DISCUSSION PAPER

Can Turkey Emerge from Covid-19 as a 'Developmental State'?

Mustafa Metin Başbay

TRTWORLD
research centre

DISCUSSION PAPER

Can Turkey Emerge from Covid-19 as a 'Developmental State'?

Mustafa Metin Başbay

TRT WORLD
re|search
centre

WRITTEN BY

Mustafa Metin Başbay

PUBLISHER

TRT WORLD RESEARCH CENTRE

June 2020

TRT WORLD İSTANBUL

AHMET ADNAN SAYGUN STREET NO:83 34347

ULUS, BEŞİKTAŞ

İSTANBUL / TURKEY

TRT WORLD LONDON

PORTLAND HOUSE

4 GREAT PORTLAND STREET NO:4

LONDON / UNITED KINGDOM

TRT WORLD WASHINGTON D.C.

1819 L STREET NW SUITE 700 20036

WASHINGTON DC

www.trtworld.com

researchcentre.trtworld.com

Introduction

Recently, talk of Turkey moving towards a new economic model is becoming louder. This has been the main theme of the current economic administration since it came to power in August 2018. At the time, Turkey was struggling with economic turbulence caused by the country's accumulated debts and increasing geopolitical risks. Since then, the government has been pursuing its ambition to move towards a more resilient economic structure predicated upon a more sophisticated, high-value-added production sector, and a larger exports sector. With the Covid-19 crisis causing upheavals in economic and political orders worldwide, Turkey's endeavour seems to have taken a more serious turn. The government has announced it will be restricting imports in strategic sectors to protect its domestic producers. This is a crucial and necessary step for realising its agenda, but fine-tuning trade regulations and targeting them efficiently are equally challenging and important.

Beginning in the early 2000s, Turkey experienced a growth miracle that improved income levels substantially and removed millions of people out of poverty. The main factors of this success were the country's improving macroeconomic fundamentals and development of country-wide infrastructure, which boosted capital inflows and private sector productivity. The government effectively dealt with the country's chronic problems, such as high public debt and inflation, through a more disciplined approach to government budgeting and monetary policy. However, the limits of this approach have arguably been reached; the more recent rise in the country's income levels has been sustained via sharply increasing external debt, mostly channelled to consumption rather than productivity-increasing investments. Accordingly, the government needs to adopt a different approach and assume a more proactive role in changing the sectoral composition of the economy towards higher value-added production and high-tech industries.

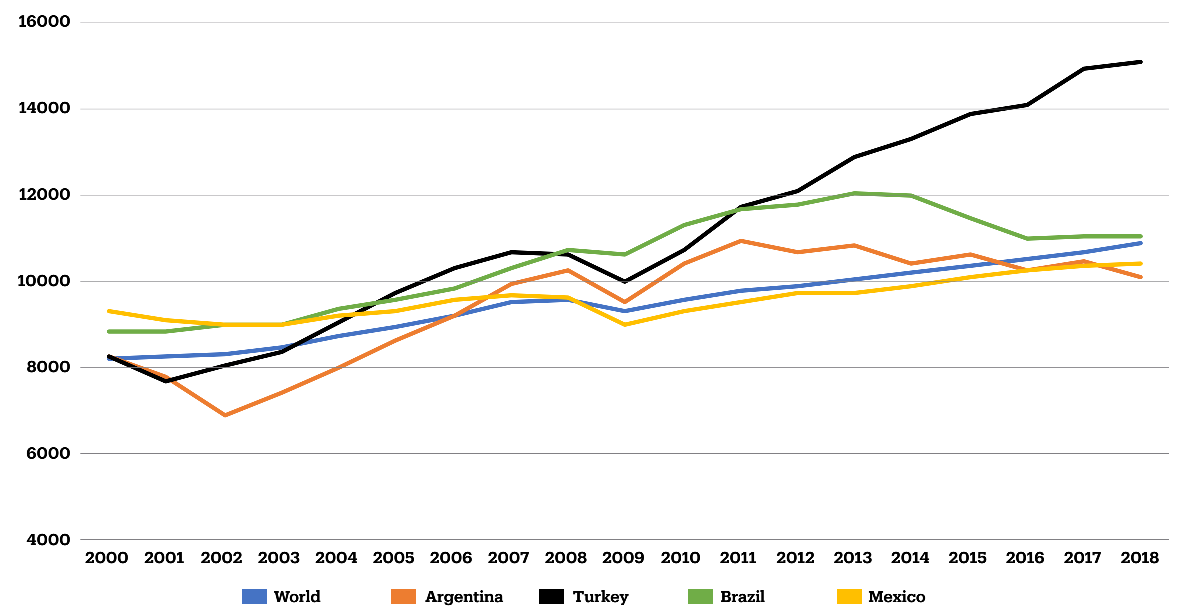
The radical move to impose higher tariffs on the country's imports should also be interpreted in the context of the government's changing policy approach to the economy. Upon his announcement of higher import tariffs, Finance Minister Berat Albayrak said, "*domestic production will be pushed forward*", and "*importing will not be easy*" anymore. Furthermore, Albayrak openly criticised the previous policy approach, and indicated a change of paradigm in policymaking. According to him, "*Turkey had been turned into an import heaven*" by previous administrations. This clear criticism of free trade fundamentalism, accompanied with the government's repeated emphasis on its new agenda of moving towards higher value-added industries, shows a serious paradigm change in the AKP's approach to economic policy. Also, considering the timing of it, rising criticism of neoliberal globalisation in the context of the Covid-19 crisis seems to have been critical vis-à-vis this policy move.

This paper introduces the recent history of the Turkish economy, and explains the main dynamics that led to high-income growth since the early 2000s. This involves the claim that the limits of the government's non-interventionist and more market-based approach to the economy have been reached, and are unlikely to bring about similar success in the future. Secondly, it describes the nature of change in the government's approach to the economy and explains why government interventionism, including trade regulations, is required for changing the sectoral composition of production towards more sophisticated, high-value-added industries. Finally, it reflects on how trade regulations should be applied and the missteps that should be avoided on the ground. This paper concludes that the deep transformations caused by the Covid-19 crisis provide developing countries like Turkey with more space and flexibility for policymaking. This enables Turkey to take bold steps in realising its ambitions. Overall, this is a positive development, but it should be well-designed to reap the maximum benefits.

1. Time to move on for Turkey

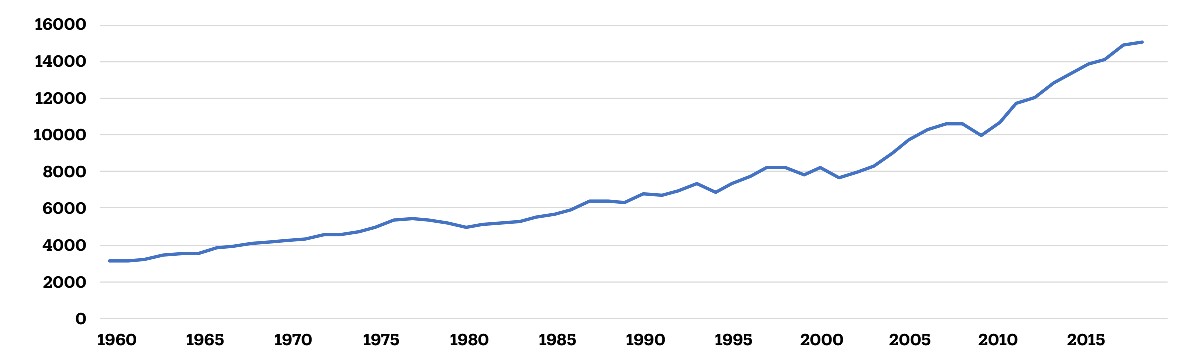
Turkey experienced very high growth rates in the last two decades. In nothing short of a growth miracle, between 2002 and 2018, Turkey's annual per capita income growth rate averaged around 4.2%, which is significantly above its historical average and the growth rates of other developing countries in Turkey's income range (World Bank, 2020; Figures 1 & 2). Consequently, the average citizen's purchasing power multiplied, and millions of people moved out of poverty. The critical factors behind this success story were the swift improvement in Turkey's macroeconomic fundamentals, such as concerning public debt and inflation records (following the government's disciplined approach to public budget and monetary policy), as well as aggressive investments in the country's physical infrastructure. This facilitated the private sector then taking the lead in the country's investment drive, and increasing Turkey's trade volume with the rest of the word.

Figure 1: **GDP per capita in constant 2010 dollars, 2000-2018**



Source: World Bank

Figure 2: **GDP per capita, Turkey 1960-2018, constant 2010 US dollars**



Source: World Bank

After coming to power in 2002, one of the main tenets of the AKP's approach to the economy was maintaining a disciplined stance on the government's budget. This is understandable, considering that public debt had been the most vulnerable aspect of the Turkish economy for decades and the main cause of several major crises. In fact, at the time, the country was just coming out of another one of such debt crises in 2001. In the following decade, Turkey's public debt to GDP ratio has drastically declined from 70% to 30%. Currently, Turkey ranks as the 4th least indebted country among OECD countries in terms of public debt (OECD, 2020). Furthermore, improved monetary discipline solved another one of Turkey's chronic problems: inflation. Although it is still quite high compared to other OECD countries, and has recently surged, when compared to Turkey's historical records Turkey's inflation rates were largely taken under control in the early 2000s, and have remained within reasonable levels since then (World Bank, 2020).

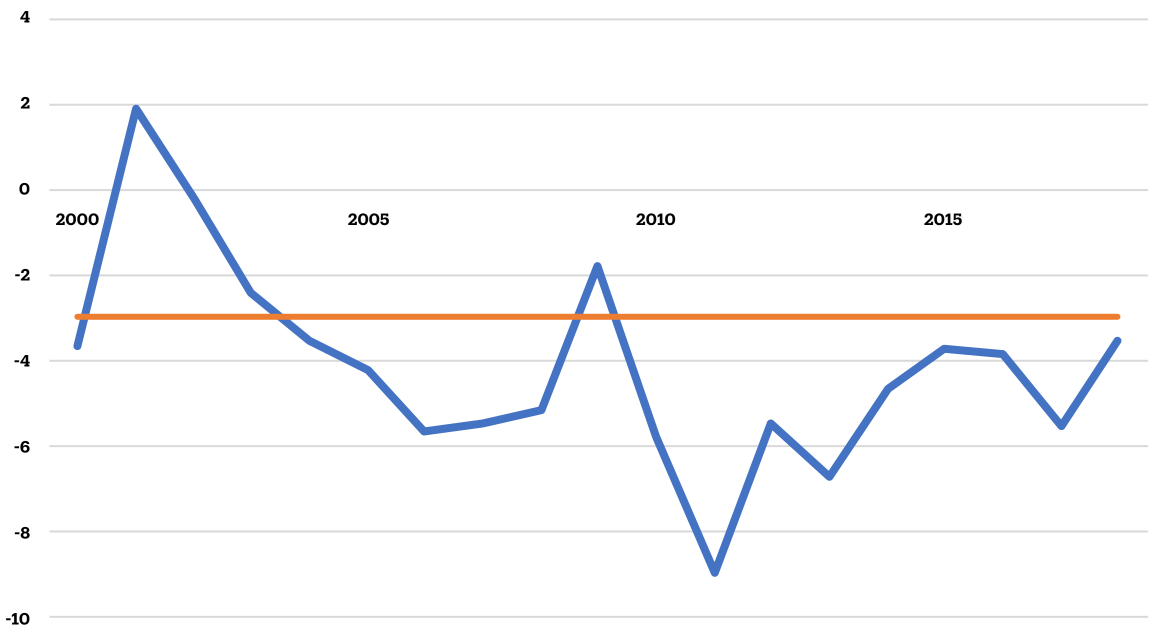
The government's efforts also focused on improving the country's infrastructure. Transportation systems, as well as communication networks, have been enhanced with more ports, airports, and trainlines, as well as extensive road and bridge projects across the country. Consequently, private sector productivity increased, capacity in domestic and international trade multiplied, and foreign direct investments to the country soared. Labour-intensive manufacturing industries, such as textile, construction, or automotive industries, have flourished, and various aspects of service industries have expanded. Indeed, this expansion in economic activities went hand in hand with a substantial urbanisation process. Millions moved to urban areas and were incorporated into manufacturing and service industries. In fact, as pointed out by economic historians, throughout Turkey's economic history the transfer of population from agriculture to urban industries has always been the main channel through which economic growth has been sustained (Pamuk, 2012).

However, according to many, this story has mostly ended. As the country's gradual transition from a largely agricultural economy to an urban one is finalising, the possibilities of increasing income levels via labour-intensive manufacturing are also being depleted (Basbay, 2019a). In other words, in order to maintain the income rise, Turkey needs to find other ways to increase its productive capacity. Otherwise, when growth does not come from increasing productivity, it is maintained via increasing external debt. Indeed, during the last decade, while public debt has been largely kept under control, Turkey's total external debt, inclusive of private sector debt, has steadily increased (Figure 4). This foreign capital has gone to domestic companies that are driven by internal demand, rather than exports, and continued to boost consumption levels in Turkey. This trend is clearly visible in Turkey's current account deficit (Figure 3).

Furthermore, Turkey's geopolitical risks have been on the rise recently due to confrontations with its longtime ally, the US, on regional issues as well as rising political tensions with its neighbours. This is significant, because with increasing political risks comes economic risks. These risks are exemplified by US President Trump's repeated threats of sanctions against Turkey in recent years. In fact, this threat was partly realised in August 2018 when President Trump imposed sanctions on Turkey's exports, which started a massive capital outflow. This process has not been fully reversed since then, and Turkey is still under the pressure of a drought of foreign funds (even if gold reserves are at a record high). Moreover, the tensions between the US and Turkey have still not been fully resolved on all issues, and Washington continues to show the stick of economic sanctions. Therefore, Turkey's reduction of its dependence on foreign capital is critical not only for increasing its economic resilience, but also for its political resilience (Başbay, 2019b).

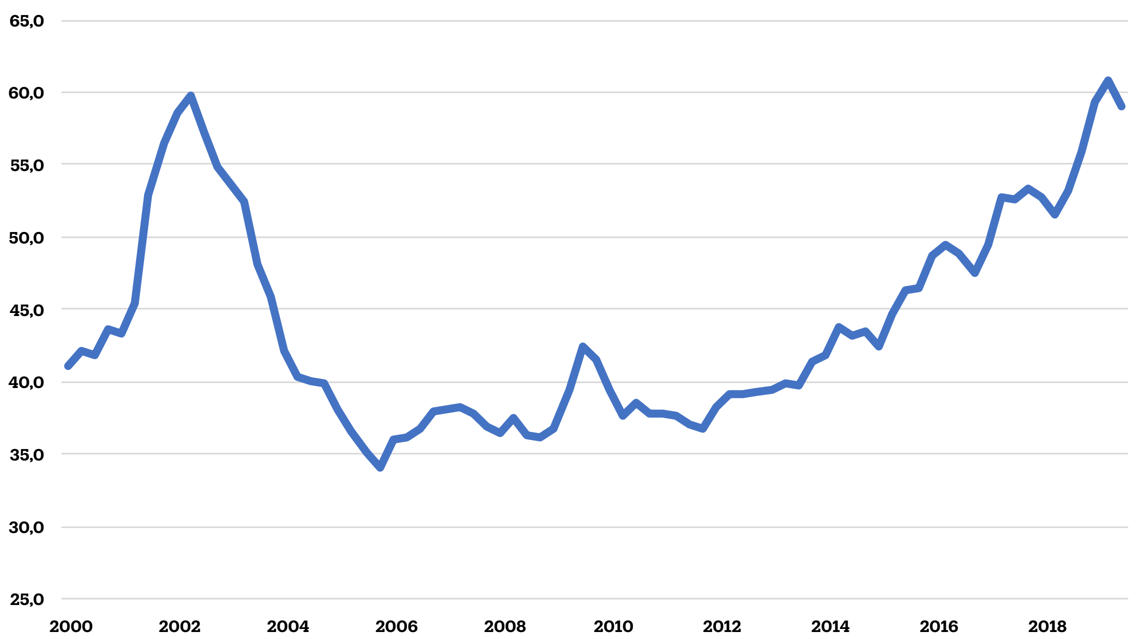
In sum, both the long-run dynamics of Turkey's development path and the more recent geopolitical problems force Turkey to reformulate its growth strategy. Turkey has to deal with its long-prevailing account deficit problem, and reduce its accumulated debt volume. Simply put, Turkey needs to move towards high-technology, high-value-added manufacturing industries and boost its export levels so that the economy can maintain its high growth trajectory while limiting its account deficit. However, such strategic sectors, though have much higher potential for productivity improvements over time, are largely capital-intensive, and involve huge fixed costs and require substantial investments at the initial stage. Moreover, it takes time and continued investment to acquire the know-how and expertise in building capacity in such sophisticated industries (Cherif & Hasanov, 2019). Therefore, the prize is great, but so are the costs and risks involved.

Figure 3: **Current Account Deficit vs. -3% Maastricht criterion, % of GDP, 2000-2018**



Source: World Bank

Figure 4: **Turkey's Debt to GDP ratio, 2000-2019**



Source: Central Bank of Turkey

2. There is an Opportunity in every Crisis

Arguably, the ambitious attempt to move Turkey towards more high-tech industries requires more government activism, or what economists call an industrial policy. Even if the private sector would be the main actor in this endeavour, without government support, it is unlikely that private businesses will move towards these highly risky, costly, and long-term investments in high-tech industries. As a result, Turkey's government needs to switch gears and move beyond simply assuring that macroeconomic fundamentals are in place, and provide the legal and physical infrastructures to meet this challenge. It should support and protect strategic industries via financial support, direct involvement in R&D, building sector-specific infrastructure and so on. This major transformation is akin to a 'developmental state' that facilitates and leads the way for private businesses (Başbay, 2019a). Intriguingly, the Covid-19 crisis opens a new phase in this change of paradigm in the Turkish government's role in the economy.

It can be said that, in the first half of AKP rule in Turkey, the governments' 'hands-off approach' to the economy brought about the intended results. A developing country's transition from a pre-modern agricultural basis to low-value-added urban industries may be somewhat spontaneous, because these countries have a comparative advantage in such labour-intensive industries thanks to their large populations and cheap labour force. Hence, as long as the government provides a favourable macroeconomic environment and assures the legal and physical infrastructure for the smooth functioning of the economy, private businesses lead the way in economic growth. As more people migrate to cities, more employment is supplied to labour-intensive production, which allows for keeping wages and profits fairly stable while businesses expand. However, when this transition is completed, and income levels reach around 10-12 thousand dollars, countries begin to lose this advantage. This makes it the time for improving the technological sophistication of productive capacity, such as moving from textiles to electronics or from construction to auto-production (Aiyar *et al*. 2013).

Selective policy interventions by the government are vital, because in a liberal economy, private businesses normally do not get involved in what is best for the national economy in the long run but rather what is best for their rather narrowly defined interests. For instance, a private firm would prefer to invest in businesses with less risk, smaller fixed costs, and a shorter gestation period. Even if a firm decided to embark on investments in more sophisticated industries, it would find it difficult to access credit for such a risky business venture. Consequently, developing countries are stuck with low-value-added, non-sophisticated sectors – although they need investments in high-tech industries in order to move towards high-income levels and become developed countries themselves. As a result, the government's involvement in the economy becomes rather a requirement than an adventurous initiative (Amsden, 1989, 1997; Wade, 1990; Chang, 2002).

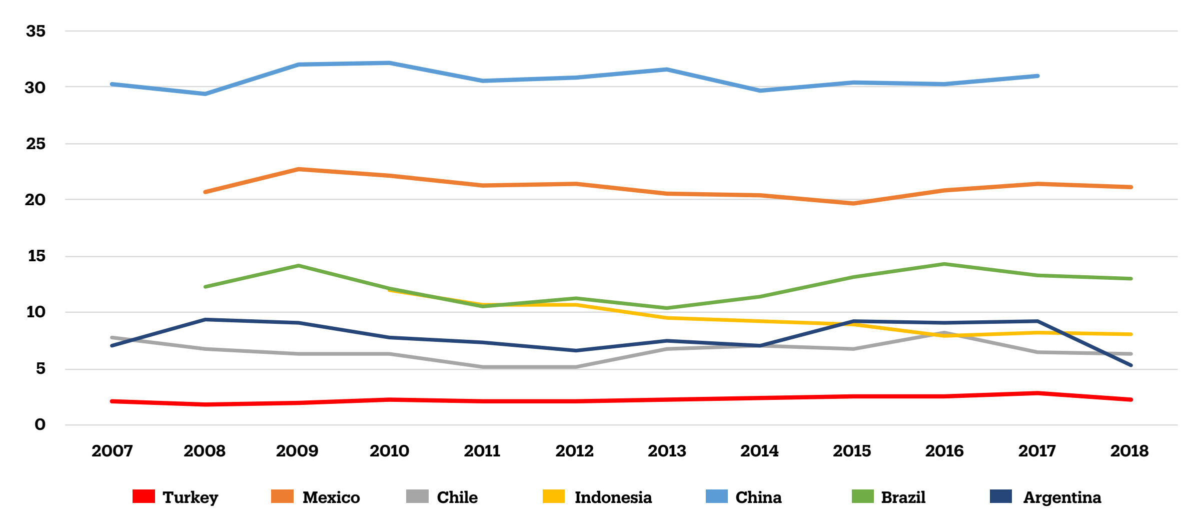
The case can be made that this shift in the government's approach to the economy has already taken place (Yağcı, 2017). In recent years, particularly since the new cabinet came to power after the 2018 elections, the economic administration under the AKP government clearly declared their intention to change the country's sectoral composition towards high-value-added export industries. Accordingly, the government moved beyond paying only lip service and, although with gradual steps, adopted a holistic industrial policy (Basbay, 2019a). Turkey has been investing in various areas, such as electric cars, renewable energy technologies, the defence industry, and more recently pharmaceuticals. Moreover, the government has been providing low-cost, long-term credit support to export-led manufacturing industries, while state banks have employed their arsenal to provide credit to boost domestic investments in strategic sectors (Ergöçün & Şahin, 2019).

Still, the most dramatic move came in the middle of the Covid-19 crisis. In May, Finance Minister Berat Albayrak declared that the country would be restricting its imports in strategic sectors by imposing higher tariffs in order to protect domestic production. After preferential credit support and subsidies, trade regulations tick another box for what development economists would consider a standard industrial policy package. In many cases, restrictions on imports are critical, because they protect newly emerging high-tech industries in developing countries (Chang, 2002). In these highly sophisticated sectors, it often takes years for newly emerging companies to acquire the necessary know-how and improve their competitiveness via learning-by-doing. However, these 'infant industries' are often driven out of the market by established foreign companies before they can increase their scale and complete their learning process. As a result, import tariffs can be useful to temporarily shield them from foreign competition, providing them with the chance to improve their competitive muscle without getting crushed in global markets.

This is a fairly radical move which would not have been expected to occur just a few months ago. After four decades of hyper-globalisation, liberal trade had become the unquestioned norm both in academia and policymaking circles. The Covid-19 crisis seems to have served as a revelatory moment, providing a more flexible policy environment for developing countries such as Turkey without facing too much pressure from the gatekeepers of the free-trade order. In fact, a revision of the neoliberal approach was already taking place, especially since the 2008 global financial crisis. Then came the Trump Presidency and the trade wars between the US and China. Finally, Covid-19 has ostensibly been the last nail in the neoliberal globalisation's coffin. Now, across the globe, governments are assuming more power and responsibility in economies and, willingly or not, intervening into the way international trade functions (Basbay, 2020).

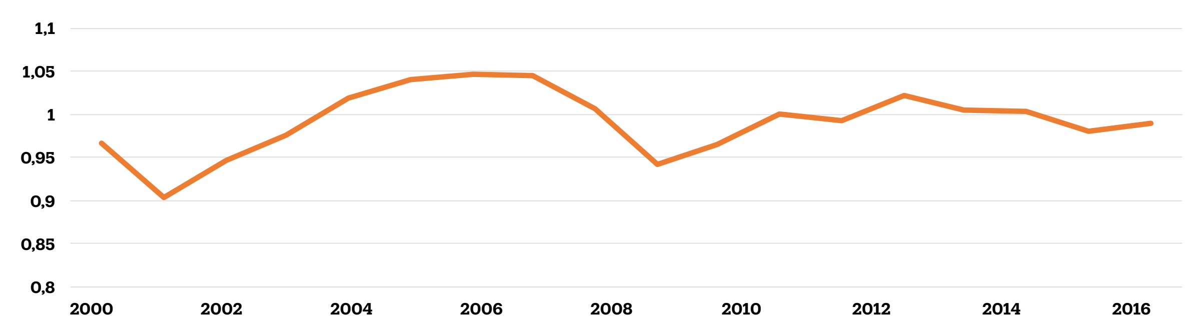
In sum, the Covid-19 crisis, while possibly causing a major transformation in the global economic order, has offered a moment of reflection on decades of hyper-globalisation and neoliberal fundamentalism. Major disruptions in trade relations and the economy force governments to think outside the box, and citizens, even in developed economies, are questioning the benefits of unfettered markets. In this environment, Turkey seems to have found more space for manoeuvring and an opportunity to further its agenda of boosting domestic production. The government underlines that it is committed to the ambitious plan. However, we are still at the beginning of this new endeavour. Trade regulations can bring about the intended results, but such deep structural transformation requires an elaborate and long-term plan.

Figure 5: **High-technology Exports, % of Manufactured Exports**



Source: World Bank

Figure 6: **Total Factor Productivity at Constant National Prices, 2011=1**



Source: Penn World Tables

3. Challenges Ahead

For the Turkish government's developmental agenda, there are many lessons in the other notable success stories of the 20th century. The academic literature analysing successful and failed cases of government interventionism in the economy has accumulated substantial information and insight from throughout the 20th century. A handful of countries, mostly concentrated in East Asia, have been successful in moving beyond middle-income levels and becoming fully industrialised, high-income countries. These examples include: Japan, South Korea, Taiwan, Singapore, and more recently China. Countries that exhibit how selective government policies, including but not restricted to trade protections, may be utilised to enable the private sector to drive investments in strategic industries and facilitate economic transformation. There are several major conclusions to be drawn from these success stories.

First, governments should avoid populist temptations such as building self-sufficiency or producing most of what the country needs. As pointed out by many, adopting a wholesome approach to trade protections usually creates more problems than it solves (Chang, 2008). We have witnessed in countries like India, Brazil, and Argentina, how a closed economy can lead to inefficiency and welfare-loss in the name of self-sufficiency. Free trade is basically a cooperative mechanism which enables a country to take advantage of specialisation and division of labour across countries. Thanks to international trade, a country does not need to spread its limited resources, such as labour and capital, over a wide variety of productive activities and instead concentrate on what it is best. It allows for improvements in the welfare of all countries involved via exchange. As a result, it is fundamentally an efficient tool.

Therefore, the government's intervention should involve protecting only a few strategically selected sectors that require 'short-term' insulation from foreign competition until they develop their own capacity. It is illogical and unmanageable for a developing country, or any country for that matter, to protect all its industries from competition and preserve efficiency. This will likely lead to a substantial loss of welfare. A country should continue taking part in free trade and importing a wide variety of products from other countries while trying to develop its own capacity in just a few strategic sectors. The phrase 'short-term' should also be underlined. The government should not protect the selected sectors for too long, but only until they develop sufficiently to be able to compete in global trade on their own. If protection from competition is excessively lengthy, it limits productivity growth rather than enabling it.

Second, the government should fine-tune its interventions in foreign trade in a way which does not disadvantage domestic producers by imposing tariffs on intermediate goods or raw materials used in production. This is more complex than it sounds, because most products are outputs of certain sectors while the inputs of others. Occasionally, governments, while trying to protect the former, damage the latter. Admittedly, there will be trade-offs involved in the government's decisions. Thus, the government should carefully weigh the benefits and costs of protecting the certain sectors for the overall economy and target them accordingly. It should also be noted that this would involve redistributive effects between businesses and potentially between different geographies and segments of society. Accordingly, there is a political dimension to this as well, which is beyond the scope of this paper.

Third, the government's plan should be pragmatist and flexible. As Alice Amsden stated, it should "let go of losers". Namely, if a specific sector does not seem to be improving its productivity level, trade protections provided for the sector or the company should be lifted. Unpromising sectors which appear to have no prospects should be let go (Amsden, 1997). Otherwise, protecting non-dynamic sectors for too long leads to efficiency loss without bringing about any positive consequences. In that respect, Brazil's computer industry in the late 80s provides a good example. Even though it was protected from global competition and made substantial profits in the domestic market, the Brazilian computer industry failed to advance its technological basis enough to be able to export its product. Eventually, the government admitted that the protectionist policy failed to elevate the industry to international standards. In contrast, East Asian countries were quite good at detecting non-dynamic sectors and letting go of them from their protectionist agenda.

Fourth, the administration needs to step up its fight against economic fraud and deception. Private sector actors are usually tempted to cash in on the protected domestic market rather than investing in productivity enhancements. For instance, the protective tariffs are meant to provide the domestic entrepreneur with a price advantage, in the hope that they will use this opportunity to improve efficiency and eventually become able to produce the product independently in a cost-effective manner. However, unless the entrepreneur actually invests in R&D and technology development, this expectation will not materialise. Also, trade protections often go hand in hand with subsidies, which makes the intentions of the investor even more crucial. If government support is being wasted on investments that are more profitable in the short-run, rather than being invested in long-run improvements in technological sophistication, the government's plan to develop domestic industries will fail. In fact, both Korea and Japan not only monitored the financial accounts of protected companies but also employed government officials within these companies to keep them at arm's length. Companies, which did not invest in technological improvements, were cut from support.

Finally, it is imperative to put in place severe measures against favouritism. Businesses always try to lobby the government. They may endeavour to persuade authorities to expand protections towards their sectors and extend them for much longer than needed. However, this practice risks generating the problems mentioned above, namely trying to protect too many sectors for too long. Then, what starts as a well-planned protective scheme for a few strategic sectors may turn into a mechanism to favour an inordinate number of companies and sectors at the cost of social welfare. Therefore, the government should put in place well-defined criteria and a transparent procedure in determining which sectors will be protected through tariffs or supported with subsidies. Furthermore, monitoring and reporting a technocratic bureaucracy should continue in a disciplined and transparent manner to prevent abuse of the system.

Conclusion

Turkey is rightly celebrated as a success story for its growth record in the 2000s. Impressive improvements in the country's economic fundamentals, such as its public debt record and inflation rate, were accompanied by vast investments by the government in physical infrastructure across the country. These have enabled private industries to lead the way in a massive expansion of labour-intensive manufacturing as well as various service industries and multiply the average citizen's income level. However, in recent years, Turkey has faced the pressure of rising external private sector debt due to the country's high account deficit. Moreover, Turkey faces a dearth of foreign capital inflows in the wake of rising geopolitical tensions with the US and other major powers over a number of regional issues. Indeed, the rising risk premium associated with the threat of sanctions by the US against Turkey has diverted some foreign investors from investing in Turkey.

Under these conditions, Turkey seems compelled to change its approach to the country's economic growth. As discussed by many economists, increasing income levels beyond middle-income range via labour-intensive manufacturing is mostly not possible. In order to maintain a high growth trajectory and become a high-income country, developing countries need to transform their sectoral composition towards high-value-added, high-tech, and sophisticated industries with higher export potential. Failing to accomplish this leads to either growth slow-downs or rising external debt, as has happened in Turkey. Therefore, Turkey's economy needs to transform towards sophisticated sectors with better prospects for economic growth, which arguably requires strategic leadership from the government and its direct involvement through subsidies and trade protection.

In that regard, the paradigm change in the current government's approach to the economy from a more market-based, liberal framework to a more interventionist and proactive one becomes increasingly apparent in recent years. As part of this new agenda, the government has been extending cheap and long-term credit to strategic manufacturing industries, directly engaging with R&D intensive industries, such as defence or renewable energy, and providing subsidies to critical sectors such as electric cars. Most recently, in a momentous decision, the government announced that it would be imposing higher tariffs on the country's imports in order to support domestic production in strategic sectors. It is fair to say that the extraordinary circumstances created by the Covid-19 crisis have laid the basis for and encouraged this bold policy move by the Turkish government. As globalisation and neo-liberal market fundamentalism are being criticised across the world, and governments' taking a more direct role in the economy becomes normalised, the Turkish government also seems encouraged to take this radical step in line with its new approach.

Overall, Turkey's growing developmental approach is to be celebrated as a significant and vital step in order to sustain the country's development and become a fully industrialised nation. Ironically, Covid-19 seems to have been an enabling and encouraging factor in realising this transition. However, in order for this agenda to be successful, industrial policy and trade protections particularly should be designed and implemented in a pragmatic and sophisticated manner. This process potentially involves a trial-and-error mechanism as well as constant revisions of government strategy. Although there are risks involved in such radical policy moves, they are worth taking to let the Turkish economy grow and flourish in the long-term.

References

Aiyar, M. S., Duval, M. R. A., Puy, M. D., Wu, M. Y., & Zhang, M. L. (2013). Growth slowdowns and the middle-income trap (No. 13-71). International Monetary Fund.

Amsden, A. H. (1989). Asia's next giant: South Korea and late industrialisation. Oxford: Oxford University Press.

Amsden, A. H. (1997). Bringing production back in—Understanding Government's economic role in late industrialisation. World Development, 25(4), 469-480.

Başbay, M. M. (2019a). Turkey's Economy: The case for Industrial Policy. TRT World Research Centre. https://researchcentre.trtworld.com/publications/discussion-papers/turkey-s-economy-the-case-for-industrial-policy.

Başbay, M. M. (2019b). 'Root of Turkey's economic troubles: US foreign policy.' Anadolu Agency. 9 May 2019. https://www.aa.com.tr/en/analysis/root-of-turkeys-economic-troubles-us-foreign-policy/1474346.

Basbay, M. M. (2020). Reordering Capitalism: A New Economic World Order post-Covid-19. TRT World Research Centre. https://researchcentre.trtworld.com/publications/discussion-papers/reordering-capitalism-a-new-economic-world-order-post-covid-19.

Central Bank of the Republic of Turkey (2019). Current Account Deficit Statistics. Retrieved from September 2019 Report.

Chang, H-J. (1993). The Political Economy of Industrial Policy in Korea, Cambridge Journal of Economics, 1993, no. 2 (reprinted in H-J. Chang, The East Asian Development Experience).

Chang, H-J. (2002). Kicking away the ladder: development strategy in historical perspective. Anthem Press.

Chang, H. J. (2008). Bad Samaritans: The guilty secrets of rich nations and the threat to global prosperity. Random House.

Chang, H-J. (2011). Industrial policy: can we go beyond an unproductive confrontation? In Annual World Bank Conference on Development Economics (pp. 83-109).

Cherif, R., & Hasanov, F. (2019). The Return of the Policy That Shall Not Be Named: Principles of Industrial Policy.

Ergöçün G. & Şahin, T. (2019). 'Turkey announces $4.9B financing for strategic sectors'. Anadolu Agency. 23 May 2019. www.aa.com.tr.

Feenstra, R. C., Inklaar, R., Timmer, M. P. (2015). The next generation of the Penn World Table. The American Economic Review, 105(10), 3150-3182.

Mazzucato, M. (2013). The Entrepreneurial State: Debunking Public vs. Private Sector Myths. Anthem Press.

Pamuk, Ş. (2012). Türkiye'nin 200 Yıllık İktisadi Tarihi. Türkiye İş Bankası Kültür Yayınları.

Yağcı, M. (2017). The political economy of AK Party rule in Turkey: From a regulatory to a developmental state? Insight Turkey, 19(2), 89-114.

Wade, R. (1990). Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation. Princeton, NJ: Princeton University Press.

World Bank (2020). Various country statistics on Turkey, Data. [online] http://data.worldbank.org. [Accessed 10 June 2020].

TRTWORLD
research
centre

TRTWORLD
research
centre