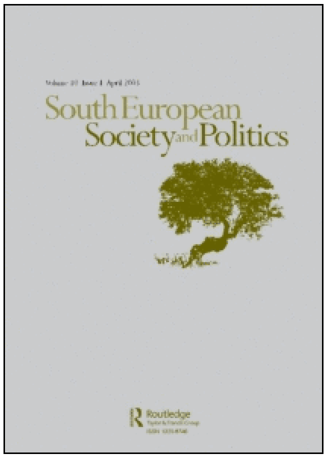

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Turkey's Political Economy in the Age of Financial Globalization: The Significance of the EU Anchor

Ziya Öniş & Caner Bakır

The recent Turkish experience clearly illustrates how markets and politics can interact in producing significant economic transformation. Focusing on the new phase of neo-liberal restructuring in Turkey in the post-crisis era, we highlight the importance of the European Union (EU) and International Monetary Fund (IMF) anchors and the specific domestic and external linkages through which these double external anchors have operated. We argue that the anchors played significant and complementary roles in the recent transformation process in Turkey. We also underline some of the tensions that are likely to arise in the new era of accession negotiations with the EU given the incomplete transformation accomplished so far.

Keywords: Turkey; IMF; European Union; External Anchors; Economic Reforms; State Capacity

The recent phase of neo-liberal restructuring in Turkey following the crisis of February 2001 represents a real rupture in the history of the Turkish economy. Our central argument in this paper is that Turkey has benefited significantly from the presence of a double external anchor, with both the International Monetary Fund (IMF) and the European Union (EU) playing significant and complementary roles in the recent transformation process. Especially, the EU has been an important catalyst for change in the political and economic realms. The significance of the EU's influence increased considerably following the decision at the EU's Helsinki Summit in December 1999 to grant Turkey formal candidate status. As a result of the Helsinki decision, the key political and economic actors faced a more powerful set of incentives for change and the implementation of deep-seated institutional reforms.

There is already an extensive literature on the importance of the EU anchor for Turkey (Alper & Öniş 2003; Keyman & Öniş 2004; Tocci 2005). The present paper, however, goes beyond the existing literature by providing a discussion of the EU

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anchor as part of a package that involves the role of the IMF, the impact of the crises and the role of key domestic actors. Hence, it provides a rather nuanced analysis of how the 'anchor' actually operates in a specific national context.

The economic crisis of February 2001 was a major setback for the Turkish economy. A major collapse of output was accompanied by a dramatic increase in unemployment. This was different from the earlier crises encountered by the Turkish economy in the sense that the burden fell not only on unskilled labour or wage earners. All sections of society—rich and poor, educated and uneducated—were affected in varying degrees. In spite of these negative ramifications, a positive side-effect of the crisis has been to help to break down resistance to reform and to improve the hand that key external actors such as the IMF and the EU have been able to play in accelerating the momentum of the reform process.

The Turkish experience is important in illustrating the importance of two general propositions. The first proposition is that for 'emerging markets', which are exposed to the forces of financial globalization, the regional context within which they find themselves is a crucial variable in terms of their ability to deal with global forces effectively. Second, state capacity is also a critical variable that influences the ability of countries to benefit from a globalizing world economy. These two processes are, to a certain extent, interdependent.

Powerful external anchors play an important role in the process of reform implementation and the development of state capacity. External anchors, such as the IMF or the EU, can help domestic policy-makers to override strong resistance on the part of domestic interest groups. A good example would be the resistance of domestic banking lobbies against reform involving tighter regulation of the banking and the financial system. External anchors can generate greater commitment on the part of key economic agents. They make the reforms more credible by tying the hands of governments through conditional agreements. By rendering the reform process more credible, external anchors can also contribute to the development of strong constituencies or public support for the reform process. The impact of external anchors is not confined to reform implementation in the short run. They can have a significant impact on the process of long-term improvements in the institutional capacities of the state (Francois 1997; Rodrik 1996). The critical point, however, is that actors themselves need to display a high degree of commitment to assist the reform process. For example, if IMF financial assistance is weak and EU conditionality is not accompanied by the prospect of full membership, this will be interpreted as a sign of weak commitment on the part of key external anchors. This, in turn, will significantly reduce both the incentives to undertake reform and the credibility of the reform process itself.

State capacity concerns the degree to which ultimate decision-making power is concentrated in the hands of a relatively small number of officials and the degree to which these officials act autonomously. Partial centralization in bureaucracy and its administrative core, along with increased autonomy of some of this bureaucracy, contributes to the strengthening of state capacity in the economic and financial realms.

In the Turkish context, the EU, IMF and World Bank (WB) have been external actors pushing for institutional reforms that would contribute to strengthening regulatory capacity in economic governance (e.g. establishment of the Competition Authority, the Banking Regulation and Supervision Authority, the Central Bank reform of 2001). However, there are limits to relying mainly on external actors. First, there is a need for convergence of political and bureaucratic will, as well as a high degree of domestic societal mobilization for institutional reforms in the direction of strengthening state capacity in Turkey. Second, the state's long-term *developmental* and *redistributive* roles are insufficiently emphasized in the institutional reforms pressed by the external anchors. The primary emphasis remains on developing the *regulatory* capacity of the state.

Turkey and the EU in the Context of Financial Globalization

The opening up of the Turkish economy is not a new process. It effectively started in 1980, following the major crisis of the previous model of import-substituting industrialization in the late 1970s (Celasun & Rodrik 1989; Öniş 1998; Yeldan & Köse 1998). The first phase of Turkish neo-liberalism constituted the 'de-regulation phase', involving an attempt to reduce the role of the state in economic affairs including elimination of controls over key relative prices. This phase involved key multilateral actors such as the IMF, the WB and the Organization for Economic Cooperation and Development (OECD). It was, on the whole, more successful than the second phase of Turkish neo-liberalism during the 1990s, which could be classified as the 'rhetorical transition and institutional crisis' phase (Table 1). 'Rhetorical transition' refers to the fact that regulatory institutions were set up during this period. However, the emergence of such institutions as legal entities failed to be translated into effective implementation. As a consequence, the Turkish state faced an 'institutional crisis' in which the opening up of the economy was not complemented by a parallel development in the state's institutional capacities to undertake effective regulation.

The critical turning point in Turkish neo-liberalism was the decision taken in August 1989 to open up the capital accounts completely. The decision to move to full convertibility in 1989 meant that the Turkish economy was fully exposed to the forces of financial globalization. What became obvious during the context of the 1990s, however, was that the Turkish economy was ill-equipped to deal with the forces of financial globalization, for two basic reasons. Firstly, the macro-economy was inherently unstable; the Turkish economy was characterized by a combination of large fiscal deficits and chronically high rates of inflation. Secondly, the financial system was not properly regulated. The decision to liberalize the capital accounts fully in the summer of 1989 was a premature decision (Rodrik 1990).

The consequence of this decision, in the midst of a high degree of domestic economic and political instability, was that the Turkish economy's performance became heavily dependent on highly volatile short-term capital flows with costly ramifications. As a result of its domestic weaknesses, during this period the Turkish

Table 1 Three Phases of the Turkish Neo-liberal Experiment

	External actors and their involvement	Domestic political context	Quality of economic performance
Phase I 'De-regulation phase' 1980–89	IMF, WB and the OECD are heavily involved in the early 1980s; their influence diminishes following the recovery process; EU is in the background.	Authoritarian interlude followed by transition to democracy; continuity of leadership under Özal; strong executive and firm commitment to reform at least towards the end of the decade.	Significant recovery and surge in exports during the early 1980s; quality of performance deteriorates towards the end of the decade due to growing fiscal instability and rising inflation.
Phase II 'Rhetorical transition and institutional crisis' 1989–2001	IMF temporarily involved after the 1994 crisis; EU is weakly involved through the CU; both the IMF and the EU become important in 1999; however, their real impact is not immediate. New bureaucratic agencies are introduced but they have not emerged as strong and autonomous players in their regulatory territory.	Weak coalition government unable to impose fiscal discipline; lack of commitment to reform, but goes along with the CU as a necessary step to EU membership.	Economic performance generally weak; growth heavily conditional on short-term capital flows; fragile, debt-led growth, associated with three crises in less than a decade with devastating consequences for overall growth, employment and income distribution.
Phase III 'Re-regulation phase' 2001 onwards	Both IMF and EU become powerful anchors in the post-2001 era; the WB is also important but secondary.	Government commitment to reform increases considerably, particularly following AKP election victory. Majority government for the first time for over a decade conducive to economic stability	Significant improvement in economic performance; too early to say sustainable growth has been fully consolidated; elements of fragility given the continued importance of short-term capital inflows and a large current account deficit.

economy failed to capitalize on the growing volume of foreign direct investment directed towards emerging markets. The 1990s as a decade also illustrate how the interplay of politics and economics has a crucial influence on the performance of the Turkish economy. In striking contrast to the experience of the 1980s, the Turkish political system during the 1990s was characterized by successive weak coalition governments that lacked the political will and the capacity to impose fiscal discipline and create an environment conducive to sustained economic growth. The fact that the country was involved in a costly war against terrorism in the southeast also exercised a negative impact on investment as well as constituting a drain on fiscal resources.

Furthermore, leader-dominated political parties whose primary objective was to distribute patronage resources to their clients, as opposed to developing coherent social and economic policies, constituted one of Turkey's primary 'democratic deficits' during the period. Yet another major element of the democratic deficit involved the politicization and weakening of the bureaucratic apparatus. These democratic deficits, in turn, had a significant spill-over effect on the economy, resulting in an economic structure characterized by pervasive rent-seeking and corruption (Eder 2003).

One positive development of the period was the reactivation of the Customs Union (CU) agreement with the EU, which became effective at the end of 1995. Turkey applied for full membership of the then European Community in 1987, during the premiership of Turgut Özal. However, the outcome of the application was negative. Instead, a decision was taken to reactivate the CU agreement as the natural corollary of the long-standing Ankara agreement of 1963. For Turkish policy-makers, the CU signified a natural intermediate step towards EU membership in the long run; but in EU circles there was certainly no serious political support for eventual Turkish membership (see European Commission 1999). The CU agreement was important in accelerating and basically completing the process of trade liberalization which had already started in the early 1980s. Consequently, Turkish firms were strongly exposed to external competition. This helped to engineer a transformative impact on Turkish industry with previously inward-oriented sectors such as the manufacture of cars emerging as important export industries in recent years (Dutz et al. 2005). However, this transformation has been limited: during the period between 1990 and 2004, the share of agriculture in the gross national product (GNP) decreased to 11.3 per cent from 17.3 per cent, that of industry remained constant at 25 per cent, whereas the share of services increased from 38.2 per cent to 45.5 per cent (Eğilmez 2005). This partial transformation also manifested itself in terms of trade. Turkey runs a trade surplus only in 'labour intensive, capital-based' sectors (Köse & Öncü 2004).

The CU agreement has also been instrumental in the process of accomplishing some key regulatory reforms. Important regulatory institutions such as the Competition Authority have been set up as a response to meet the basic conditions of the CU agreement. Although the primary emphasis was on the economic realm, the CU also included political conditionality relating to the improvement of human rights practices in Turkey. Nevertheless, the CU per se, without the prospect of full EU membership, failed to exercise a sufficiently powerful transformative influence on the Turkish economy or democracy. Turkey was clearly in a disadvantageous position vis-à-vis its Eastern European counterparts. These countries received significant pre-accession aid from the EU under the auspices of the Phare programme and formally started the process of negotiating for full membership in 1998. In contrast, Turkey failed to receive any financial assistance as part of the CU agreement, due to the Greek veto. There was certainly a credibility and commitment problem on both sides. Turkish policy-makers were not sufficiently committed to reform, because the incentives provided by the EU appeared to lack strength and credibility. Similarly, from the EU perspective, Turkey did not seem to exhibit the kind of commitment necessary to satisfy the conditions for full membership, even in the long run (Uğur 1999).

By the end of the decade, in spite of the CU, the Turkish economy was characterized by considerable instability. A lopsided pattern of growth had developed which was heavily dependent on the accumulation of domestic and external debt and inflows of short-term speculative capital. This pattern of development, in turn, helped to generate a strong rentier class, whose fortunes became increasingly dependent on lending to the government at high rates of interest (Yeldan & Köse 1998). Not surprisingly, the profitability of large industrial establishments became progressively dependent on their financial rather than manufacturing activities (Istanbul Chamber of Industry 1992–1998).

In the kind of environment described, Turkey encountered its first crisis of the neo-liberal era in 1994. The crisis of 1994 was an important setback to the Turkish economy (Özatay 1996). Nevertheless, the fact the crisis was short-lived and followed by a rapid recovery meant that the behaviour of policy-makers and, hence, the underlying imbalances in the Turkish economy were not reversed. Indeed, by the end of the 1990s, with chronic fiscal deficits and high rates of inflation, there was growing awareness that the Turkish economy was on an unsustainable course. This led to the signing of a stand-by agreement with the IMF in December 1999 which involved a combination of measures aimed at fiscal adjustment and medium-term structural reforms. This was a unique event in the history of the Turkish economy in that an agreement was signed with the IMF without the country actually experiencing a financial or balance-of-payments crisis.[1] What was ironic, however, is that the presence of an IMF programme failed to provide sufficient protection. The Turkish economy remained highly vulnerable given the broad extent of adjustment and the weak commitment on the part of the coalition government to some of the programme's key components such as privatization and the regulation of the banking system. Therefore, it was not surprising that the Turkish economy experienced what is popularly referred to as the 'twin crises' in November 2000 and February 2001. The IMF was exposed to criticism for these crises due to failures in programme design involving insufficient focus on the problems of the banking sector and the adoption of a controlled exchange rate system as well as the provision of inadequate financial assistance (see Öniş & Rubin 2003; Akyüz & Boratav 2003).

Crises became far more frequent in the era of financial globalization with costly consequences. Although the Turkish economy managed to grow at high rates in certain years, the frequency and the depth of the crises helped to pull down the average growth rate. This in turn limited the ability of the Turkish economy to converge to the standards of high-income economies within a reasonable time span.

The 2001 Crisis as a Turning Point: The Significance of the Turkey–IMF–EU Triangle

The crisis of February 2001 was particularly costly in terms of its economic consequences. From a longer-term perspective, however, the very depth of the crisis constituted an advantage in the sense that it helped to change the balance of power in Turkey's political economy quite radically in favour of the 'pro-reform coalition'. This shift in the balance of power was particularly evident in the IMF's relations with the ongoing coalition government, which up to the point of the crisis, had been a reluctant partner in the reform process. The coalition government whose two dominant members were the left-of-centre Democratic Left Party (the DSP) under the leadership of Prime Minister Bülent Ecevit, and the right-of-centre Nationalist Action Party (the MHP) under the leadership of Devlet Bahçeli, was quite nationalistic in outlook. Given that their base of electoral support was primarily derived from poorer segments of society, these parties were reluctant to endorse key elements of the IMF-inspired reform package, the massive cuts in agricultural subsidies being a good example.[2]

Following the crisis of February 2001, the resistance of the coalition government to key components of the reform package was effectively broken and the IMF gained the upper hand. This shift in the underlying balance of power in the policy-making process was also, in part, a consequence of the fact that the IMF was willing to allocate substantial financial resources to help Turkey's recovery process. Clearly, geo-political considerations came into the picture in the sense that Turkey was a key ally of the United States (US) in the Middle East, which is a region of critical interest from a US foreign policy perspective. Argentina, which experienced a similar crisis in the same year as Turkey, for example, was not equally fortunate in eliciting similar magnitudes of IMF support (see Öniş 2006).

The increase in the power of the IMF to push the reform process was evident in a number of different areas and notably in the banking sector (Bakır 2006). A new agency, the Bank Regulatory and Supervisory Agency (BRSA) was established in June 1999 following the ratification of the IMF-sponsored Banking Act. It took responsibility for banking supervision and regulation from the Treasury and the Central Bank and became operational in September 2000. The BRSA also incorporated Sworn Bank Auditors and Savings Deposit Insurance Fund (SDIF) in 2001. Further, the regulation and supervision of non-bank financial institutions were transferred from the Treasury to the BRSA in 2005. However, in the pre-crisis period, there was no natural constituency pressuring for the establishment of an agency like the BRSA and there was a lack of political and bureaucratic will as well as fierce resistance from powerful banking lobbies. As a result, the BRSA was unable to perform a proper regulatory role in such a way as to prevent the twin crises. The latter essentially stemmed from the malfunctioning and under-regulation of both the private and the public components of the banking system. Following the February crisis, however, the BRSA was able, with IMF support in the background, to attain partial autonomy from politicians and interest groups and to press ahead with tough regulatory measures with some domestic support (see Alper & Öniş 2004).

The BRSA example is a good illustration of a major characteristic of the new era, which we label the 're-regulation' phase (Table 1). 'Re-regulation' refers to the development of regulatory capacities of the state, which involves not only the setting up of new institutions but also a significant increase in their powers of implementation. There is no doubt that effective measures were taken in the direction of stronger financial regulation in Turkey after the 2001 crisis. Turkey is on the way to establishing a regulatory state. However, 'a regulatory state, which can adopt a proactive approach in the financial services industry by steering and coordinating policy community still does not exist' in Turkey (Bakır 2006, p. 202). For that reason, significant progress needs to be made in terms of strengthening regulatory institutions as well as developing a strong state capacity.

Another interesting aspect of economic governance in the post-crisis period involved the appointment of Kemal Derviş as the minister responsible for the Treasury in the coalition government. Derviş, with a distinguished career at the WB, was brought into government by Prime Minister Ecevit to help the process of Turkey's economic recovery through the implementation of the 'Strong Economy Programme'. What is interesting in this context is that, although Derviş was formally a member of the coalition government with strong affinities to Ecevit's DSP, he was at the same time a figure who stood above politics. His role was that of a technocrat who was brought into office rather than that of an elected politician or party member. He was appointed as part of a top-down process of restructuring because he benefited from being a member of a transnational policy community. Thus, the changing balance of power involved not only a shift in the powers of the IMF with respect to the incumbent government, but also a shift in the powers and autonomy of the team of technocrats assembled around the personality of Derviş working in close cooperation with the IMF and the WB.

Derviş's strong credentials arguably provided the programme with a legitimacy that would have been missing if the latter had been portrayed simply as an externally imposed set of disciplines. Derviş was an influential actor with joint membership of the domestic and transnational policy communities (Bakır 2006). He performed the function of a 'mediator', effectively administering the government's relations with the twin organizations (the IMF and the WB). Similarly, the twin organizations also needed him, not only because he effectively translated policy ideas and policy paradigms into domestic policy but also because he facilitated policy formulation and implementation. This, in turn, prevented both a debtor moral hazard and a road accident similar to that which had happened during the previous programme. Arguably, without such a 'policy entrepreneur', Turkey could not have developed the degree of trust on the part of external anchors necessary to attain large-scale financial assistance. Needless to say, the IMF was not interested in Turkey's economic transformation for its own sake but in order to ensure that Turkey would not default on its debt. Nevertheless, without such assistance, it would have been very difficult to generate a successful restructuring process.

Following the Helsinki decision of 1999 to recognize Turkey as a candidate for full membership, the EU became a far more powerful actor in the Turkish setting in terms of facilitating the process of fundamental economic and political reforms. Nevertheless, the early focus of the EU was much more on the political side of the reform process—specifically in the realm of civil and human rights. Economic reforms, although an integral component of the Copenhagen criteria, were not the EU's immediate concern. The fact that there was an ongoing IMF programme implicitly entailed a certain division of responsibility, with the IMF taking care of the economic side and the EU more actively involved in political reform.

However, this pattern changed quite radically in the post-crisis era, with the EU emerging as a critical element of the pro-reform coalition in the economic sphere. The material hardships associated with the 2001 crisis rendered the potential economic benefits of EU membership all the more attractive. The opinion polls taken in 2002 suggested that there was strong and broad-based support for EU membership. with 74 per cent of the Turkish public supporting full membership (see Çarkoğlu 2003). What was also crucial was that economic actors, both domestic and foreign, recognized the importance of the EU as a kind of long-term and permanent external anchor. By its very nature, the IMF could not fulfil this role, as its responsibility was temporary and confined to the completion of the recovery process. In other words, the redefinition of Turkey's relations with the EU after December 1999 was instrumental in implementing the difficult economic reform process and helped the IMF in breaking the resistance of anti-reform forces. This was the powerful new element of a double external anchor.

The context within which Turkey found itself after 2001 helped to generate a kind of virtuous cycle whereby economic and democratization reforms could go hand in hand. Market participants, who were the principal actors promoting economic reform, also became strong supporters of EU conditionality, primarily for its economic benefits. As a consequence, the coalition government was not able to resist the kind of far-reaching democratization reforms implemented during the summer of 2002. This was due to the fact that the failure to implement such reforms would have meant a loss of trust on the part of the market participants in the government's ability to maintain the momentum of the economic recovery process. Markets, in a way, became an instrument of political reform. Political reforms, in turn, helped to generate greater confidence in Turkey's ability to create a favourable climate for domestic and foreign investment. Indeed, it is interesting to refer to the reports of transnational private financial actors such as rating agencies and transnational banks, who monitored the EU-related political reforms quite closely in their assessments concerning the future performance of the Turkish economy.[3] These transnational financial actors were not interested in political reforms such as democratization, human rights or the resolution of the Cyprus issue per se. However, they conceived the accomplishments of these political reforms as a necessary step for stabilizing the economy and the consolidation of economic reforms.

The process of reform implementation has taken a new and positive shape following the victory of the Justice and Development Party (the AKP) in the elections of November 2002. Capitalizing on its broad-based political support, the new government was able to accelerate the pace of economic and political reforms, with mutually reinforcing consequences. As a result, a more favourable environment conducive to economic reforms was created as Turkey came progressively closer to the EU. One of the key steps in this process was the Copenhagen Summit of 2002 which strongly signalled the opening of accession negotiations. The summit was important because it generated strong political will and public support for institutional reforms. This followed other key steps such as the historic decision of the EU Council in December 2004 to initiate accession negotiations and finally the October 2005 decision to actually inaugurate the negotiation process. Hence, a combination of powerful external pressures and a display of political leadership and will at home helped to produce an economic environment that by late 2005 already sharply differed from the situation in February 2001.

Has Sustainable Growth Been Consolidated in the 2001–5 Era? A Critical Evaluation

The Strong Economy Programme, which was put into effect in the aftermath of the 2001 crisis, continued to be implemented in an uninterrupted fashion during the early years of the AKP government. The outcome, judged by the principal macroeconomic indicators, has been rather impressive. Turkey has been able to accomplish tight fiscal discipline. Inflation, for the first time in three decades, has been stabilized at single-digit levels. The dramatic fall in inflation rates has been accompanied by a strong surge in economic growth. Indeed, Turkey managed to achieve a record growth rate in real GNP of 9.9 per cent in 2004. The combination of falling inflation and high rates of economic growth suggests that the prospects of achieving sustained growth as opposed to temporary spurts are higher than at any time in the course of the post-1980 neo-liberal era.

Table 2 shows major macroeconomic developments in the Turkish economy between 2000 and 2005. It aims to compare the AKP government's performance with the recent past. The government's commitment to the IMF stabilization plan produced positive results, such as single-digit inflation, reduced real interest rates, high economic growth, a primary surplus, reduced public debt, confidence in Turkish lira (reversed currency substitution), and commercial banks' increasing engagement in productive lending. However, continuing major economic challenges stem from the failure to reduce the unemployment rate and the worsening of the current account deficit due to heavy import dependence and appreciation of the Turkish lira. The high current account deficit renders the Turkish economy vulnerable in the presence of continued dependence on short-term capital inflows.

Moreover, a cause of concern is the lopsided pattern in Turkey's recent recovery process. Certainly, the better-off regions and the wealthier and more educated sections of society have been the principal gainers from this process. In contrast, the rural poor,

Table 2 Macroeconomic Performance of the Turkish Economy (per cent), 2000–5

Indicator	2000	2001	2002	2003	2004	2005
GNP growth	6.3	− 9.5	7.9	5.9	9.9	5.5
Unemployment rate	6.6	8.4	10.3	10.5	10.3	10.3
Inflation	39.0	68.5	29.7	18.4	9.3	7.7
Treasury interest rate (annual average)	36.0	63.9	49.8	28.7	24.9	16.2
Budget deficit/GNP	− 10.6	− 16.2	− 14.3	− 11.2	− 7.1	− 2.0
Primary surplus/GNP	5.7	7.1	4.7	5.3	6.1	7.4
Total public sector debt stock/GNP	60	110	90	90	80	70
Current account deficit/GNP	− 4.9	2.4	− 1.0	− 2.9	− 5.2	− 6.4
Currency substitution	N.A	55.0	54.0	46.3	41.0	33.5
Foreign exchange deposits/total bank deposits	55.3	55.3	55.3	55.3	40.8	33.3
Credit/total bank deposits	36.5	36.5	36.5	36.5	44.8	63.8

Sources: State Planning Organization, Main Economic Indicators.

in particular, have been feeling the negative effects of the massive cuts in agricultural subsidies. Although there has been employment growth in the post-crisis period, unemployment rates tend to be high. If growth does not sufficiently translate into employment creation, this could be a serious economic and political problem given the disproportionately young population (Global Policy Network 2005). Youth unemployment, which is likely to be concentrated in the country's poorer regions, could be a source of electoral support for nationalist parties, leading to euroscepticism and a rising threat both to Turkey's EU aspirations and the continuity of the economic programme. The current tax system, which involves a heavy burden on employers, discourages formal employment and encourages the use of informal labour, with the underground or informal component of the economy reaching serious magnitudes (see OECD 2004). This brings us to the point that the reform process is incomplete in key areas such as the tax system and the social security structure. Finally, one should also be aware of the fact that foreign direct investment (FDI) outflows have been increasing parallel to the increase in FDI inflows, as many Turkish firms themselves become international.[4] This might not be a problem as long as FDI inflows reach significant magnitudes and FDI outflows create important trade and investment links with neighbouring countries. However, if inflows are insufficient to match outflows, this could exert a detrimental effect on the future performance of the Turkish economy.

The favourable investment climate has also been accompanied by a noticeable increase in inflows of foreign direct investment. In 2003, FDI inflows amounted to US$745 million (Treasury 2006). This figure was fairly representative of the weak FDI performance in the neo-liberal era. In 2005, however, FDI inflows amounted to US$8,427 million, representing a phenomenal increase. In 2005 the EU-25 constituted 38 per cent of total FDI inflows. Banking and telecommunications were the leading sectors for FDI inflows. In addition to the overall improvement in the political and macroeconomic environment, the AKP government made a serious effort during the course of 2003 to improve the investment climate by eliminating legal, institutional and bureaucratic obstacles to FDI through new legislation.[5] The dramatic increase in FDI inflows was closely associated with large-scale privatization.[6]

What is also striking is that the recent recovery process has been based primarily on improvements in productivity. This might again be interpreted as a sign of a major departure from previous Turkish economic patterns. Total factor productivity growth accounted for 3.3 per cent of overall growth in the 1990–2000 period. In sharp contrast, the contribution of total factor productivity increased to 51.3 per cent in the 2002–4 period (Tıktık 2005).

Several factors were collectively responsible for this quite striking upturn in economic performance. The commitment of the AKP government to the success of the economic programme is important, although one should be careful not to exaggerate the contribution of the present government, considering the important steps that had already been taken by the economic team led by Kemal Derviş under the previous coalition government. Since the AKP's 2002 election victory, Turkey has benefited from the presence of a government with a comfortable parliamentary majority and from the firm commitment it has displayed to the basic ingredients of the programme. The fact that Turkey had two powerful external anchors also constituted a considerable advantage in improving the investment climate. One may underline the ability of the coalition government, if somewhat reluctantly, and then of the AKP government, perhaps more willingly, to accomplish the politically difficult set of democratization reforms. Bringing Turkey closer to the EU in the process, these political reforms had favourable repercussions on the perceptions and expectations of economic actors. Similarly, the AKP government's foreign policy initiatives, involving the promotion of a peaceful settlement to the Cyprus dispute along the lines of the Annan Plan and the development of friendly relations with all neighbouring countries, had positive spin-off effects in the economic sphere. Institutional reforms such as the Central Bank Law of 2001 were also important in creating the necessary environment for a legally independent Central Bank, which was among the crucial steps in bringing inflation rates to single-digit figures (Bakır 2005). Without the political commitment of the government in power and without broad-based public support in favour of stabilization, institutional reforms in themselves might have failed to generate the desired outcome. The very depth of the crisis was an important factor in shaping public opinion and helping to generate broad-based support, thereby limiting potential resistance to tight fiscal discipline and longer-term structural reforms. Turkey has also benefited from the buoyancy of global liquidity.

A three–four-year period is too early to judge whether a process of sustained growth has been fully consolidated. Inevitably, growth accelerates in the early stages as countries tend to bounce back from the crisis. A similar process of recovery was also evident in Argentina, where the domestic and external environment was less conducive to economic recovery. Although FDI inflows have been increasing in Turkey, the real challenge will be whether these flows will accelerate on a sustained basis over time. A cause for concern in the recent recovery process is the coexistence of a large current account deficit and large inflows of short-term capital. In the past, the coexistence of such forces tended to undermine investor confidence, precipitating speculative attacks and financial crises. In the current context such an outcome is less likely, given a much more tightly regulated banking system and a broadly favourable set of expectations on the part of key market actors. The fact that a flexible exchange rate regime has been implemented in the post-crisis period also offers a source of protection for any possible speculative attack. Nevertheless, over-optimism could be costly if policy-makers fail to take action in line with these possible danger signals.

The Political Economy in the New Era of Accession Negotiations

The December 2004 European Council decision that accession negotiations with Turkey would formally start the following year was clearly a favourable development that helped to sustain the positive investment climate that had developed during the previous two or three years. It was also important in terms of consolidating the position of the AKP government. A major setback on the EU front in December 2004 could possibly have triggered a vicious circle of negative reactions in financial markets, leading to a serious economic downturn which, in turn, would have undermined the comfortable majority on which the AKP government was based. Clearly, these forces could have operated in a mutually reinforcing direction in such a way as to reverse the post-crisis recovery process.

If the Turkish economy is able to grow at rates of six to seven per cent per annum over the course of the next few years, then this will help to contain the serious distributional conflicts that have been key elements of the Turkish political economy. This kind of high-growth scenario is based on large inflows of FDI and significant improvements in savings, investment and productivity performance (see Derviş et al. 2004). There is nothing certain about the persistence of the high-FDI/high-growth scenario, especially in an environment of intense international competition for FDI flows. Similarly, considerable question marks exist concerning Turkey's ability to generate the kind of solid pre-accession aid that the new East European members of the EU received during their transition to full membership.

A low-growth scenario, however, could seriously upset the benign equilibrium with potentially negative political consequences. The period of lengthy accession negotiations with the EU is likely to entail costly adjustments in terms of restructuring the agricultural sector and implementation of tight regulations in line with EU norms. In the new era, however, conflicts may emerge between IMF and EU disciplines, especially taking into consideration the EU's social and environmental requirements.

In a slow-growth environment, the costly nature of the adjustment process may undermine the enthusiasm of key sections of Turkish society both within and without the business community. The outcome could be a radical revitalization of the nationalistic and eurosceptic bloc in Turkey. Indeed, the political contest is likely to be amongst the different segments of the centre right, involving the 'Muslim Democrats' and the 'nationalists' in an environment where European-style social democracy is largely non-existent. The fact that the electoral contest is already moving in such a direction was already evident during the municipal elections of March 2004, which saw an improvement in the electoral fortunes of two nationalist and eurosceptic parties, the MHP and the DYP (True Path Party).

Rural poverty and unemployment, especially youth unemployment, are the two key issues that are likely to present a formidable challenge in the new era. In a slow-growth environment, the possibility of growth without employment is likely to be even stronger. This effectively means that large segments of society will look for alternative venues to express their political grievances. In this environment, the eurosceptic parties will position themselves as the natural alternative to the AKP. Further strengthening of such parties, in turn, may emerge as a serious threat to the ongoing process of democratic consolidation and economic reforms. Similar conjectures can be made in the case of small and medium-sized businesses associated with the business association, The Independent Association of Industrialists and Businessmen (MÜSIAD), which have been a major electoral backbone of the AKP. Such enterprises have been less receptive than large conglomerates to the tight IMF disciplines, which effectively limit their ability to borrow on a substantial scale from the banking system to finance their operations. If the economy continues on a high-growth path, small businesses would also be likely to share in the economic benefits and a possible distributional conflict between small and large business units would be avoided. In a less dynamic economic environment, however, small and medium-sized businesses may also start to look for alternative avenues for political representation. All these considerations highlight the fact that the AKP itself is based on a broad coalition of support. The very success of the Muslim Democrats in 2002 and 2004 was based on their ability to forge a broad electoral coalition that brought various diverse and potentially conflicting elements of Turkish society together. The danger is that if things start to go wrong in the economy or in external relations, a serious fragmentation of this cross-class coalition could result with potentially destabilizing consequences.

External developments can play a disequilibriating role with potentially negative consequences for political and economic stability. In line with the successful reform process in Turkey, a significant pro-Turkey coalition has emerged within the EU. Yet, considerable divisions still exist in the EU over the question of Turkish membership. Furthermore, the EU has recently been faced with a serious internal crisis in the context of the constitutional debate. As a result, the EU continues to send ambiguous signals, making the implementation of EU-related reforms all the more difficult. Added to this, the Cyprus dispute continues to be a serious hurdle on the path to EU membership, and given the asymmetric incentives provided by the EU to the key actors concerned, it is unlikely to be resolved in a smooth manner in the near future. Finally, the Kurdish question, which is tied to the ongoing domestic democratization process, the instability in northern Iraq and deteriorating relations with the US all present formidable challenges. All these considerations suggest that the recent transformation that Turkey has been experiencing in both the economic and political spheres could experience serious setbacks. Given the progress made so far, however, it is highly unlikely that such setbacks would involve a complete reversal of the reform process.

Concluding Observations

Turkey was exposed to the forces of financial globalization with largely negative consequences during the course of the 1990s. The Turkish economy was not adequately prepared for full-scale capital account liberalization in 1989, given the depth of domestic macroeconomic and political imbalances and the under-regulated nature of the financial system. The outcome was a highly fragile and lopsided pattern of economic growth, fuelled by short-term and speculative capital inflows. This environment was quite conducive to financial crises and, indeed, Turkey has experienced three consecutive financial crises with costly ramifications within a period of less than a decade.

Turkey's relations with the EU during the course of the 1990s took the principal form of the CU agreement, with the prospect of full membership only being clarified at Helsinki in 1999. In spite of its positive repercussions, the CU itself was not a sufficiently powerful instrument to reverse the negative consequences of Turkey's exposure to financial globalization. The EU emerged as a much more powerful anchor for reform, once the promise of full membership was made and a more credible set of incentives was given to economic and democratic reformers after 1999.

In retrospect, however, it was not the Helsinki decision but the 2001 crisis that represented the real turning point in Turkey's economic trajectory. The EU anchor became much more important in the post-crisis context. The very depth of the crisis had two important implications. First, it created public support for the reform process. Secondly, it helped to increase the power of external anchors to push in the direction of reform. This in turn laid the foundations of a process of sustainable, inflation-free growth for the first time in three decades. The fact that government commitment to reform increased markedly in the post-crisis era also contributed to the emergence of a virtuous cycle, whereby positive developments on the economic, democratization and foreign policy fronts had mutually reinforcing consequences. The recovery process has gone hand in hand with the deepening of Turkey's relations with the EU, illustrating the critical significance of the EU anchor, from which the IMF also benefited.

The new era of accession negotiations, however, presents a new set of challenges. The transition period, which is likely to take a decade, will perhaps be even more critical to Turkey than the subsequent phase of full membership in terms of fully consolidating the political and economic reform process. Setbacks are likely to occur during this transitional phase and one should not assume that external anchors per se—a temporary anchor in the case of the IMF and a permanent anchor in the case of the EU—will provide Turkey with automatic protection against possible crises in the future. Specifically, the Turkish state needs to strengthen its capacity to transform its economic structure, to deal not only with the competitive challenges posed by economic/financial globalization but also with developmental and redistributional challenges that may contribute to economic and political instability. If Turkey is able to maintain a broad social contract in favour of the continuation of reform during the critical transition phase, one may reach the apparently paradoxical conclusion that whether it becomes a member or not in 2015 will not have such a dramatic impact on the quality of its economic performance and the nature of its democratic regime.

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Notes

[1] On the nature and contents of the programme agreed with the IMF in December 1999, see the Turkish government's letter of intent, available at <www.imf.org/external/np/loi/1999/120999.htm>.

[2] The only exception to this was the minor member of the coalition government, the Motherland Party (ANAP), under the leadership of Mesut Yılmaz. This party, the main representative of the urban bourgeoisie, was more liberal in outlook and more receptive towards an IMF-style reform process. ANAP also differed from the two dominant coalition partners in being much more receptive to the kinds of political and economic conditions associated with EU membership.

[3] Reports published during the post-crisis era by financial actors such as Deutsche Bank, Morgan Stanley, J. P, Morgan, Goldman & Sachs and Merrill Lynch, among others, clearly highlight the importance of the EU for the long-term performance of the Turkish economy and underline the need to press ahead with both the economic and the political components of the Copenhagen criteria. An example of a typical comment is as follows: 'The EU wants to see implementation and not just laws passed,' says Peter Worthington, Director of Economic Research for Eastern Europe, the Middle East and Africa at Credit Suisse First Boston (CSFB) in London. 'It's one thing to say that you'll ban torture under police custody, and another thing to actually do it, but there are now signs that implementation is improving as well.' Quoted from Fittipaldi (2004).

[4] For example, FDI outflows from Turkey reached US$856.3 million in 2004 from US$410.6 million in 2003 (Treasury 2005).

[5] For evidence on changing legislation designed to create a better macro- as well as micro-institutional framework for reform, see the report prepared by Ibrahim Çanakçı, Undersecretary of the Treasury (2005).

[6] For evidence on recent privatizations, see the report of the Turkish Privatization Administration, available at <http://www.oib.gov.tr/program/uygulamalar/yillara_gore.htm>.

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