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This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

The BTI is a joint project of the Bertelsmann Stiftung and the Center for Applied Policy Research (C•A•P) at Munich University.

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Executive Summary

Turkey is the only Islamic country that is based on a secular political system whose institutions operate effectively and in line with the constitution. In comparison to other countries in the Middle East, democratic rules of the game function well, and elections are free and fair. In principle, all citizens have the same civil rights; yet, the Kurdish minority is being discriminated against, although any discrimination based on cultural, religious or ethnic differences is forbidden and the Turkish constitution and the European Convention on Human Rights are the core warrants against any civil rights violations. The judiciary is free both from direct influence or intervention by other institutions, the process of judicial review of legislative or executive acts function adequately, yet cases of corruption occur. The administrative system works sufficiently in general and public security and order is assured throughout most of the country, except for parts of East and Southeast Anatolia, where the PKK and its successor organizations operate. Participatory and pluralist democracy is supported and monitored by the EU, which has been monitoring the performance of both the Turkish administration and the judiciary since 1999, as part of Turkey’s efforts to join the EU. In its 2005 annual progress report, the European Commission declared for the first time that Turkey was a well-functioning market economy and thus complies with one of the Copenhagen criteria.

Since the crisis of 2001, an impressive reform package aiming at, and eventually implementing, fiscal consolidation and institutional reform has contributed to a strong and hitherto rather sustainable economic growth. As a result, GDP growth has been impressive and stable (approximately 7.46 % between 2002 and 2006). During 2002-2006, output increased by one-third, representing the strongest pace of growth among OECD countries. At the same time, annual inflation decreased steadily, reaching single digits in 2004 for the first time in three decades, and the public debt burden has been
significantly reduced. Tight fiscal and monetary policies improved confidence and reduced risk premium, thereby enhancing business investment and FDI inflows, the latter of which amounted to $9.6 billion in 2005 and $20.7 billion. Nonetheless, the current account deficit is still enormous, exchange rate movements have been volatile, and the recent increase in inflation and rising levels of private sector external debt show that Turkey is still vulnerable and in need of additional reform measures that can sustain growth and economic stabilization.

History and Characteristics of Transformation

Turkey’s social and political transformation dates back to 1923, as the arrival of Atatürk changed Turkish society fundamentally and led to the establishment of a modern, secular Western-oriented republic. The Turkish experience in regard to social and cultural transformation has widely been described as unique, not only because of its totality and success against the background of a predominantly Islamic society, but also because of the synthesis it sought, i.e. the amalgamation of Western and pre-Islamic Turkish cultures that replaced the cultural heritage of the Ottoman empire. This has not been an easy task given the history and geographical location of Turkey, given that it lies at a strategic political and cultural “crossroads” between Europe and Asia. Undoubtedly, due to this unique position the Turkish identity is a mix of European, Balkan, Mediterranean, Middle Eastern, Caucasian and Asian identities.

Following Atatürk’s death in 1938, Ismet İnönü was elected as the second President of the Republic. Although he was able to keep Turkey out of the Second World War, it was negatively affected by the war – the army was kept alert and ready, prices increased rapidly, most of the basic food items were rationed, and the black market was flourishing. After it won the elections in 1950, marking the beginning of multi-party politics in Turkey, the Democratic Party (DP) ruled for the next 10 years and brought a noticeable liveliness to the economy and contributed to a substantial increase of the average living standard. In the framework of its economic policies, it proved instrumental in regard to infrastructure development, agricultural mechanization and eventually industrialization. During the second term of the DP in power, however, the Turkish economic situation deteriorated massively, inflation and public debt increased and the government introduced censorship measures to silence the growing public dissent. The growing tensions and the economy’s failure motivated the military under General Gürsel in May 1960 to intervene and remove Prime Minister Menderes from power. Military rule was yet short-lived as the system returned to civilian control only one and a half years later. In the subsequent years, the political situation remained tense, as none of the ruling governments was able to stay in power for long. While this situation led to the second military coup by memorandum in 1971, the Turkish economy performed relatively well, in view of the average growth rate of 5.7% until
1970 and the acceleration of industrialization. In what followed, Turkey went through a period of political instability and economic crisis. The two oil crises, as well as the military embargo that was imposed by the United States after the invasion in Cyprus in 1974 hit the country very hard in economic terms, but at the core of the crisis were certainly the hostilities between the communists and the ultranationalist camp. At the end of the 1970s, the situation became unsustainable and the military intervened for the third time in 1980. At the end of its almost two-year long rule, it had reestablished civilian control and supported the Motherland Party of Turgut Özal.

While until 1980, the Turkish economy was mainly based on import substitution and a rather large agricultural sector, economic policies under Özal shifted towards a market economic paradigm based on export-oriented industrialization. As part of his liberal economic policy, Özal orchestrated fundamental changes in the Law for the Protection of the Value of Turkish Currency and the foreign currency exchange system, and liberalized imports and exports. State subsidies were decreased and modern value added tax put into effect to increase state revenues. Revenue-sharing bonds were issued for sale, the mass housing and privatization administrations were established and free trade zones formed. As a consequence, economic growth accelerated and the chronic foreign currency deficit problem diminished. Yet, although significant progress has been made and the private sector was empowered, the public finance policy has led to serious budget deficits, which resulted in two severe economic crises in 1994 and 2001, respectively.

Since 2002, the Turkish government has been working closely with the IMF and the World Bank to implement a structural reform program with the aim of stabilizing and strengthening the economy mainly through controlling public expenditures and inflation, increasing transparency in public financial management, accelerating privatizations and foreign investments as well as reforming the agriculture and financial sectors in accordance with the requirements that EU membership imply. In recent years, one-third of the Turkish constitution has been changed; over two hundred new laws have been passed, most of which directed towards the modernization of Turkey’s penal code, the protection of the freedom of expression and religious pluralism, and the protection of human rights. Furthermore, state security courts have been abolished and for the first time, Turkey only recently appointed a civilian as head of the National Security Council.

The most important underlying characteristic of Turkey’s transformation process throughout the different periods has been and still is the basic contradiction between the state elite’s attempts at preserving the fundamentals of the Kemalist republic, as defined by them and written into every constitution, and the “deviating” dynamics unleashed by political democracy and economic liberalization which time and again led to societal processes that tended to “emancipate” the country from the straitjacket of Kemalist orthodoxy.
Transformation Status

I. Democracy

1. Stateness

The state practices its monopoly on the use of force over the entire physical territory of the country. Yet, as part of its struggle against the PKK and its successor organizations, in particular in East Anatolia, it is exposed to separatist violence, but also has to cope with religious fundamentalism and organized crime.

With the exception of the PKK, all citizens, including cultural, religious and ethnic minorities accept the official concept of the Turkish nation state. In theory, all citizens have the same civil rights and discrimination based on cultural, religious or ethnic origin is forbidden. Although legislative change has taken place lately, it has not yet been followed by behavioral change in society. Moreover, members of the religious minorities are practically excluded from certain positions, such as becoming a civil servant or an army officer.

The state functions as a secular order with modern institutions. From the beginning of the foundation of republic the secularism builds the main axis of legal, social, and political order. Religion or religious dogmas do not have direct influence on politics. On the other hand, a constitutional institution (Art. 136) the Directorate for Religious Affairs (Diyanet) practices a firm state control over the religious affairs regarding the basic applications and the interpretations of the religion. An essential shortcoming of Diyanet is the exclusion of religious communities other than Sunni Islam. Particularly the Alevi community is not represented in Diyanet.

The administrative system works sufficiently. Nevertheless a comprehensive administrative reconstruction, which envisages a modern, decentralized, participatory and transparent model, needs to be undertaken. For the most part, the law enforcement is not affected by corruption.
2 | Political Participation

All elections since 1950 have been free and fair.

In principle, the democratically elected government has the effective power to govern, though it has been constrained by the military’s strong influence in Turkish politics. The latter must be considered a “political enclave,” as it, in the form of the Office of the General Staff, in practice operates independently from civilian elected authorities and is not under parliamentary scrutiny except for budgetary affairs. This situation of “defective democracy” can best observed in the military’s activity against “Kurdish separatism” of the PKK which is completely directed and controlled by the military establishment without any civilian guidance and thus control by the government or the parliament.

Concerning the freedom of association, the legal framework is generally in line with international standards. As regards freedom of assembly, public demonstrations are subject to fewer restrictions than in the past. However, in some cases security forces used excessive force, especially when the demonstrations were carried out without permission.

Amendments to the anti-terror law were adopted in June 2006 as a response to the escalation of ethnic terrorism. Under the new law, the list of what constitutes a terrorist offence was extended and a wide definition of terrorism maintained. The law introduces the circumstances, under which the legal restrictions on freedom of expression, the press and the media can be practiced. According to annual report, prepared by the European Commission in 2006, the prosecutions and convictions for the expression of non-violent opinion under certain provisions of the new penal code are a cause for serious concern and may contribute to the creation of a climate of self-censorship. This is particularly the case for Article 301, which penalizes insulting Turkishness, the republic as well as the organs and institutions of the state. Although this article includes a provision that expression of thought intended to criticize should not constitute a crime, it has repeatedly been used to prosecute non-violent opinions expressed by journalists, writers, publishers, academics and human rights activists. In 2006, a public debate emerged over the need to change the electoral system, which currently requires political parties to reach a 10% threshold at national level to achieve representation in Parliament. Yet, the European Court of Human Rights rejected on 30 January 2007 the claim that the imposition of an electoral threshold of 10% in parliamentary elections interfered with the free expression of the opinion of the people in the choice of the legislature.
3 | Rule of Law

State powers in Turkey are separated and checks and balances function properly as described in the constitution. Yet, again, the influence of the military leadership must not be underestimated, as it has repeatedly shown, and expressed, its intention to intervene in the political process if deemed appropriate in its view.

The judiciary is relatively free from direct influence or intervention by other institutions. This statement must be qualified, however, to the extent that decisions of the High Military Council concerning personal affairs, especially repulsion from the ranks due to “political non-reliability”, are not open to judicial review. The judicial system has some structural weaknesses, as cases proceed slowly and inefficiently, due to backlog and the large number of pending cases.

With regard to the independence of the judiciary, as pointed out in the annual report of the European Commission, judges and prosecutors are attached to the Ministry of Justice with respect to their administrative functions. The High Council of Judges and Prosecutors, the supreme governing body of the judiciary, does not have its own secretariat, separate premises (located in the Ministry of Justice) and budget. The judicial inspectors, who are responsible for evaluating the performance of judges and prosecutors, are attached to the Ministry rather than to the High Council.

Generally, the state and the society hold civil servants accountable and conflicts of interest are sanctioned. However, politicians enjoy a different treatment, as those who misuse their public mandate or power in office can hardly be charged and prosecuted by the state tribunal. The wide scope of parliamentary immunity remains a major problem in the context of the fight against corruption. Overall, during the period under study, there has been some limited progress in the fight against corruption, notably on increasing transparency in the public administration.

Overall, civil rights are guaranteed and protected. Yet, although a written regulation exists, members of religious minorities are practically excluded from becoming a civil servant or an army officer. The European Union supervises Turkey regarding the fulfillment of the Copenhagen political criteria. Furthermore, Turkey as a member of the European Council, is obliged to implement the provisions of the European Convention on Human Rights. In spite of this obligation, however, there is still a high number of appeals to the ECHR against Turkey, but many of the pending cases date back to the period before 2004.
4 | Stability of Democratic Institutions

Basic democratic institutions work together in a relatively harmonious and effective way. All relevant political decisions are prepared, made, implemented and reviewed by the appropriate organ, as described in the Turkish constitution. Since 1999 the performance of the administrative system and the system of justice have been examined and improved with the guidance of the European Commission.

All relevant political and social players with the exception of the PKK and its successor organizations accept the democratic institutions as legitimate.

5 | Political and Social Integration

Since the last national elections in November 2002 the Justice and Development Party (AKP) has held a comfortable majority in the Turkish Grand National Assembly and has been governing since then. Mr. Erdogan, the current prime minister, founded the party in August 2001 and won the elections, just 15 months after the foundation. As of January 2007, the AKP has 354 seats in Parliament, the main opposition party, the Republican People’s Party (CHP), is represented with 153 deputies. Because of the election threshold of 10%, only two parties were represented in parliament during 2002-2007, and the country was politically rather stable. Throughout the years, however, several deputies from the AKP as well as the CHP have changed their party affiliation and in some cases established new parties. As a result, the number of political parties currently represented in Parliament has increased to six. Therefore, some of the parties that did not pass the election threshold of 10% in the November 2002 elections gained seats in Parliament: the True Path Party (DYP) 4, the Social Democrat People’s Party (SHP) 1, the Motherland Party (ANAP) 21 and the People’s Ascension Party (HYP) 1 seat. Nine members of Parliament are independent and 6 seats are vacant. In general, however, the party system in Turkey is still very unstable and the voter volatility is very high - the absence of a socially rooted party system is undoubtedly one of the main reasons.

There is a close-knit network of a wide range of interest groups promoting the growth of participatory democracy. Currently, there is an increasing variety of organizations in Turkey including approximately 80,000 registered associations, and several hundred unions and chambers. Yet, the major actors of civil society have limited substantial and beneficial influence on policy-making in recent years. Nevertheless, the impact of civil society institutions is growing. According to the annual report of the European Commission, the recent reform environment has led to positive developments in terms of civil society organizations, as they
have become more vocal and better organized, especially since the adoption of the new Law on Associations.

The consent of Turkish people to democracy is very high. With the exception of fundamental movements, all social, economic and political groups are devoted to a pluralist democratic system. On the other hand the level of trust and confidence in political parties and politicians is very low.

Autonomous, self-organized groups and voluntary associations are traditionally well-developed and well-organized. They work and cooperate well with each other. These self-organizations enjoy a high level of trust among the population.

II. Market Economy

6 | Level of Socioeconomic Development

Since the crisis of 2001, an impressive package of fiscal consolidation and institutional reform has created a strong foundation for economic growth. As a result, GDP growth has been strong and stable (approx. 7.4% between 2002 and 2006). Over the 2002-06 period, output increased by a third, representing the strongest pace of growth among OECD countries. At the same time, annual inflation fell steadily, reaching single digits in 2004 for the first time in three decades. The public debt burden has been significantly reduced. Tight fiscal and monetary policies improved confidence and reduced risk premium, thereby enhancing business investment and FDI inflows ($9.6 billion in 2005 and $18.6 billion by November 2006). Yet the current account deficit is large, exchange rate movements have been volatile, and the recent increase in inflation and rising levels of private sector external debt draw attention to Turkey’s vulnerabilities and to the need for additional policies to contain risks. On the other hand, there are extreme income disparities between rural and urban regions, particularly in the east and south-east regions of the country. These uneven development patterns affect the economic structure and cause remarkable social problems as well. According to household budget survey results of 2005, the household disposable income first quintile’s share received from the total disposable income is 6.1%, whereas households of the fifth quintile’s share received 46.2% of it. By this result, the ratio of the fifth quintile’s share to the first quintile’s share S80/S20 which is the inequality criteria, has been calculated as 7.3 in comparison to 7.7 in 2004. The Gini coefficient decreased 0.2% and is currently at 0.38 for Turkey, i.e. 0.37 for urban areas and 0.38 for rural areas. According to Human
Development Index 2006 (0.757, rank: 92) the life expectancy at birth is 68.9 years and the adult literacy is 87.4 %. The demographic growth rate is sinking steadily and is currently at 1.27 %; in contrast, the unemployment rate is decreasing slowly (9.6 % as Nov. 2006). The gender-related Development Index of the UNDP ranks Turkey in position 71. There are some gender-related inequalities with respect to the adult literacy rate (79.6 % for female and 95.3 % for male) and the estimated earned income ($4,038 for females and $11,408 US$ for males.) In recent decades the access of the school-age population to education has been expanded significantly. However, the quality of education remains low, and the education system focuses predominantly on providing good quality education to the most able students, who are channeled towards university and work in the formal sector. As a result, the most binding human capital shortages are at the middle and low end of the labor market. Despite this, resources continue to be skewed towards the ‘high end’. Although it was originally conceptualized as a merit-based system, the system favors students from higher-income families with more resources and this raises efficiency and equity concerns.

<table>
<thead>
<tr>
<th>Economic indicators</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
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<tbody>
<tr>
<td><strong>GDP $ mn.</strong></td>
<td>183,888</td>
<td>240,376</td>
<td>302,786</td>
<td>362,502</td>
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<tr>
<td><strong>Growth of GDP %</strong></td>
<td>7.9</td>
<td>5.8</td>
<td>8.9</td>
<td>7.4</td>
</tr>
<tr>
<td><strong>Inflation (CPI) %</strong></td>
<td>45</td>
<td>25.3</td>
<td>8.6</td>
<td>8.2</td>
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<tr>
<td><strong>Unemployment %</strong></td>
<td>10.4</td>
<td>10.5</td>
<td>10.3</td>
<td>-</td>
</tr>
<tr>
<td><strong>Foreign direct investment % of GDP</strong></td>
<td>0.6</td>
<td>0.7</td>
<td>1.0</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>Export growth %</strong></td>
<td>11.1</td>
<td>16</td>
<td>12.5</td>
<td>8.6</td>
</tr>
<tr>
<td><strong>Import growth %</strong></td>
<td>15.8</td>
<td>27.1</td>
<td>24.7</td>
<td>11.6</td>
</tr>
<tr>
<td><strong>Current account balance $ mn.</strong></td>
<td>-1524</td>
<td>-8036</td>
<td>-15604</td>
<td>-23155</td>
</tr>
<tr>
<td><strong>Public debt $ mn.</strong></td>
<td>59,986 6</td>
<td>64,244.3</td>
<td>68,352.4</td>
<td>62,580.4</td>
</tr>
<tr>
<td><strong>External debt $ mn.</strong></td>
<td>130,951.4</td>
<td>145,148.3</td>
<td>162,403.9</td>
<td>171,059.0</td>
</tr>
<tr>
<td><strong>External debt service % of GNI</strong></td>
<td>15.1</td>
<td>11.9</td>
<td>11.1</td>
<td>11.6</td>
</tr>
<tr>
<td><strong>Cash surplus or deficit % of GDP</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Tax Revenue % of GDP</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Government consumption % of GDP</strong></td>
<td>14.0</td>
<td>13.6</td>
<td>13.2</td>
<td>13.1</td>
</tr>
</tbody>
</table>
Public expnd. on edu.  % of GDP  |  2002  |  2003  |  2004  |  2005 
--- | --- | --- | --- | --- 
3.6 | 3.7 | 4.0 | 4.0 
Public expnd. on health  % of GDP  |  2002  |  2003  |  2004  |  2005 
--- | --- | --- | --- | --- 
5.2 | 5.4 | 5.6 | 5.2 
R&D expenditure  % of GDP  |  2002  |  2003  |  2004  |  2005 
--- | --- | --- | --- | --- 
0.7 | - | - | - 
Military expenditure  % of GDP  |  2002  |  2003  |  2004  |  2005 
--- | --- | --- | --- | --- 
4.4 | 3.8 | 3.1 | 2.8 

7 | Organization of the Market and Competition

The state fully guarantees and maintains the market competition and all market participants have principally equal opportunities. According to the annual report by the European Commission in 2006, the work of the Competition Authority continued to be satisfactory and its role in the market was further supported by the privatization process. Transparency in the corporate sector improved and accounting standards were upgraded although not yet fully implemented. No improvements were made concerning monitoring of state aids. The absence of transparent monitoring and policies to decrease distortions negatively affects the climate. Public procurement policies continued to be undermined by further exceptions made to the regulatory framework. To conclude, some improvements in competition policy took place, but in certain areas deficiencies remained or worsened. Overall, significant privatization continued. There are no barriers of market entry or exit. In 2005, 47,401 enterprises were established and 8,886 firms went bankrupt. In 2006, 52,699 enterprises were established and more than 9,471 firms went bankrupt. According to the European Commission’s report, restrictions on foreign ownership still exist in the areas of civil aviation, maritime transport, road transport, ground-handling services, yachting, broadcasting, electricity, financial corporations, private employment offices, tourism, education and defense sectors. The share of the informal sector is very high in comparison to other European economies and the existence of a substantial informal economy (estimated over 60 %) hampers viable market economy development in Turkey. Nonetheless, the European Commission declared for the first time in its 2005 annual report the existence of a well functioning market economy.

With the establishment of the customs union, Turkey fulfilled the obligation to adopt the anti-trust legislation of the EU and established an independent body (High Committee for Competition) with a mission of monitoring the market and implementing the anti-trust rules when necessary. The Committee operates effectively with respect to privatizations, mergers and acquisitions, and it also ensured that market positions were not abused.
Foreign trade is fully liberalized. The import regime of 2005, reflecting both Turkey’s international rights and obligations and the country’s economic needs, has been prepared by taking into account the agreement establishing the World Trade Organization (WTO), the Customs Union Agreement between Turkey and the European Union, the free trade agreements signed with various countries, the preferential treatments granted by Turkey to the least developed countries and some developing countries within the framework of the generalized system of preferences and also the specific needs and requirements of the agricultural and industrial sector. Regarding the provisions of the Decision No: 1/95 on the EU-Turkey Customs Union, Turkey has to apply simultaneously the EU common external tariff (CET) for most imports of industrial products and for the industrial component of processed agricultural products imported from the third countries. Also according to the provisions of the Customs Union Agreement, Turkey has to align itself with the EU’s preferences under the Generalized System of Preferences (GSP) which regulates autonomous customs duty preferences in favor of the least developed countries and some developing countries. Turkey enacted a new Decree on August 25, 2004 with the major aim of completing its obligations and aligning itself to the EU’s GSP regime. With this new decree all industrial products covered by the EU’s GSP regime are included into Turkey’s GSP. As a result Turkey has fully completed the adoption of the EU’s GSP regime in terms of countries and products. At the same time, Turkey has been implementing an export-oriented strategy since 1980. The basic objective of this strategy is to have an outward-oriented economic structure in the framework of a free-market economy and to be integrated with world markets.

The Turkish banking sector system is organized according to international and European standards, with functional supervision, minimum capital requirements and market discipline. According to a report prepared by the Central Bank of Turkey, the Turkish banking sector consists of deposit banks, development and investment banks and participation banks that operate according to the profit/loss sharing principle. The number of banks decreased after the 2001 financial crises to fifty. The asset concentration ratio of the largest 5 banks is 59% and 28% if the largest 10 banks are considered (as of September 2006). The total asset size of the sector has reached 317.5 billion US$ as of September 2006. While the asset size of the Turkish banking sector to GDP ratio was 83.5% in 2005, it reached 89%5% in June 2006. This indicates that the Turkish banking sector has been growing more rapidly than the GDP, which has been continuously increasing for the last 18 quarters. As a result of the increasing interest of foreign investors in the Turkish banking sector in 2006, the share of equity held by foreigners reached 17%4% of the balance sheet of the banking sector in September 2006. Despite the fluctuations of the May-June period 2006, the increasing interest of foreigners in the banking sector points to the fact that foreigners consider the growth potential of the Turkish banking sector as high.
8 | Currency and Price Stability

Turkey’s positive macroeconomic performance between 2002 and 2006 was also supported by a favorable international environment, characterized by strong world trade and - despite higher oil prices - relatively low inflation, low interest rates and a strong global appetite for emerging market assets. In Mai-June 2006, however, interest rate hikes in major industrial countries prompted a change in the risk appetite of the international financial markets. This significantly affected the Turkish economy: the currency depreciated significantly, long-term interest rates rose sharply and inflation accelerated. More recently pressures weakened and the exchange rate recovered somewhat and long-term interest rates declined again. Turkey was not the only country hit by the reduced risk appetite of international investors, but it was among the group of emerging market economies that was most affected. One reason for this was Turkey’s large and widening current account deficit, fed by large capital inflows, including a large share of portfolio capital, which had fuelled an appreciation of the currency. Furthermore, Turkey’s relatively short history of responsible macroeconomic policies (since 2001) makes it vulnerable to external shocks. Sustained strong economic performance in this more difficult international environment will require the bolstering of confidence in macroeconomic policy and political commitment to structural reform. According to Morgan Stanley, fiscal consolidation has no doubt played a critical role in ending Turkey’s self-fulfilling inflation process and improving the effectiveness of monetary policy. However, the government’s commitment to multi-year fiscal programming is just one of the underpinnings of disinflation. Along with a variety of structural changes, the increased institutional independence of the central bank has enhanced policy credibility, better anchored inflation expectations to ambitious targets, and thereby led to a significant reduction in the country’s risk premium.

Since the crisis, the Turkish economy has recovered strongly thanks to good monetary and fiscal policies and structural economic reforms made with the support of the International Monetary Fund. Though Turkey has made great progress reducing inflation, it has not yet converged with the low levels prevalent in most other industrialized countries. Turkey’s other persistent economic weaknesses is its large, short-term domestic public debt, and runaway state spending have also been brought under control. Net public debt to GDP has fallen from 92% in 2001 to under 60% in 2005 and increased slightly to around 60% at the end of 2006. The composition of the debt, with much of its short-term debt needing to be rolled over in the domestic financial market, remains a risk, but the Turkish Treasury has gradually reduced this by increasing maturities and reducing the share of foreign exchange-denominated debt. Turkey’s five straight years of tight fiscal policy have brought public sector balances under control,
with the overall public sector deficit now around zero. Although 2007 is a double election year, the government is obviously determined to resist applying a populist and pragmatic economic course, despite the fact that the domestic lobby’s pressure is significant.

**9 | Private Property**

Property rights and the regulation of the acquisition of private property are in principle well-defined in the Turkish legal system. As reported in the 2006 report of the European Commission, limited further progress was made in legislative alignment with provisions concerning copyright and related rights. Turkey has aligned its legislation concerning copyright and neighboring rights to a large extent. Weak administrative capacity, frequent and inconsistent changes of legislation, as well as conflicts over collective management of rights remained as problematic issues, however. Little progress can be reported concerning industrial property rights (IPR). The Law establishing an Investment Support and Promotion Agency has entered into force. The Agency has been established in Ankara and is attached to the Prime Ministry with administrative and financial independence. The time required to establish a company was shortened and application procedures have been simplified. However, further improvement is necessary regarding the business environment, in particular as regards reducing red tape. Corporate governance principles are not fully implemented. Turkey has a SME strategy in line with the European Charter for Small Enterprises. A common SME definition for all Turkish institutions was introduced, and it is in line with the acquis communautaire.

Private companies are given widest legal and institutional safeguards and they comprise the most important component of the Turkish economy. The privatization is continuing slowly, particularly in the energy sector. The majority of privatizations, which have been carried out were consistent with the elementary market principles. The export sector is the locomotive of the Turkish economy and nearly 98% of the 500 most important exporting firms consist of private companies.

**10 | Welfare Regime**

In the field of social protection, the Parliament adopted legislation on social security reform in May and June 2006, providing for a complete overhaul of the Turkish social security system. This will be simplified and bureaucracy reduced, benefits-liabilities will be equal for everybody, free healthcare will be provided to all children below 18. The reform aims to ensure the long-term financial stability of the social security system and to regulate assistance to the poorest. Upgrading
of the administrative capacity of the newly established social security institution is ongoing. The inspection capacity of the social security system requires strengthening. The OECD reported recently that the new social security reform has significantly improved the long-run sustainability of the pension system. However, the pension system continues to serve as an important barrier to a more rapid expansion of the formal-sector economy in two ways. First, early-retirement incentives (including severance payments) continue to push many middle-aged workers into the informal sector. Second, even when the transition to the new pension rules is complete, net replacement rates will remain very high by OECD standards, requiring high social security contribution rates that make it too expensive for firms to employ low-skilled labor in the formal sector. Thus, further pension reform is one of the keys to overcoming Turkey’s economic duality. Finally, since the pension system does not cover the informal sector, it does little to alleviate poverty among the wider population of older people. A number of reforms that would increase the retirement age reduce inter-generational inequities, and permit a significant cut in the tax wedge on labor, while better addressing old-age poverty concerns at all levels of income, became the subject of discussions. Lately the Constitutional Court declared a part of the reform as unconstitutional and thus cancelled it. The commencement of the whole reform has been postponed due to a Presidential veto.

According to the annual report of the European Commission there are no developments in the field of anti-discrimination. Transposition of the EC directives concerning discrimination on grounds of racial or ethnic origin, religion or belief, disability, age and sexual orientation is incomplete. In particular the transposition of the non-employment aspects of the Racial Equality Directive needs to be addressed. An effective and independent “Equality Body” needs to be established to promote non-discrimination and equal treatment. As regards equal opportunities, further alignment is required in particular concerning parental leave, equal pay, and equal access to employment, burden of proof; as well as statutory and occupational social security. Furthermore, the Equality Body required by the aquis remains to be established. Participation of women in the labor force is at a very low level (under 25%), and the female employment rate has dropped to around 20%. The administrative capacity of the Directorate General for the Status of Women needs to be strengthened. Although a written regulation exists, the members of the religious minorities are practically excluded from becoming a civil servant or an army officer.

11 | Economic Performance

The strong recovery of the Turkish economy after the 2001 crises took place because of tight monetary and fiscal policies and structural reforms. The Turkish
economy with its almost $400 billion GDP is the 17th biggest economy of the world and the 6th biggest if compared to the 27 EU countries. The average growth rate of GDP between 2002-2006 was 7.5%. Exports rose yearly between 2002-2006 by 22.4%, and imports increased during this period by 23.6%. The annual inflation rate decreased from 29.7% in 2002 to a one digit 9.8% at the end of 2006. Net public debt to GDP has fallen from 92% in 2001 to under 60% in 2005 and to around 50 % at the end of 2006. Foreign direct investments (FDI) reached $9.6 billion in 2005 (more than the total value of the last 20 years) and $18.6 billion in November 2006. The current account deficit increased sharply to 6.3% of the GDP in 2005 and is estimated to be around 8% of the GDP in 2006, driven by strong domestic demand growth, higher oil prices and lower tourism earnings. However, Turkey can still easily finance its current account deficit. It has recently increased considerably its foreign currency reserves as a result of very high privatization revenues, including those that came from foreign investors. Average per capita income (in ppp, Euro) amounted to just over 25% of the EU-25 average in 2005. The strong IMF connection and the perspective to EU membership construct the main anchor for the Turkish economy.

12 | Sustainability

Turkey has not ratified the Kyoto Protocol, nor has it transposed the Emissions Trading Directive and related decisions of the European Union. According to the annual report of the European Commission some progress can be reported in the field of water quality and waste management capacity. With the adoption of the regulation on the protection of wildlife habitats, some progress was made in aligning with the EU law on nature protection. However, transposition, implementation and enforcement, remain very low. The level of alignment on noise remains advanced. As regards air quality legislation, some progress can be reported. No progress, however, can be reported in the area of industrial pollution control, risk management in the chemicals sector, genetically modified organisms, and in the area of forestry. Turkey has a well-developed administrative capacity, though implementation requires attention. Progress was made as regards the administrative capacity. Since 2006 the environmental law defines a clearer role for the Ministry of Environment and Forestry, as it allows for recruitment of additional staff, as well as for additional financial resources in the environment sector. The UN-Human Development Report 2006 points out that Turkey’s carbon dioxide emission is 0.9 % of the world total. Sustainable development needs to be introduced as a cross-cutting policy, particularly in energy, transport and agriculture policies.

Turkey’s biggest asset is its young and well-educated human resources. At the same time, Turkey is the leading country in Europe in sending students abroad for
higher education. All over the world it is the fifth in this field. This is expected to contribute considerably to enhance the human capacity not only of Turkey, but also of the whole region. The schooling rate in Turkey in 2005-2006 has reached 95.5% in the primary education, 85.1% in secondary and 30.5% in the field of higher education. The share of education in GDP rose to 4.1% in 2006. In the field of research and development, Turkey continued to be associated with the EU’s 6th Framework Program for Research and Technological Development (FP 6). Turkey takes part in the FP 7 as an associated member of the EU, and it also cooperates actively with the Joint Research Centre (direct actions). Turkey’s research policy resulted in significantly increased budgets for research and development: nearly fivefold compared to 2002 levels. Due to the European Commission’s monitoring improvements were also achieved in Turkey’s science and research capacities, including its gradually more successful participation in the FP 6. Turkey’s success rate under the FP6 improved and it is now about 17%. However, it is below the EU averages of about 20%. In terms of funding, Turkey was mostly successful in obtaining small projects. Taking into account actions that Turkey has taken with respect to the mobility of researchers, science and society and the 3% of GDP that are foreseen for science and technology action plan measures, Turkey is already well-integrated into the European Research Area. Involvement of the private sector and SME in research is very low and the number of scientists is below the EU average. Research is not sufficiently integrated in the education curricula.
Transformation Management

I. Level of Difficulty

There are only a few structural constraints on governance. The strength of the country is certainly its high level of economic development, a relatively young and well-educated labor force; the existence of a basic infrastructure, compared to the regional shortcomings in South-East and East Anatolia. Besides the difficulties to combine elements of a traditional society with modern orientations, there are also deficiencies in the administrative and legal system, as mentioned above. The start of the accession negotiations with the EU in October 2005 contributed massively to the maintenance of political and economic stability.

Turkey has a moderate tradition of civil society in comparison to other EU Member States. But since 1999, the lack of fundamental legal order in terms of civic and democratic institutions has been removed. The European Commission welcomes this improvement as it declared that “as concerns civil society organizations, the recent reform environment has led to positive developments. Civil society organizations have become relatively more vocal and better organized, especially since the adoption of the new Law on Associations.”

The heritage of the Ottoman Empire is significant in today’s society. It is obvious that Turkish society contains elements from every nationality of the Ottoman Empire. According to Article 66 of the Turkish Constitution, “everyone bound to the Turkish state through the bond of citizenship is a Turk”. That means Turkish nationality is based on a modern constitutional citizenship and not on ethnicity. Consequently, Turkishness refers to all citizens of Turkey. It considers that since all Turkish citizens have the same rights and benefits of citizenship, there is no such nomenclature as minority in Turkey, except for the three minorities recognized by the Treaty of Lausanne. The latter stipulates that minorities in Turkey consist exclusively of non-Muslim religious communities, and these recognized minorities are Jews, Armenians and Greeks. But there are ethnically different communities in Turkey which, in the light of the relevant international and European standards, are eager to qualify themselves as minorities. The conflict potential in the Turkish society has been described as
The two main determining factors of the recent socio-cultural behavior in Turkey are the two polarizations along the lines of nationalism and religion: One being Kurdish vs. Turkish nationalism, and the other being Islam vs. secularism. Moreover, it should also be pointed out that extreme Turkish nationalists and nationalistic Kemalists are at least as militant and aggressive as their counterparts and the answer to the question who agitates whom is by no means clear if one takes a longer historical perspective. Until recent reforms were undertaken, there were many legal restrictions on publishing in languages other than Turkish. Since 1999, minorities have the right to publish and diffuse media, such as newspapers or audiovisual channels, in their own languages and operate private courses that teach any language spoken in Turkey. Yet, Turkish is still the only official language that can be used in schools and universities. In conclusion, it is evident that ethnic, religious or social conflicts in Turkey do exist, but there are rather few official political attempts to reconcile them.

II. Management Performance

14 | Steering Capability

During the period under review, the government was determined to initiate and manage a reform process in the field of democracy and human rights in Turkey, which began in 1999. The political leaders have been rather effective in initiating reforms with the aim to improve democracy and human rights standards to the highest level attainable by aligning fully the Turkish legislation and implementation with the international and in particular the European Union norms. Undoubtedly, the requirements of EU harmonization play a crucial role in further accelerating the process and in the period of review the European Commission classified the reforms and improvements as compatible with the Copenhagen criteria.

The government seems to be eager to implement many of its reforms, but although the large proportion of Turkish society welcomes them, there is a certain resistance to change. According to the Eurling report from 2006, Turkey needs to give new impetus to the pace of political reform; full and effective implementation of the reforms is of utmost importance for Turkey to ensure the irreversibility and sustainability of the changes. Hence, concrete results are required. However, the government has in fact taken some important steps to ensure effective and full implementation: comprehensive joint projects in
conjunction with the Council of Europe and the European Union on human rights training for the security forces as well as the judiciary are under way; bilateral programs with several European countries have been initiated. Recently, a special monitoring group (Reform Monitoring Group) at the political level was established to overview the progress in the actual implementation of the reforms. The Group is chaired by the Deputy Prime Minister and the Minister of Foreign Affairs (who is also entrusted with the responsibility for human rights) and comprises the Minister of Justice and the Minister of the Interior. The Group convenes frequently to address the issues related to the implementation.

In Turkey, the political leadership holds the decision-making power in its hand and is somewhat unwilling to delegate this power. Due to this old-fashioned attitude the large number of the political elite shows little willingness and ability to learn. Accepting failures is the first condition of learning from that failure. Yet, in the area of relations with the EU, at least Prime Minister Erdogan, who has linked his political credibility with a successful EU entry process, demonstrated the ability of complex learning. He can act flexibly, and can replace failed policies with new ones.

15 | Resource Efficiency

The allocation of resources and the efficient use of them is one of the fundamental shortcomings of the public sector in Turkey. Particularly the personnel policy of the government could be illuminating in terms of the efficient use of human resources: The number of employees in the public sector reached 2,3 million in June 2006. Many of them have been employed although they are under qualified or have inadequate capabilities. The fact that political opinion plays an important role in the selection processes is generally shared by the public. An indicator of the existing inefficiency would be the 22 % share of the personnel expenditure in the state budget. Out of $127 billion of the total expenditure in the 2006 budget, $27 billion were spent for personnel. In the area of public administration there are some attempts or discussions on the modernization of the administrative capacity of the state, but a comprehensive reform, including decentralization is not planned yet. Regarding the efficient use of budget resources the deviation of planned expenditures from the actual expenditures stayed in 2005 and 2006 in the acceptable range. The two Maastricht criteria have been met in 2006. According to estimations the ratio of budget deficit to GDP will be around zero, and the ratio of total public debt to GDP will remain at around 50 %.

The one-party government has become the stability factor since 2002. The political leaders coordinate the central governmental issues in accordance with the local administrative issues. A harmonious performance at all levels of
management necessitates political stability. Though the governing party AKP has won most of the municipalities in the country at the latest local elections in 2004, the objectives or interests conflicts can be eliminated rapidly and the policy coordination works without major difficulties.

According to the 2006 progress report prepared by the European Commission on Turkey there has been some limited progress in the fight against corruption, notably on increasing transparency in the public administration. However, as mentioned further above, corruption remains widespread and anti-corruption authorities and policies are still weak. Concerning transparency in the public administration, the Law on Access to Information was amended in 2006 to enable citizens to dispute all decisions of state agencies regarding denials of requests for information. The parliamentary investigation commissions on the gasoline smuggling and on the illegal public offering completed their reports. Both reports show a wide range of corruption activities. The first case involved a former Minister of Finance and Minister of State, and has serious economic and financial implications. The reports included recommendations for measures to be taken by the public institutions. However, a number of issues remain to be addressed. Turkey needs to improve its legislation on financing and auditing of political parties. The wide scope of parliamentary immunity remains a significant problem in the context of corruption in Turkey. With regard to corruption investigations carried out by the Inspection Boards, the need for a prior authorization from the hierarchy when investigating some categories of public officials hampers the investigation. There is a need for better co-ordination of the system currently in place for combating corruption. The designation of a body with sufficient independence responsible for the conception and monitoring the implementation of anti-corruption measures could be helpful in this respect.

16 | Consensus-Building

All major actors in and out of the political life in Turkey agree on a market economy and democracy. It is not only a consensus on which the political actors agree, it is more the consequence of the modernization, westernization and finally EU-membership process in Turkey.

In principle, there are no anti-democratic veto powers to threaten the government. Yet, the National Security Council and the Armed Forces has exercised in the past, and may do so in the future, political influence on the Turkish political system.

The cleavages between religious, conservative, traditional and modern groups contain a potential of conflict that can escalate unless the government finally
resorts to appropriate measures. The government failed to mediate many conflicts effectively like the “headscarf” issue because of its involvement or biased manner. Furthermore, contrary to its conservative-religious base, it refrained from igniting and fuelling this issue every time it recognized the decisive resistance of the state establishment against any loosening of the strict legal situation in that respect. In terms of ethnic conflicts the government has tried to depolarize the conflict between Turkish and Kurdish groups as it has repeatedly emphasized the need for a political solution.

It is obvious that the political leadership considers the civil society as an integral part of a participatory democracy. Particularly the economic and professional interest associations and the media are assigned an imported role.

Undoubtedly, during the period under review the government has not managed to resolve the Armenian massacre/genocide issue, though it has shown a greater degree of readiness to resolve this issue than previous governments and the military.

17 | International Cooperation

The multi-dimensional character of Turkish foreign policy finds expression in and is best reflected by Turkey’s membership in a wide range of leading international and regional organizations, such as the United Nations, the Council of Europe, the North Atlantic Treaty Organization (NATO), the Organization for Economic Cooperation and Development (OECD), the Organization for Security and Cooperation in Europe (OSCE), the World Trade Organization (WTO), the Organization of the Islamic Conference (OIC), the Black Sea Economic Cooperation Organization (BSEC), the Economic Cooperation Organization (ECO), the Developing 8 (D-8), along with her candidature to membership in the EU as a country to have officially started the process of accession negotiations. Membership to the EU is a process, which has its roots back in late 1950s; it has been the main pillar of Turkish foreign policy. Turkey has recently begun to extend its economic ties beyond the more familiar terrain of the Balkans, the Middle East, the Caucasus and Central Asia. Turkey’s official vision for the 21st century is to achieve full integration with the European Union and to become a leading country in the region. Turkey also participates as a permanent observer in the activities of the Organization of American States, the Association of Caribbean States, and the African Union and seeks to establish similar institutional links with the Arab League and the Association of South East Asian Nations.

For the most part, the government is considered as a credible and reliable partner by the international community, though some are still suspicious of the AKP’s alleged “hidden agenda”.
The political leadership is willing to develop good neighborly relations. According to the Ministry of Foreign Affairs the primary objective of Turkish foreign policy is to help secure and nurture a peaceful, stable, prosperous and cooperative regional and international environment that is conducive to human development at home as well as in the neighboring countries and beyond. One major issue, however, remains the normalization of relations with Armenia; the second major issue is the stability of its borders with Northern Iraq in view of a rising number of incursions of extremist Kurds based in Iraq.
Strategic Outlook

In 1999 the European Union declared Turkey for the first time as a candidate country and eligible for accession. Since then the goal of EU accession has been, even more than before, the major motivating force for the transformation in the country. The accession partnership, adopted in 2001, provides Turkey with a roadmap to bring about democracy, rule of law, human rights, and respect for and protection of minorities. Turkey fulfilled the Copenhagen criteria by December 2004 as the Commission reported. Fulfillment of these criteria is a prerequisite for EU membership and the EU started membership negotiations officially on 3 October 2005.

There is still a broad consensus in society with respect to the political reform course; however pro-European reformers in Turkey are weakened internally due to the lack of credibility of EU policies towards Turkey. Some EU member states, particularly those with a conservative/Christian Democratic government, frequently indicated their reluctance to accept Turkey as a full member irrespective of its compliance with the Copenhagen criteria. Religion, geography, demography, economic development as well as the legitimate concerns over democracy and human rights were cited as the impeding factors to Turkey’s EU membership. Clearly, to transform these resentments remain one of the major challenges of any Turkish government for the next years to come.

Economically speaking the recent positive economic developments are creating serious and highly promising business opportunities for local and multinational companies. The FDI inflow in 2005 ($9.6 billion) and in 2006 (estimated at $19 billion) is clear evidence of such a trend. Tight fiscal and monetary policies and structural reforms became the main anchor of the stability and growth policies in the country and should not be deviated. The labor market has recently started to improve, but needs to gain more momentum.

Although the strength of the domestic economy, higher oil prices, a strengthened Turkish Lira and increased substitution between domestically produced raw materials and imported goods caused a current account deficit of 6.3% of GDP in 2005, the extreme income disparities between rural and urban regions, particularly in the east and southeast regions of the country are and will remain for some time an ongoing source of social problems. Finally, the major test of time will be whether the system has reached a solid degree of sustainability and will continue to make further progress on its path to truly comply with the democratic rules of the game. Although the military during the
period under review has refrained itself from major interventions, it has made its continuously powerful voice heard and may feel tempted to intervene once the AKP government crosses certain red lines. Hand in hand with the challenge of creating a consolidated European democracy goes the question whether Turkish nationalism, which has been dramatically on the rise lately, can be transformed into pro-European reform-mindedness. Also, it remains to be seen which repercussions a potential “no” vote by the European Council may have on the Turkish domestic scene.