

# Analysis on the Risk of Turkey Falling into the "Middle Income Trap"

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**Abstract:** In 2007 Turkey was classified as an "upper-middle-income country" by the World Bank, but it soon became Mired in bottlenecks. The main reasons for Turkey to fall into this trap are: domestic and foreign political instability, industrial structure imbalance, insufficient innovation-driven capacity, weak financial system, etc., which hinder Turkey's productivity improvement and economic growth, but also hinder social development. For developing countries, on the one hand, they should properly handle their internal diplomatic relations and create a stable environment for their own economic development. On the other hand, we should vigorously develop human capital, accelerate scientific and technological innovation, and at the same time control the freedom of financial markets and control the scale of foreign debt.

**Keywords:** Turkey Middle-income trap Lira crisis Debt burden.

## 1. Introduction

In the 1980s, Turkey implemented the policy of opening to the outside world, and its economy achieved leapfrog development, from a traditional agricultural country with a relatively backward economic foundation to a modern industrial country. Since the AK Party came to power in 2002, Turkey has increased investment in infrastructure construction, constantly improved the investment environment to attract foreign investment, vigorously developed foreign trade, and political democracy has stabilized the social order and effectively controlled the inflation rate, so Turkey has maintained steady economic growth for nearly 30 years. From 1984 to 2014, China's economic aggregate increased from US \$60 billion to US \$939 billion, ranking 16th in the World, and per capita national income increased from US \$1,246 to US \$12,157. As early as 2007, the World Bank classified Turkey as an upper-middle income country, and the Central Intelligence Agency classified Turkey as a developed country, which is globally recognized as an emerging market and newly industrialized country.

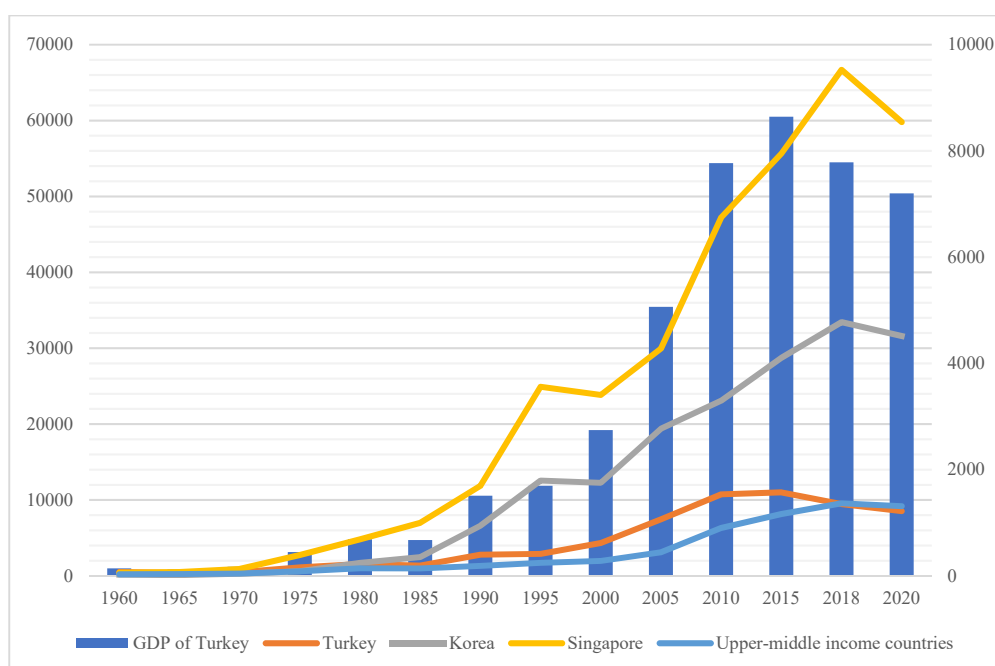
However, only 30 years later, Turkey's economic development has gradually stalled, and even the situation of economic recession, the development level is far less than South Korea, Singapore and other newly industrialized countries. According to the World Bank, Turkey's gross domestic product (GDP) fell from \$939 billion in 2014 to \$720 billion in 2020, and even experienced negative economic growth in 2014-2020, while Turkey's per capita GDP fell to \$8,536 in these years. Return to middle-income countries. At the same time, the persistent high inflation rate, high unemployment rate and high debt status quo persist, troubling the further development of the Turkish economy. Since entering the threshold of middle-income countries in the 1980s, Turkey's development has experienced "ups and downs". Whether Turkey will fall into the "middle-income trap" like Latin American and Southeast Asian countries has gradually aroused scholars' thinking. So what has caused Turkey to lose its booming economy and fall into the middle-

income trap that now frustrates most countries? With its domestic politics complicated and the global economy weak, how can Turkey escape the risk of falling into the "middle-income trap"?

## 2. The Characteristics of Turkey's "Middle-income Trap"

### 2.1. The economy is in recession and per capita income levels are plummeting

After more than 10 years of development, Turkey's per capita GDP reached \$509 in 1960, much higher than the world average of the same year (\$458), and once became one of the wealthiest countries in the Middle East. By 1975, Turkey's per capita GDP exceeded \$1,000 and was classified as a "middle-income country" by the World Bank. In the 1980s, Turkey gradually implemented the strategy of opening up to the outside world, coupled with a relatively stable domestic political environment, Turkey's per capita GDP reached 2,021.86 US dollars in 1989, and exceeded 4,000 US dollars in 1998, officially entering the ranks of "middle and high-income countries". Subsequently, Turkey joined the EU Customs Union and the G20 in 1995 and 1999 respectively, and the economic ties between Turkey and Europe and the United States were unprecedented, and the level of economic development was further improved. In 2014, the total economic volume of Turkey rose to 939 billion US dollars. National income per capita increased from \$1,246 to \$12,157. However, since 2010, Turkey's development as a whole remained in the same place, and in 2014, Turkey's economy gradually declined, the per capita GDP fell to 8536 US dollars in the past few years, although located in the upper middle income level, but still hovering in the ranks of middle-income countries, while South Korea is also an emerging market. As early as 2006, its per capita GDP was close to \$20,000, entering the ranks of high-income countries. Since 2018, Turkey's per capita GDP has fallen below the average level of upper-middle-income countries, and the decline has gradually increased.



**Figure 1.** Total GDP of Turkey and GDP per capita of relevant regions, 1960-2020 (unit: current US dollars)

Source: World Bank, World Development Indicators, 2021.

## 2.2. The income gap is wide, and the wealth gap is serious

Although Turkey once entered the group of high-income countries, its domestic income distribution problem has not been effectively solved for a long time, and social contradictions have been intensified, which has become one of the reasons for its falling into the "middle income trap". When the economy enters the middle and high income stage, if the income gap fails to narrow with the increase of income level, not only will independent innovation be inhibited, but

also economic growth will be stalled [1]. Turkey's domestic Gini coefficient has remained high for a long time, and in recent years it has exceeded the international income gap warning line. At the same time, the problem of poverty continues to plague Turkey's economic development. From 2014 to 2021, the poor population in Turkey has long accounted for more than 20% of the total population, while the vast majority of the country's property is only in the hands of a few capitalists, and the phenomenon of poverty differentiation is serious.

**Table 1.** Turkey's Gini coefficient and regional poverty rate, 2014-2021

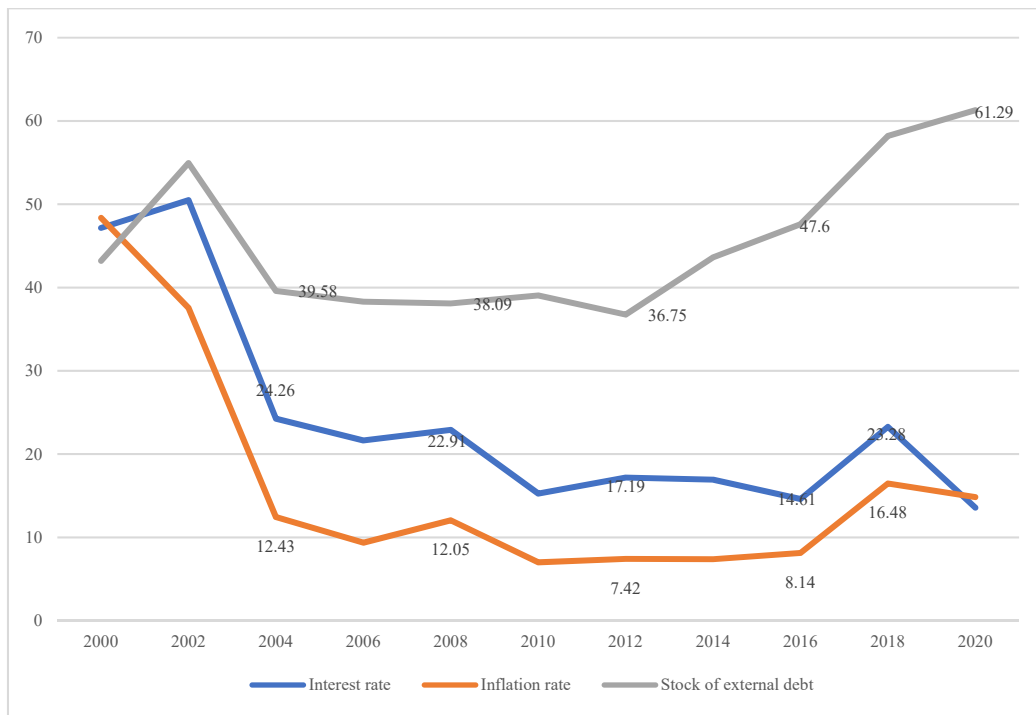
Year	2014	2015	2016	2017	2018	2019	2020	2021
Gini coefficient	0.391	0.397	0.404	0.405	0.408	0.395	0.410	0.401
Poverty rate	0.218	0.219	0.212	0.201	0.212	0.213	0.219	0.213

Source: World Bank, World Development Indicators, 2021.

## 2.3. Inflation is high and the debt burden is heavy

In recent years, the frequent outbreak of the Turkish lira crisis, on the one hand, is manifested by the continuous devaluation of the currency, on the other hand, it has brought increasing inflation in Turkey. In 1999, Turkey broke out a serious economic crisis, the inflation rate exceeded 100%, 1 million lira can only be exchanged for 1 dollar, the Turkish bank interest rate was once as high as 100%, but it still could not prevent a large number of capital flight, and today Turkey still maintains a high inflation rate. In order to offset the decline in domestic and foreign demand brought about by the international financial crisis, Turkey borrowed a large amount

of foreign debt for infrastructure investment, which also led to Turkey's long-term high foreign debt burden. As of the third quarter of 2021, Turkey's external debt has reached \$453.5 billion, and as an export-oriented economy, it has taken on high debts while having very few foreign exchange reserves. In recent years, Turkey's foreign exchange reserves have been basically around \$45 billion, while South Korea's GDP is more than twice that of Turkey, but its foreign exchange reserves are more than 10 times that of Turkey, and compared with countries that have not fallen into the middle-income trap, their foreign exchange reserves and GDP ratios are in the normal range. Coupled with the falling value of the Turkish lira against the dollar, it needs to pay more lira to service its foreign debt.



**Figure 2.** Turkey's interest rate, inflation, and external debt stock, 2000-2020

Source: World Bank, World Development Indicators, 2021.

### 3. There Are Reasons Why Turkey Risks Falling Into The "Middle-income Trap"

#### 3.1. Institutional reform is lagging and the domestic political situation is volatile

In the process of economic development, the country must create a good environment for the improvement of productivity, and the primary task is to maintain political and economic stability [2]. For a long time, the relationship between the Turkish government, the military and religion has been sensitive and complex, and the political system reform has always been unable to get rid of the influence of the military and religion, and the excessive intervention of the military in politics is also one of the reasons why Turkey has been unable to join the European Union for a long time. Until 2017, President Erdogan announced that the constitutional amendment referendum was passed, and the Turkish political system was changed from the former parliamentary system to a presidential system. The president will be given more executive powers. At the same time, frequent military coups and religious conflicts have caused great troubles to Turkey's economic development. According to statistics, since the founding of Turkey, there have been six large-scale military coups, large and small military friction is countless. In 2016, after the attempted military coup, real GDP growth fell from 6.09% in 2015 to 3.18%, the lowest level of growth since AKP came to power except in 2009. Data show that after the coup, the Turkish stock market plunged, the Turkish currency lira fell 5%, the biggest drop in eight years; In the five months after the coup, Turkey attracted \$15.8 billion in foreign investment, of which only \$2.3 billion was direct, down 50% from the same period last year. Turkey's tourism revenue fell by 23%, and the year-on-year decline widened every month. The coup and subsequent social unrest will undoubtedly put economic development in trouble.

#### 3.2. Geopolitically sensitive, the Middle East crisis is frequent

Since the upheaval in the Middle East in 2011, Turkey has had bad relations with its important trading partners Egypt, Libya and Saudi Arabia, which led to a sharp decline in GCC countries' investment in Turkey. Under the influence of geopolitics, in August 2018, the bad relations between Turkey and the United States once again triggered the lira currency crisis, which caused the real GDP growth rate (calculated by expenditure method) to fall from 7.3% in 2017 to 2.83% in 2019, and 0.88% in 2019. In addition, the terrorist threat and refugee crisis brought about by the Middle East crisis have brought more uncertainty to Turkey's domestic political and economic environment. As of the end of 2019, Turkey's domestic economic growth rate was 0.88%, down 1.9% year-on-year, inflation rate was 15.26%, and unemployment rate was 13.9%. Youth unemployment stands at 27.1 per cent and external debt remains high. Nowadays, Turkey is increasingly nostalgic for the Ottoman Empire's history. Driven by "imperial nostalgia" and geopolitical opportunities, Turkey actively intervenes in regional affairs and tries to restore its great power influence within the former Ottoman Empire. However, the huge gap between history and reality may further aggravate the existing dilemma of Turkey's domestic and foreign affairs [3].

#### 3.3. The industrial structure is unbalanced and the momentum of economic growth is insufficient

Excellent geographical advantages and resource endowment conditions, so that Turkey early to attract foreign capital and advanced technology to develop labor-intensive industries, so as to rapidly industrialization. From the beginning of January 1960 to the end of January 2020, the value added of agriculture in Turkey fell from 54.9% to 6.6% of GDP, the value added of industry increased from 17.3% to

27.8% of GDP, and the value added of services increased from 25.8% to 54.6% of GDP. The value added of goods trade as a share of GDP rose from about 6% to 54%. First of all, the rapid decline in the proportion of agriculture leads to a large number of rural population flowing into the city, which is not conducive to the development of basic industries and widens the urban-rural income gap. Second, although Turkey entered industrialization earlier, its industrialization process was slow, and although the industrial added value increased overall, it increased significantly and then declined in the middle. The decline of industries that are more resistant to risk will lead to job losses, increase unemployment, and even affect the country's innovation and creativity. Finally, Turkey's

economic growth relies too much on the service industry, and the service industry's ability to resist risks is obviously weaker than agriculture and industry, war, epidemic and other factors will seriously affect the service industry. In Turkey's service sector, tourism occupies a major position, and the decline in inbound tourism after the military coup in 2016, coupled with the ongoing unrest in the Middle East, Turkey's tourism industry is increasingly difficult to sustain. In addition, the outbreak of the novel coronavirus has again hit Turkey's service industry, and the rapid depression of the service industry is one of the important reasons for Turkey's economic decline in recent years.



Figure 3. Growth of Turkey's industrial and manufacturing industries, 2001-2020

Source: World Bank, World Development Indicators, 2021.

### 3.4. The development of human capital is slow and the ability to drive innovation is insufficient

At present, Turkey's population structure shows an obvious trend of youth, and the population has always maintained a positive growth, coupled with a large number of refugees and immigrants, compared with high-income countries, Turkey has a relatively reasonable population structure, which is conducive to the export of cheap labor, thus stimulating economic growth. However, Turkey's human capital only stays in the "quantity" advantage, the importance of human capital is far from enough, in 2019, Turkey's public education spending accounted for only 3.79% of GNP, far less than other middle and high income countries, and even far lower than the same period of Brazil 4.4%, Mexico 5.3%. In addition, Turkey's insufficient investment in science and technology research and development is also far lower than that of middle and high-income countries, in 2017, Turkey's research and development investment accounted for only 0.98% of the total GDP, while South Korea's research and development investment accounted for 4.61% of GDP, ranking second in the world. Human capital and scientific and technological

development level are often the core of a country to maintain competitiveness, and Turkey's insufficient investment in education and scientific research is often difficult to form core competitiveness, and gradually fall into the "middle income trap".

## 4. The Implications of Turkey's Fall into the "Middle-Income Trap" For Developing Countries

### 4.1. Accelerate the reform of the domestic political system and reduce excessive intervention by government agencies in the economy

Since the AKP came to power in 2002, it has made full use of the electoral system to transform Turkey's political system through successive elections. However, in order to win the election in successive elections and referendums, the government has introduced a large number of measures to stimulate the economy and welfare policies to meet the needs of voters, resulting in a huge gap in government expenditure, and the proportion of government debt to GDP has been hovering around 30% for a long time. The government's rigid

expenditure has greatly reduced its ability to regulate economic development, resulting in slow economic growth [4]. Since 2013, Turkey has faced economic development difficulties with declining economic growth, high inflation and unemployment, and one of the main reasons is President Erdogan's excessive intervention in the economy. To this end, for developing countries, it is necessary to reduce the excessive intervention of government agencies in the economy and prevent the use of economic means to seek political status.

#### **4.2. Properly handling domestic and foreign relations to avoid geopolitical conflicts**

In recent years, the adventurous character of Turkey's foreign policy has become prominent. Since taking control of the AKP regime, Erdogan has successively launched the "2023 Strategic Vision" and "2053 Strategic Vision", whose goal is to make Turkey eventually become a world power. To this end, Turkey has adopted a diplomatic strategy that highlights key points and drives all-dimensional aggressive geopolitics. Although Turkey's geopolitical enterprise in recent years has achieved obvious results, it is also facing resistance from the United States, European powers and Arab countries, and Russia and Iran are also wary of Turkey's geopolitical enterprise [5]. At the same time, Turkey's continuous interference in the internal affairs of other countries has led to a sharp deterioration of its relations with Middle Eastern countries, which has directly led to the deterioration of Turkey's international trade environment and the reduction of foreign investment. It can be seen that developing countries should properly handle international diplomatic relations, avoid the emergence of cold and hot wars, and create a good environment for domestic economic development.

#### **4.3. Improving the industrial structure and accelerating the transformation and upgrading of the manufacturing sector**

For a long time, Turkey's economic growth has been excessively dependent on the service industry, but under the influence of the novel coronavirus epidemic, the development of its service industry has suffered a major blow, a large number of people are unemployed, and the economy is rapidly declining. However, the lagging development of industry and agriculture has made it difficult to accept a large number of unemployed people, causing a serious economic and social crisis in Turkey. In addition, Turkey's manufacturing industry has always been difficult to transform and upgrade, at present, the manufacturing industry accounts for about 20% of Turkey's total economic output, but its main

export products are textile products, raw materials, transportation equipment and mechanical and electrical products with low technical level, resulting in a long-term trade deficit in international trade, which further leads to low foreign exchange income in Turkey. Therefore, developing countries should enhance their innovation capacity, speed up the transformation and upgrading of the manufacturing industry, and fundamentally reverse the situation of insufficient export capacity. Only in this way can they improve their competitiveness in the world market.

#### **4.4. Attach importance to human capital development and increase investment in technology research and development**

Despite the fact that Turkey has a younger population structure, it does not pay enough attention to human capital development, which makes it difficult to use highly innovative technical talents. Therefore, the lack of investment in scientific research has also led to the slow upgrading of Turkey's industry, which is difficult to form core competitiveness, and then its long-term trade deficit in international trade. At present, the majority of developing countries also have a young population structure. They should make full use of this advantage, vigorously develop public education, accelerate the pace of human capital development, increase investment in technological research and development, encourage technological innovation, and build core competitiveness.

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