**Equity Research**
Europe

# Economics

# Turkey

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**Economic Trends**

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## *The Next Wave*

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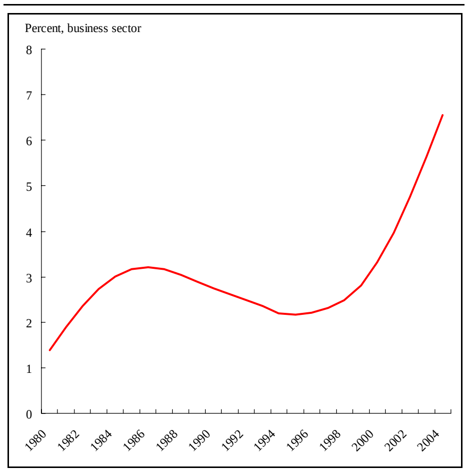
- **The Turkish economy will continue to grow at an above-trend pace, in our view**
  Turkey's economic turnaround is not a surprise or illusion, but a result of structural reforms and prudent policies. On our estimates, the economy will continue to grow at an above-trend pace, posting output increases of 7.2% in 2005 and 6.8% next year.
- **The productivity catch-up underpins the outstanding growth performance**
  The growth rate of labour productivity, the amount of output produced per unit of labour used, in the Turkish manufacturing sector surged from an average of 5.2% in the second half of the 1990s to 8.7% in the post-crisis period and to 8.4% last year.
- **With profitability, the private sector has become the engine of growth**
  Non-financial companies generated an average real return on equity of 13.5%, up from 7% in 2002 and -9% in 2001. As a result, the private sector increased capital spending by 75.1%, with machinery purchases rising by 134.2%, in the last two years.
- **Tomorrow's productivity gains have their roots in today's capital spending**
  The lagged effects of capital deepening and increasing foreign direct investment will result in a new wave of productivity growth, but the country still needs microeconomic reforms that will remove barriers to competition and eliminate labour-market rigidities.

**Productivity Growth Trend, 1980-2004**




*Source: SIS, Morgan Stanley Research*



**Please see important disclosures starting on page 3.**

# The Next Wave

**Turkey's economy will continue to grow at an above-trend pace, in our view.** Real gross domestic product increased by a cumulative rate of 24.3% in the past three years, while the country's inflation rate rapidly moved towards the single-digit territory. In our view, even such outstanding headline figures — making Turkey one of the fastest growing countries, especially excluding commodity exporters, in the world — fall short of revealing fundamental improvements in the economy. According to our calculations, the trend rate of real GDP growth accelerated from an average of 3% in the second half of the 1990s (and 3.9% in the whole of the 1990s) to 5.8% in the post-crisis period and to a staggering 7.8% last year. We have long argued that this 'miraculous' turnaround is not a surprise or an illusion, but a result of structural reforms and prudent policies that have helped normalizing the macroeconomic landscape. Therefore, Turkey will continue to grow at an above-trend pace in the coming years, posting output increases of 7.2% in 2005 and 6.8% next year.

**The productivity catch-up underpins the outstanding growth performance.** Turkey's relative productivity level is still low, but the rate of labour productivity growth has accelerated to a record-breaking pace in the last four years. The amount of output produced per unit of labour used in the manufacturing sector surged from an average of 5.2% in the second half of the 1990s to 8.7% in the post-crisis period and to 8.4% last year. Accordingly, the underlying trend rate of productivity growth accelerated from 4.5% to 8.3% in the same period. Likewise, the trend growth rate of labour productivity in the entire business sector increased from an average of 2.4% in the 1990s to 5.7% in the last three years (and to 6.6% in 2004). Moreover, productivity gains are not just limited to labour efficiency. Total factor productivity, the ratio of output produced to combined input of labour and capital, also increased from 0.5% in the 1990s to 4.8% in the post-crisis years. Again, structural changes and the normalization of macroeconomic dynamics have had a direct bearing on the economy's productivity and thereby growth potential.

**With higher productivity and profitability, the private sector has become the engine of growth.** Macroeconomic instability had been detrimental to capital accumulation and economic growth in Turkey, but the moderation of political and economic volatility has paved the way for higher profitability and investment spending in the corporate sector. Non-financial companies generated an average inflation-adjusted return on equity of 13.5% in the last two years, up from 7% in 2002 and -9% in 2001, and comparable, at last, to real returns on government securities. As a result, the private sector increased capital spending by 75.1% in real terms, with machinery and equipment purchases rising by an astonishing 134.2%, in the last two years.

**Tomorrow's productivity gains have their roots in today's capital spending.** Productivity-enhancing capital investments have raised the capital-to-labour ratio, setting the stage for future productivity improvements. Indeed, we believe that the lagged effects of capital deepening and increasing foreign direct investment will result in a new wave of productivity growth. Having said that, despite our optimistic macro assessment, the Turkish economy still faces microeconomic failures that result in technological sclerosis and limit income convergence. In particular, the prevailing institutional matrix — defining the incentive structure for economic agents — leads to an inferior equilibrium by blocking innovation and entry to product and labour markets. Thus, the country needs microeconomic reforms that will remove barriers to competition, improve incentives to become more productive, and eliminate rigidities in the labour market. In our view, greater flexibility will not only improve productive capacity but also make the economy less vulnerable to adverse shocks.

**Recent research on labour-market developments:**

- *Cheap(er) Capital and A Slow Job-Market Recovery, March 14, 2005*
- *The Cost of Labour Costs, March 7, 2005*
- *Do Prime Ministers Always Know Best?, February 18, 2005*
- *Will Santa Bring Jobs, December 16, 2004*
- *Affluent Future of a Jobless Society, October 27, 2004*
- *The Illusion of Compassion, June 21, 2004*
- *In Productivity We Trust, June 14, 2004*
- *Capital-Labour Substitution and Jobless Growth , April 23, 2004*
- *The Missing, March 22, 2004*
- *Productivity Renaissance, January 13, 2004*
- *Marx's Revenge, January 8, 2004*
- *A 'Mini' Shock?, December 16, 2003*
- *Help (Un)wanted, December 10, 2003*
- *Young, Educated and Jobless, August 28, 2003*

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