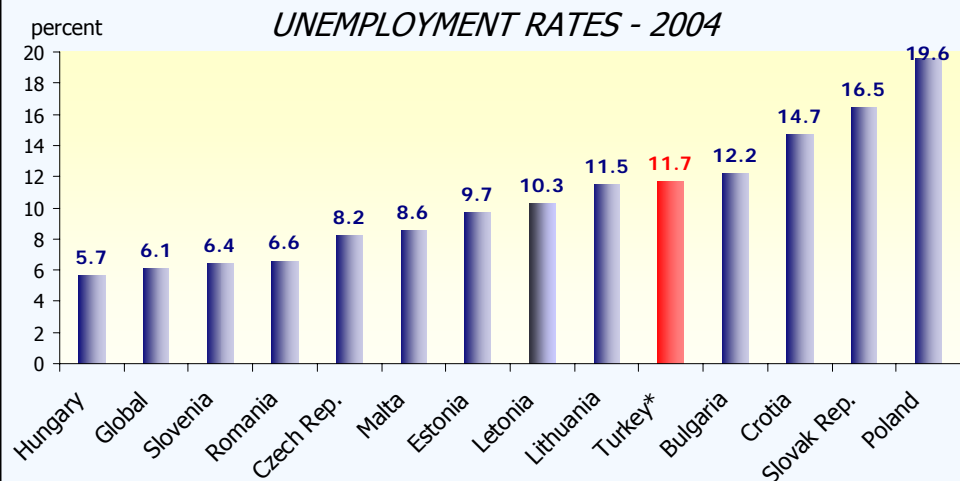
- However, as of the first quarter of 2005, the unemployment rate is 11.7 % :
- It doesn't totally reflect the high growth rates. Why?

1- Unemployment is not peculiar to our country, it is a global problem. →

✓ In 2004 global unemployment rate was 6.1 %, while global unemployment rate among the young population was 13.1 %.



Source: European Commission, * 2004, ** 2005Q1.



* 2005 Q1
Source: SIS

Sustainable Employment

2. Productivity Increases:

- In Turkey, **productivity increases have outpaced growth** for the last four years. →
- Productivity increases enabled firms to boost production without increasing their employment capacity.
- This situation, which has recently been observed throughout the world including USA and Europe, is referred to as "**Jobless Growth / Recovery**".

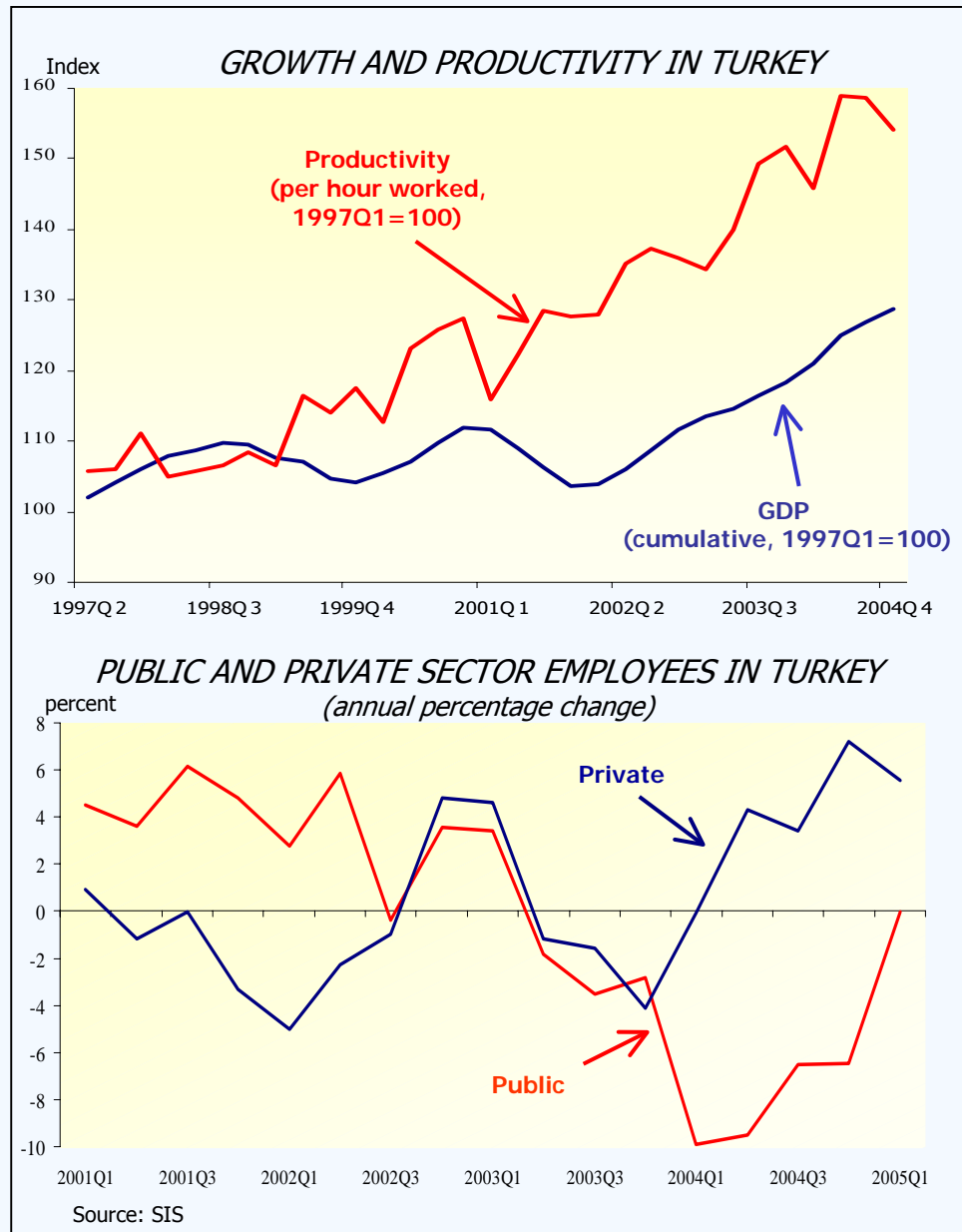
- Although, productivity increase may affect employment creation and capacity of growth adversely in the short run, **outcomes of productivity increases are favorable in the long run.**

3. The public sector has given up employing an excessive labor force; →

- Since the beginning of 2003, employment in the public sector has noticeably been decreasing.



The source of employment is now the private sector.



Sustainable Employment

4. Structural changes, within the structural transformation process in the economy, are also being observed in the labor market.

- Some sectors are expanding while others are contracting, and the sectoral distribution of employment is changing.

✓ *The share of the agricultural sector in total employment is falling, while that of the services sector is rising.* →

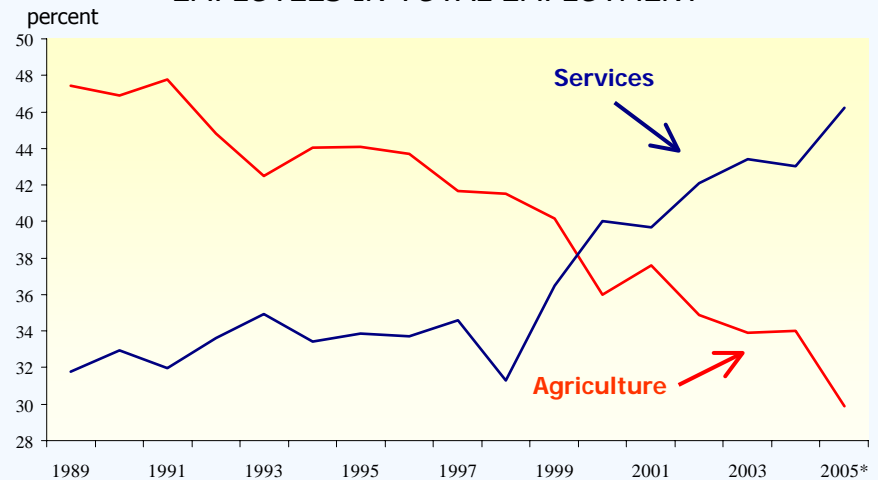
	Distribution of Employment by Sectors			
% share	Agr.	Industry	Const.	Services
1989-1999 avg.	44.0	16.3	5.8	33.5
2000-2004 avg.	35.3	18.0	5.1	41.6

✓ *Factors of production are moving into different sectors, and more effective and competitive firms are emerging.*

- Like other emerging economies, Turkey's economy is moving toward a **capital-intensive investment structure from a labor-intensive one.** →

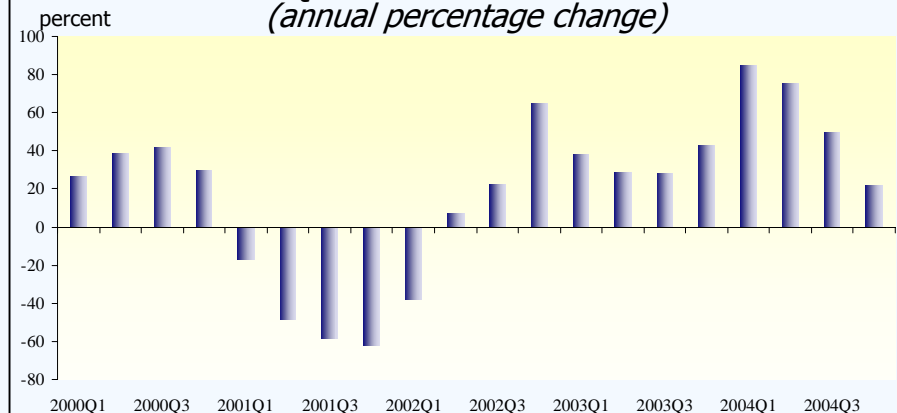
✓ *As interest rates are falling, the cost of capital is decreasing compared to the cost of labor.*

SHARE OF TURKEY'S AGRICULTURAL AND SERVICES SECTOR EMPLOYEES IN TOTAL EMPLOYMENT



* As of April.

MACHINERY-EQUIPMENT EXPENDITURES IN TURKEY (annual percentage change)



Source: SIS

Sustainable Employment

5. Structural problems of the labor market are hindering the recovery process:

- High increase in the labor force:

- ✓ *The rate of increase in population slows down, but it is still high.*
- ✓ *Participation to the labor force is increasing.*
- ✓ *Female labor force participation is also increasing.*
- ✓ *Employment in the agricultural sector is gradually falling, and the agricultural population is joining the urban labor force.*

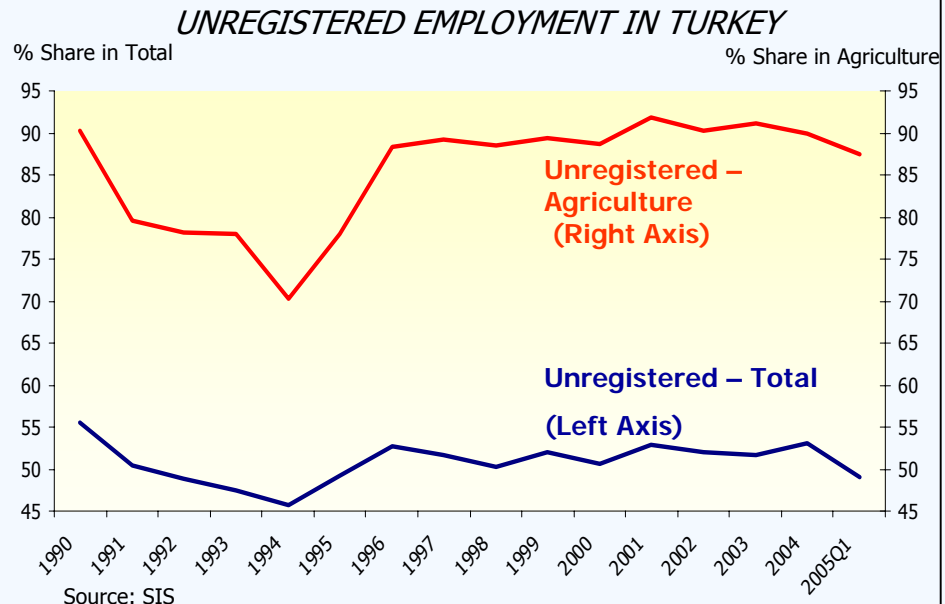
- High employment taxes: →

- ✓ *Employment taxes, which were 30.3 % in 1999, reached the highest level among the OECD countries in 2004 with 42.7%. This level is 5.9 % in Ireland and the OECD average is 26.6% .*
- ✓ *As of 2003 , the share of employment taxes in labor costs is 42.1 % in Turkey. This level is also 5.6 points above the OECD average.*

- Unregistered employment:

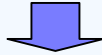
- ✓ *In particular, high employment taxes fuel unregistered employment.*
- ✓ *According to SIS data, total unregistered employment as of the first quarter of 2005 is 49 %.*
- ✓ *In the agricultural sector, the size of unregistered employment is 87.5 %.* →

Identifying the problem brings the solution.



Sustainable Employment

What can be done to provide sustainable employment?



1. Employment oriented policies should be put into practice:

- ✓ *The capacity of growth to create employment should be increased via establishing **permanent macroeconomic stability**.*
- ✓ ***Real sector – financial sector relationship to be strengthened** in order to provide sufficient financing to the private sector to create employment,*
- ✓ *The **investment environment** should be improved,*

2. Production should be increased to levels that will enable competitiveness in international markets.

- ✓ *Priority should be given to the **products with high value added**,*
- ✓ ***Regional markets should be established** to address unskilled labor force that will appear following the contraction in the agricultural sector.*

3. Employment taxes should be reduced.

4. The size of the unregistered economy should be reduced.

5. Productivity increases should be sustained.

6. Educational policies;

- ✓ *Long term planning which suits the labor demand and aims to increase the skilled labor force is required.*

7. The policies to be implemented should be in consistency with the European Employment Strategy.

– In Turkey, as of first quarter of 2005;

- ✓ *The general employment rate is 28.7 points below the Lisbon target, at 41.3 %.*

- ✓ *Female labor force employment is also far below the target, at 20.8 %.*

– In the framework of the **Lisbon Strategy**;

- ✓ *For the year of 2010, the EU sets the target of general employment rate as 70 %.*

- ✓ *Female labor force employment rate will be above 60 %.*



FROM "GROWTH" TO "SUSTAINABLE GROWTH"

CENTRAL BANK OF TURKEY

June 2005