THE NEW GOVERNMENT AND THE ECONOMY : WHAT IS IN STORE ?

The new Turkish government took office in November 2002. The Justice and Development Party (AKP) won the November elections and established a single-party government. Although it has Islamic roots, the party can be classified as a center-right party both politically and economically. The government's economic program is based upon the strategy and the targets of the existing stabilization program. However, it must be acknowledged that the performance of the AKP government up to now, has not been very successful with respect to the economy. Fiscal easing and delays in the implementation of structural measures made negotiations with the IMF difficult. There are two major issues that might dramatically affect the performance of the Turkish economy in 2003. The first one is success in implementing the existing economic program, and the second one is the conflict in Iraq.

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Considerable changes have taken place in the domestic and international relations of Turkey, which may effect the economic performance of the country in 2003. The significant modification in domestic politics has been the structure of the new Parliament established after the elections, together with the formation of the new government. The results of the elections on November 3rd, 2002 brought in significant domestic political stability in Turkey. On the international front, the result of the Copenhagen Summit, convened on December 2002, was not entirely disappointing when one remembers that Turkey succeeded in getting a conditional date for launching the membership negotiations with the EU. The continuation of the economic stabilization program and the economic and political effects of the war in Iraq are the major sources of concern in 2003.

Economic Policy Making of the New Government

According to the November 3, 2002 elections, the Justice and Development Party (AKP) won 34% of the votes, while the Republican People's Party (CHP) had 19%. Turkey has a new government formed by the AKP. The AKP, although officially new in the political arena, has its roots in a political stream with a history of more than 30 years. With the establishment of the National Order Party (Milli Nizam Partisi) by Mr. Necmettin Erbakan in 1970, a political party with an explicit Islamic rhetoric emerged in the Turkish political scene. The AKP is the sixth such party to follow this trend, albeit with some major differences from, what can be termed as, its "political predecessors". On the other hand, in terms of the development of Islamic politics in Turkey, the AKP is a far cry from representing a monolithic political block. Instead it is more akin to a broad coalition of people disillusioned with the failure of the center-right wing politics in Turkey.

Major differences that are relevant for the purpose of evaluating the economic program of the AKP can be summarized as follows:

i) The AKP's political program can be labeled as a Strategic Modernist (or Islamic Liberal), following the terminology proposed by Brumberg (1997) and adopted in Öniș (2001). This political program accepts the pluralistic democratic order and therefore coexistence with other political projects.
ii) Market mechanism is considered as the standard for allocating resources. The role of the state in the economic sphere is confined to creating the necessary environment for the market system to operate efficiently.
iii) In the AKP's program the importance of economic stability as a prerequisite of sustainable growth is explicitly acknowledged.

An examination of the government's program indicates that no major change from the strategy and the targets of the existing stabilization program is envisaged (Special Focus Note, YKB, 2002). The government is set to pursue an economic program with a view to reduce the debt to sustainable levels through fiscal discipline and the generation of a primary surplus that will secure macroeconomic stability. The program says that economic productivity, growth and social policies are to be taken into account in determining the magnitude of the primary surplus so as to ensure the sustainability of the debt stock. The program does not foresee any change in monetary policy, either. This underscores its determination to preserve the independence of the Central Bank secured under the legal arrangements finalized in 2001.

Some of the items in the government's agenda (such as tax amnesty, reduction in VAT rates in electricity and highway construction) obviously aim to revive domestic demand. However, their compatibility with the primary surplus (of the public sector) target of 6.5% of the GNP requires rather drastic, therefore unrealistic, revenue increasing measures.

Economic performance was strong in 2002 as production rose strongly and inflation slowed remarkably. The GDP and the GNP growth for the first nine months of the year amounted to 6.5% and 6.2% respectively. The 2002 end-of-the-year CPI inflation was 29.7%, significantly below the 35% target, and the WPI inflation was 30.8%, again below -though slightly - the targeted 31% level. There was no problem in the balance of payments with the current account giving a small surplus in the January-November period. However, fiscal deterioration was a major cause of anxiety.

The primary surplus target of the consolidated budget for 2002 has failed to be realized. Although, budget revenues also remained above the targeted amount, this was not enough to contain the increase in budget expenditures. Therefore, the budget deficit turned out to be much higher than planned in 2002, whereas the primary surplus remained well below the target. In fact, the budget deficit amounted to TL 39 quadrillion in 2002, compared to the target of TL 27 quadrillion and the primary surplus remained at TL 13 quadrillion, compared to the target of TL 16 quadrillion.

The 2002 budget deficit is expected to increase to 13.8% of the GDP, whereas the primary surplus is expected to remain at 4.5% of the GDP (Monthly Bulletin-YKB,2002-2003).[1]

Expectations that a single-party government would deliver more coherent and forceful reforms caused financial markets to rally after the victory of AKP in the November 2002 parliamentary elections. This rally was short-lived, as inconsistent economic policy signals and fiscal deterioration in the budget late last year caused market confidence to weaken, pushing interest rates higher.

Relations with the IMF: Fiscal deterioration and pending structural reforms

Fiscal easing and delays in the implementation of the structural measures made the negotiations with the IMF difficult. The government was short in attaining the primary surplus target for 2002 and a considerable increase in pension payments caused real problems for the 2003 budget targets. Furthermore, contradictory statements of the government officials created doubts regarding the authorities' commitments to sticking to the structural reforms.

There was a delay in the implementation of structural reforms since mid-2002. The new Turkish government was also hesitant in advancing these reforms which were crucial to support the sustainability of the fiscal adjustment and public debt reduction. The IMF suspended the final credit tranches to Turkey due to the delay in these

[1] It should be noted that this figure is the primary surplus of the consolidated budget and should not be compared with the 6.5% target which is the target for the primary surplus of the total public sector. The target for the primary surplus of the consolidated budget for 2002 was 5.6%.

reforms. The main reforms are the adoption of a privatization plan for TEKEL (the tobacco and alcohol monopoly), steps to reduce public sector employment and measures to improve taxation and limit exemptions (Turkey Country Report-IIF, 2003).

The public sector restructuring operations are not completed. The State Economic Enterprises remained overstaffed and they work inefficiently. Personnel cuts last year amounted to less than half of the redundancies called for under the IMF program.

The government unveiled its privatization program in January 2003. The Deputy Prime Minister and Government's Spokesman Abdullatif Sener noted that the government’s privatization target for 2003 was USD 4 billion and that institutions such as TEKEL, TÜPRAS, POAS and THY were all part of the program. The government also plans to sell shares of the Istanbul Stock Exchanges and the State Lottery. The targets under the new privatization program are rather ambitious given the war in Iraq and the economic situation. Energy sector liberalization is also slowly improving.

Furthermore, the government submitted some bills to the Parliament such as the Tax Amnesty Law which contradicts the IMF program. The authorities declared that they are thinking about making some changes in the Public Procurement Law which just went into effect. Therefore, although the government stated that it would stick to the IMF program, its actions cast doubt on its sincerity. For instance, the government's intentions have been ambiguous on the roles of independent agencies such as the Bank Supervision and Regulation Agency (BSRA) and the regulatory boards for electricity, natural gas and telecommunications. All these brought about difficulties in the negotiations with the IMF concerning the fourth review of the economic program.

The International Monetary Fund (IMF) delegation continued working on the fourth review of the stand-by deal and the Letter of Intent in February. Juha Kahkonen, the IMF Turkey Desk Chief, stated that economic measures declared by the AKP government were satisfactory. Kahkonen said that Turkey's 2003 budget seemed appropriate for the 6.5% primary surplus target. On the other hand, the Minister Responsible for Economic Affairs, Ali Babacan, confirmed that he expected the IMF Board of Directors to meet at the end of March or at the beginning of April to consider the release of a USD 1.6 billion loan tranche to Turkey. Prime Minister Gul stated that the government would also present an IMF-backed direct tax reform to the Parliament and move ahead with plans to implement a plan to privatize TEKEL, the state tobacco and beverages authority, another important IMF pledge.

The 2003 Budget Draft

The budget draft for 2003 was submitted to the Parliament on March 3. Prime Minister Abdullah Gul announced that several revenue increasing and expenditure cutting measures would be implemented in 2003 in order to attain the budget targets. As a result, the government expects a 5.4% primary surplus in the consolidated budget, which is compatible with the 6.5% primary surplus in the public sector.

A package announced on the same day that the budget was submitted to the Parliament consists of measures in the amount of TL 15.7 quadrillion. Of this total amount, TL 9.8 quadrillion is expected to be achieved via expenditure cuts, whereas TL 5.9 quadrillion is expected from revenue increasing measures.

The government expects GNP growth to be 5% in 2003, whereas the GNP deflator is projected as 24.4%. As a result, the nominal GNP is estimated to amount to TL 354.6 quadrillion in 2003. A goal has been set to reduce inflation by 17.4% in terms of WPI and 20% in terms of CPI by the end of 2003. Meanwhile, the average WPI and CPI inflation are estimated as 25.2% and 27.7%, respectively. Exports and imports, on the other hand, are expected to reach USD 39.2 billion and USD 54.7 billion, respectively, in 2003. Finally, the current account is projected to yield a deficit of USD 3.5 billion this year (Reuters News Agency, Monthly Bulletin-YKB).

According to the budget draft submitted to the Parliament, the authorities' target is TL 100.8 quadrillion of revenues, whereas expenditures are set as TL 146.9 quadrillion. This yields a budget deficit of TL 46.1 quadrillion for 2003, which corresponds to 13% of the GNP. The primary surplus, on the other hand, is expected to be TL 19.3 quadrillion, namely 5.4% of the GNP. This is thought to be sufficient to attain the 6.5% primary surplus in the public sector, a crucial criteria for the completion of the fourth review with the IMF. The 5.4% surplus in the primary budget balance seems achievable if the government fully implements the announced measures.

It should be mentioned that, the budget for 2003 has been prepared taking into consideration the requirements necessitated by the IMF supported economic program implemented by Turkey. However, as also stressed by the Prime Minister Gül, the budget would require some extra measures in case of war.

Conclusion and Outlook for 2003

Although it is too early to make an evaluation, it can be affirmed that the performance of the AKP government to date, has not been very successful in economic terms. The expectations of the markets worsened, fiscal discipline deteriorated and inflationary pressure again started to gain momentum. Furthermore, there was a sense of chaos in the administration's management of the economy.

As it can be seen in the performance of the budget and the primary balance figures, there was a fiscal easing in government policies. Lagging revenues with an increase in expenditures led to this fiscal easing. This situation and some indications that the government would like to change the macroeconomic program agreed upon with the IMF, weakened market confidence. Negotiations between the IMF and government authorities could not reach an agreement because of the resistance of the latter in complying with the structural reforms and budget targets.

Although exchange rate developments and jumps in international oil prices were some causes leading to a rise in the inflation rates, public price adjustments with the goal of reaching fiscal targets created risks with regard to the continuation of a reduction in inflation. As the latest inflation report of the Central Bank indicated (Central Bank Inflation Report, January 2003), it is very important, from the standpoint of the anti-inflation process, to introduce necessary structural reforms, and to implement the economic program in line with the inflation target in order to achieve fiscal discipline.

There are indications that the growth rate of the economy in 2003 will be lower than expected. The government should comply with the economic program in order to maintain a sustainable growth path.

On the foreign policy front, the government's policies regarding Iraq and Cyprus were not understood clearly by the public. Negotiations with the US government concerning the possible Iraqi war were a source of tension. The Turkish Parliament rejected on March 1, a motion to allow US troops to be deployed in Turkey as part of plans to form a second front in a possible war against Iraq. These developments increased the uncertainty in the markets regarding the Turkish role in a possible war in Iraq and the expected US financial support to relieve the economic burden of this war.

As a result, economic policies of the AKP government, up to now, have not given positive signals regarding prospective policies.

There are two major issues that might dramatically affect the performance of the Turkish economy in 2003. The first one is the level of success in implementing the existing economic program, and the second one is the conflict in Iraq.

Assuming successful implementation of the program and good relations with the IMF, it can be assumed that the government will successfully conclude its negotiations on the fourth and fifth reviews of the stand-by arrangement with the Fund. Confirming this statement, the IMF declared that it agreed with the Turkish government on key elements of a fourth review and its Board would consider the release of USD 1.6 billion loan in the first half of April, if Turkey makes the necessary reforms.

As for the Iraqi war, its repercussions on the Turkish economy will depend on its duration and dimension. A short-lived war will not create a major shock to the economy, although it may create some negative affects. The other scenario is a long drawn out war. This may be very harmful both to the Turkish and global economy with catastrophic results.

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