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Who's afraid of the Current Account Deficit?

Güven Sak

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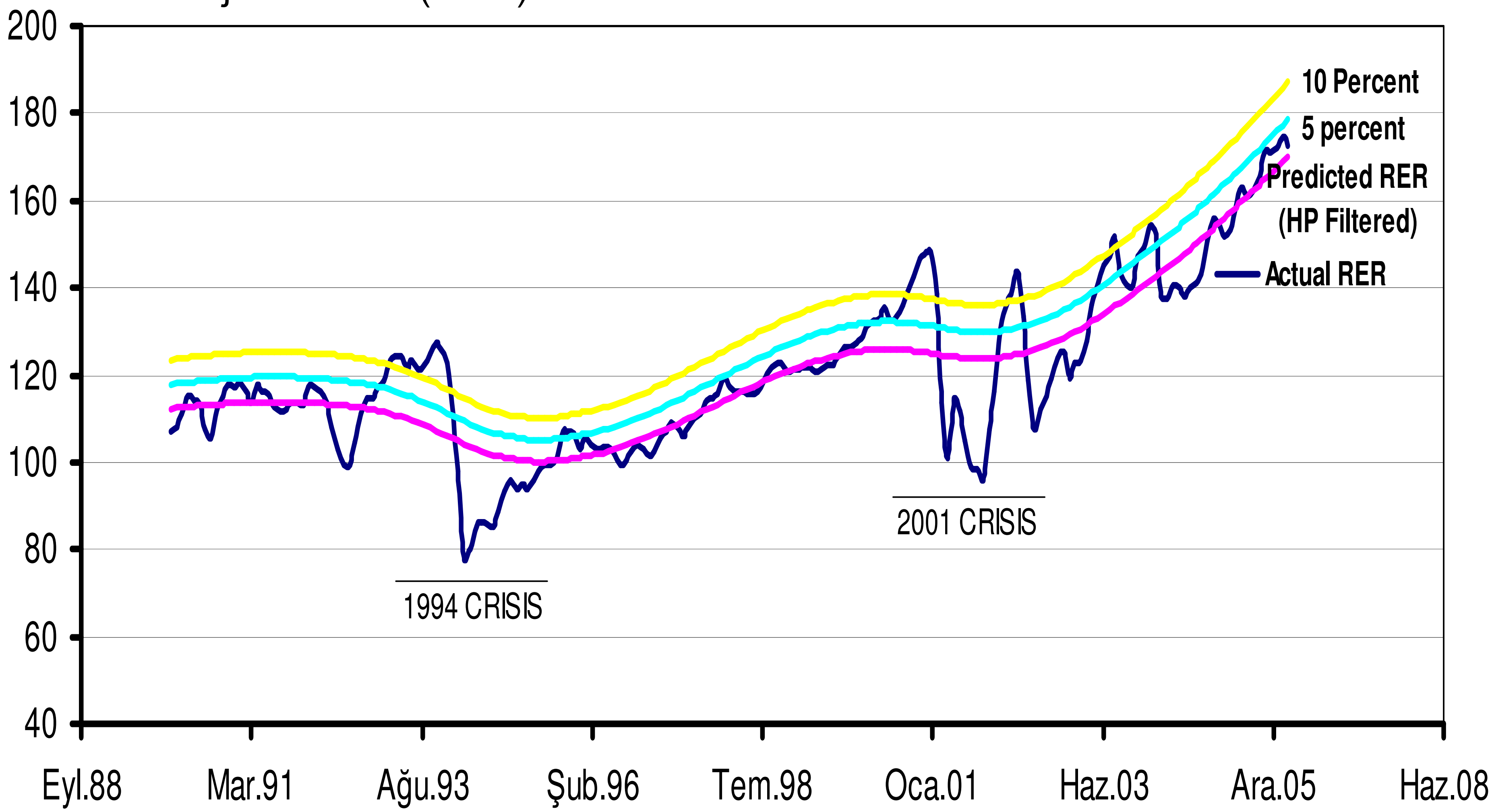
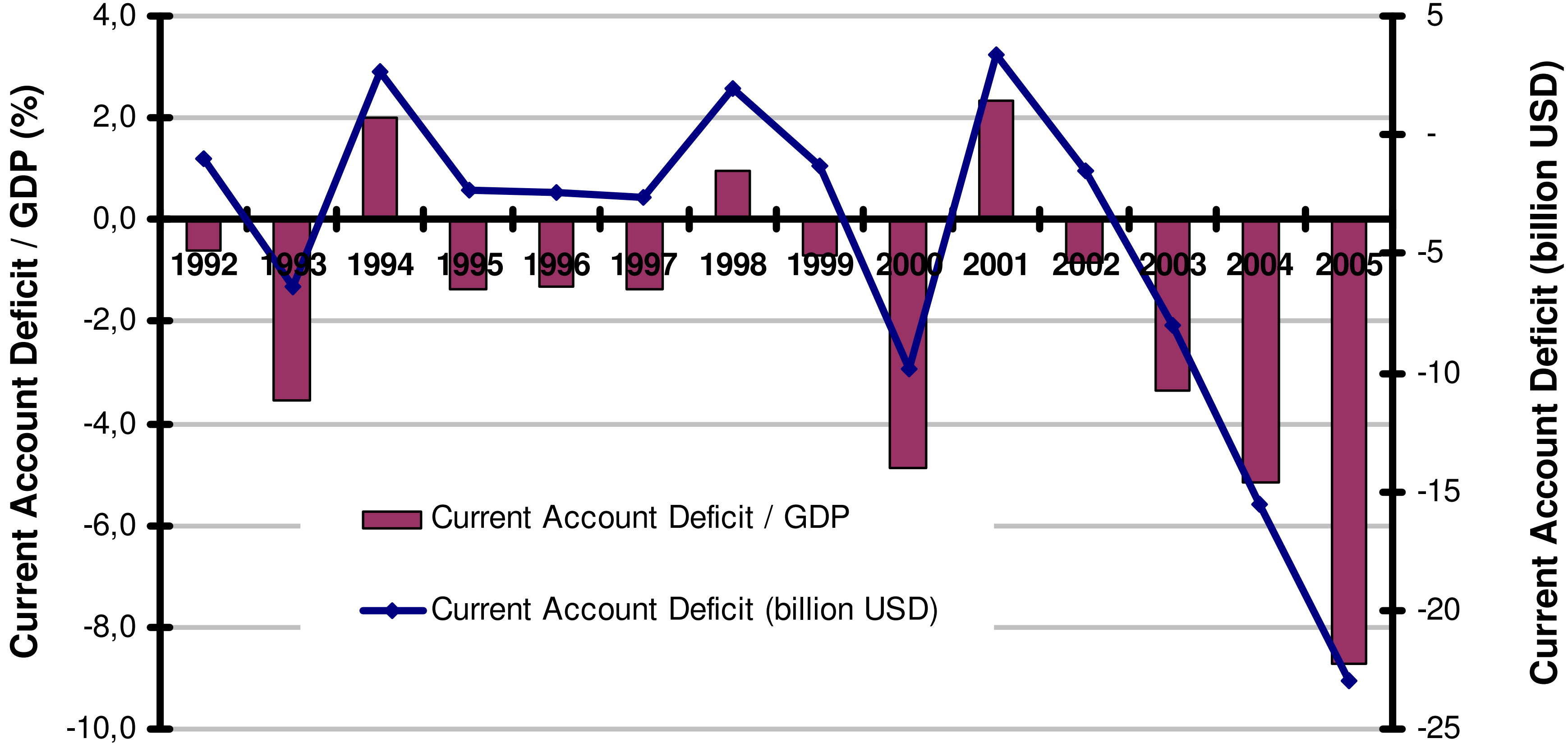
- Prof Mundell’s words of wisdom
  - → Policy consistency
  - → exchange rate shall never be neglected
  - → fund inflows and the appreciation of the currency are a price to be paid for having a consistent and coherent policy framework (curse?)

Real Appreciation of Lira

A la Goldfajn & Valdes(1999)



Current Account: scary levels?



Let’s complement Prof Mundell’s picture

- The business environment and the incentive structure has changed dramatically
- Floating exchange rate as a sweeping mechanism?
  - → As a mechanism to braek the inertia.
  - → as an igniting mechanism for creative destruction?
- The current account deficit seems to have a structural component as well as an external one (i.e. China)

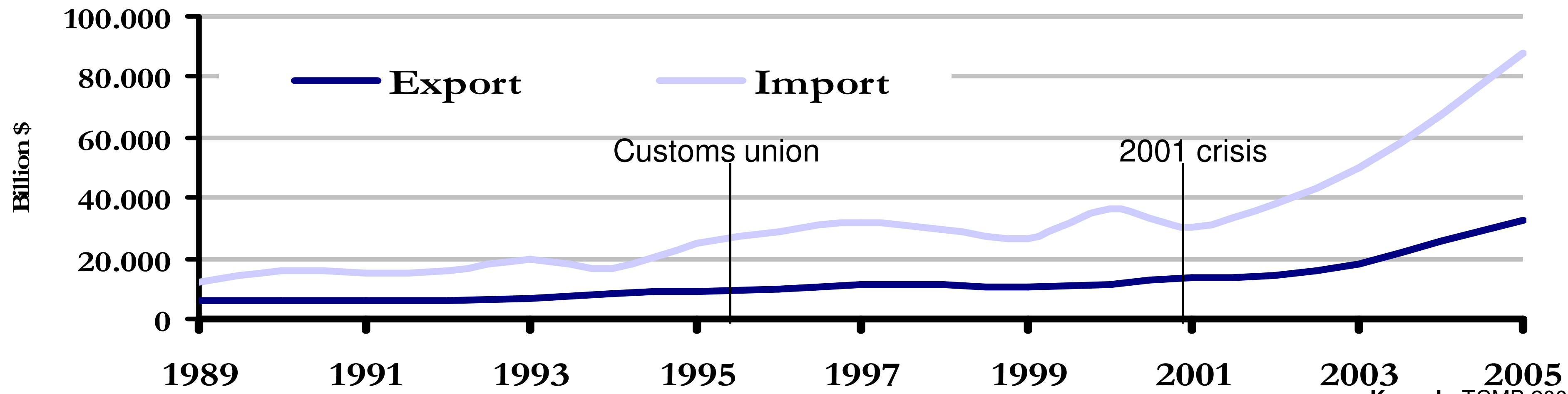
Dramatic changes in the incentive structure

- Existence of fiscal discipline
- Central bank independence and floating exchange rate regime
- A series of public sector reforms
- Banking sector reform
- Results and Outcomes:
  - ➔ Impressive growth without inflation
  - ➔ Rising Productivity as the driver of growth
  - ➔ Unemployment rate does not decrease.
  - ➔ Move from implicit to formal inflation targeting
  - ➔ Currency appreciates
  - ➔ Current account continues to deteriorate

Trade Integration: booming after 2001

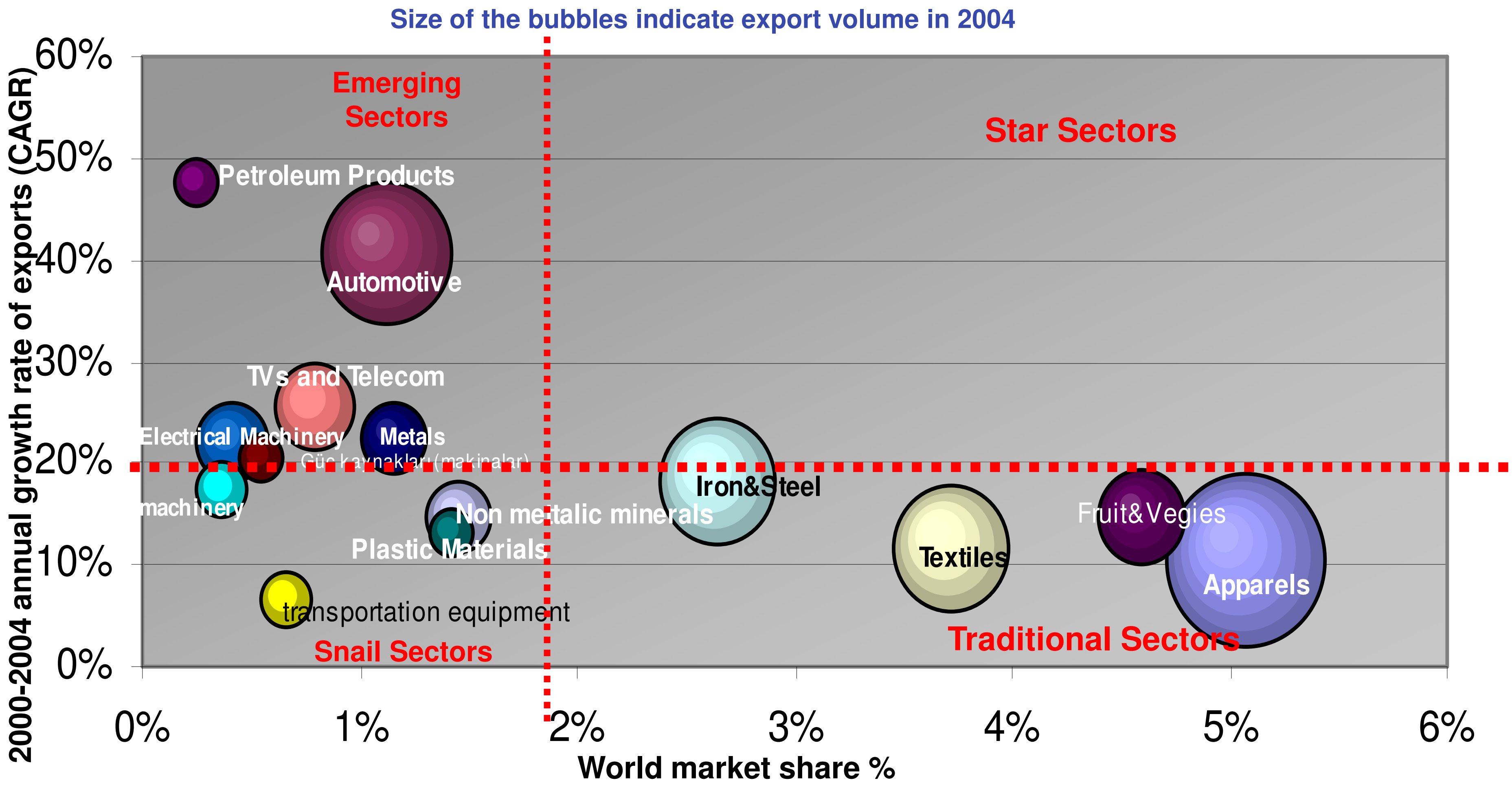
- Growth rate of trade volume
  - ➔ 1989-2001: %8.5
  - ➔ 2002-2005: %29
- Increase in import of intermediate inputs
  - ➔ 1989-2001: %8
  - ➔ 2002-2005: %33
- Turkey in global economy
  - ➔ increasing trade of goods and services
  - ➔ increasing foreign direct investment
  - ➔ change in the sectoral composition in exports

Import and Export of Intermediate Inputs, 1989-2005, billion $



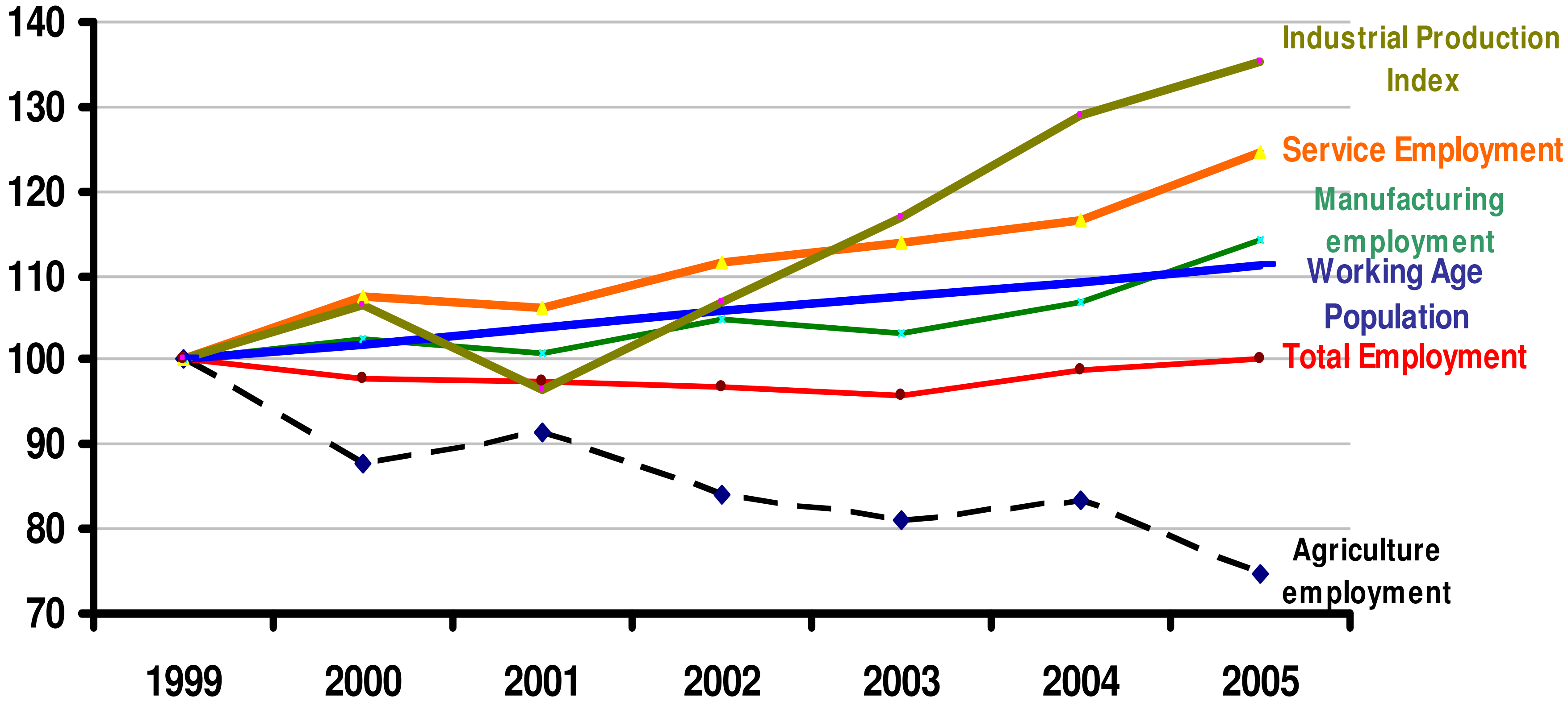
Kaynak: TCMB 2005

Loss of competitiveness?



Structural change is also reflected in employment figures

Sectoral Employment and Demographic Trends, 1999-2005, 1999 indexed to 100



Source: TÜİK and WDI

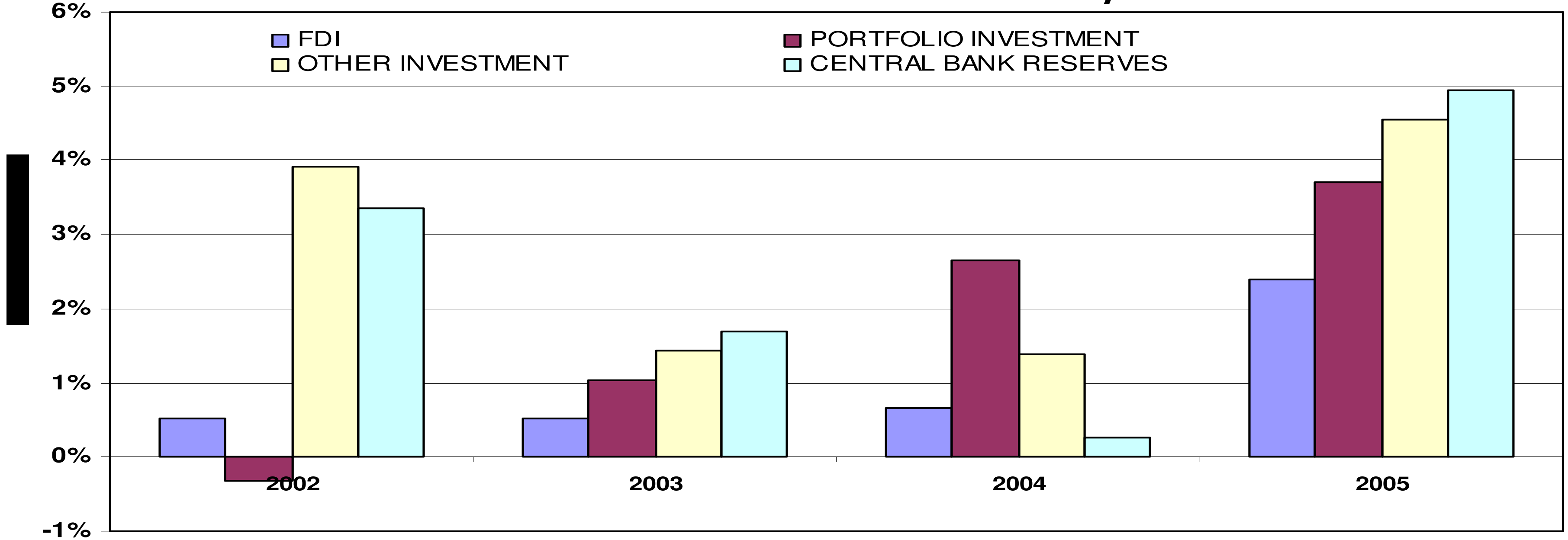
EU Accession and Current Account

- Financial and goods market integration leads to
  - → Reduction in country risk,
  - → decrease in interest rates,
  - → decrease in savings,
  - → increase in investments,
  - → current account deterioration, are the common features observed in the relatively poor accession countries.

Blanchard & Giavazzi (2001)

Financial integration: composition of current account financing

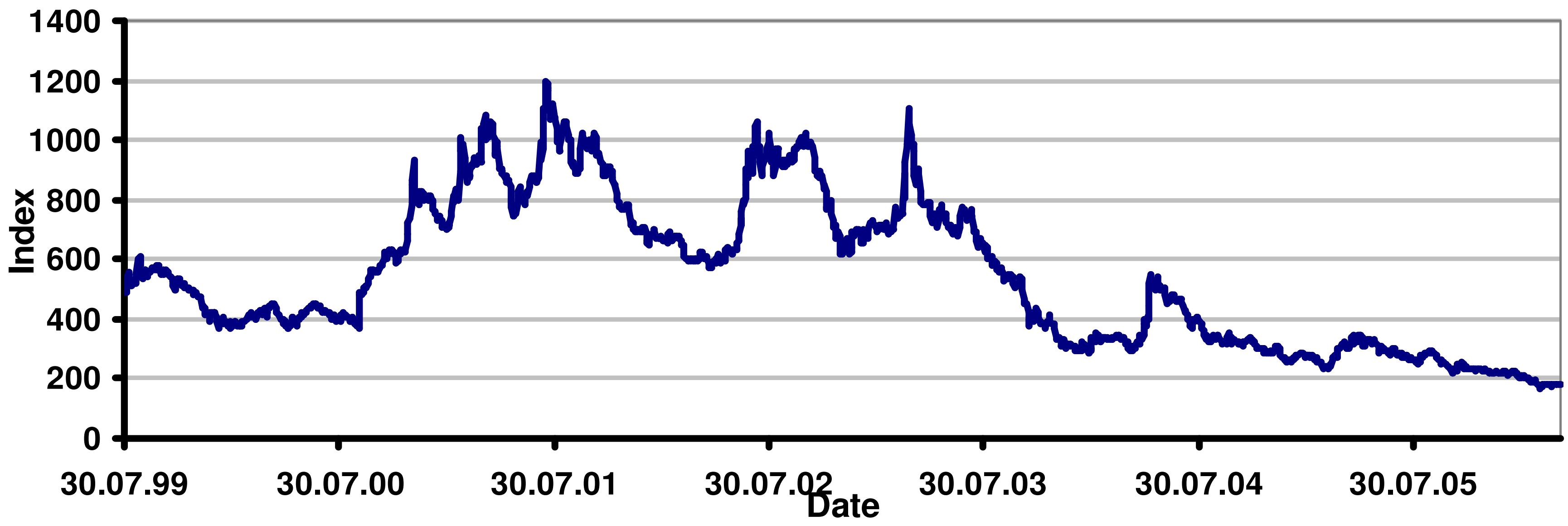
- FDI inflows increase as a result of global value chain integration
  - ➔ trade credits will increase more as a by-product
- Portfolio investments increase (ISE)
- Central bank reserves increase consistently



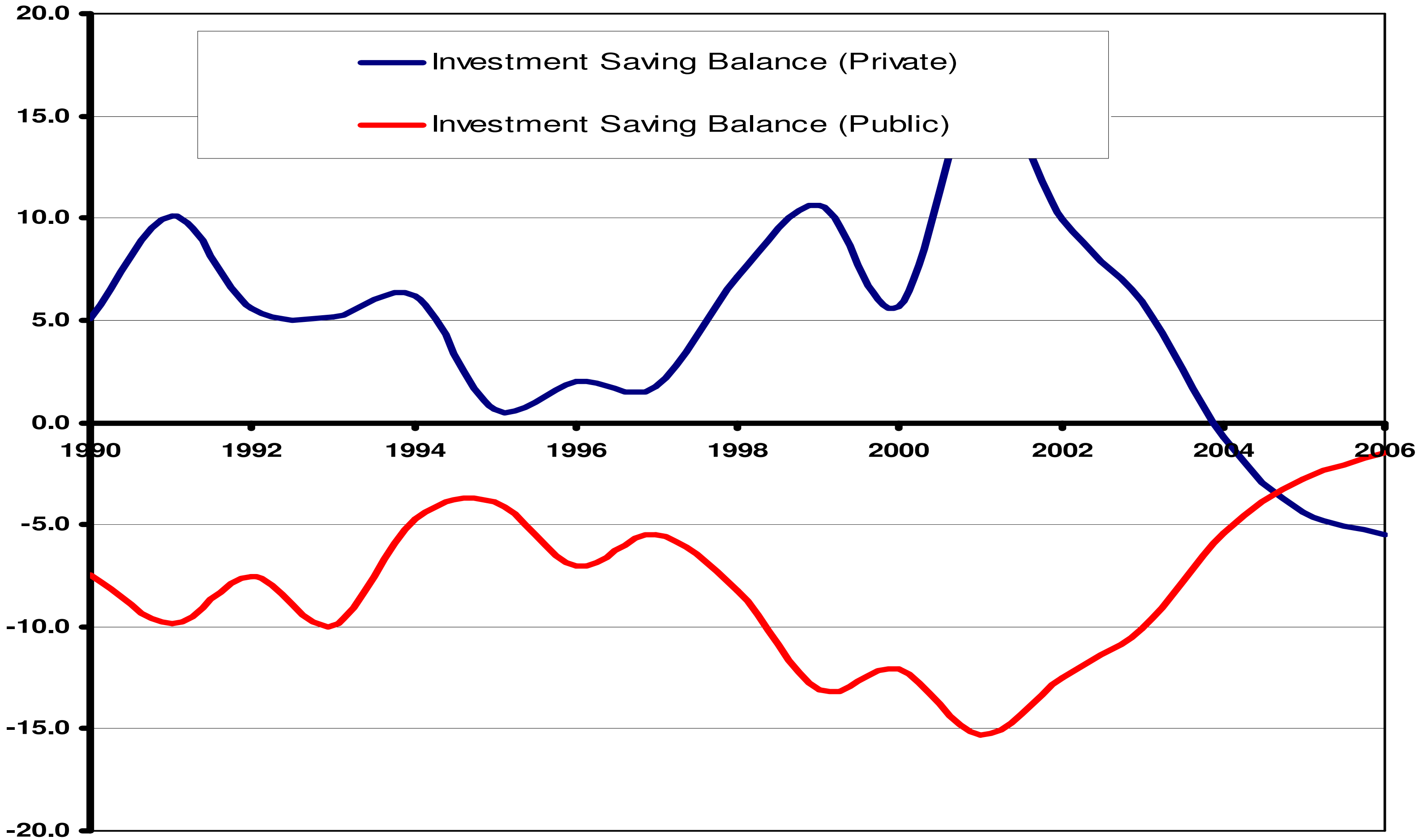
Case of Turkey

- Spread decrease
- Saving investment gap widens
- Increase in current account deficit is mainly due to increase in investment
- Increase importance of fiscal discipline. Private (S-I) decrease and public (S-I) increases

EMBI+ Turkey Government Bond Spread



A different sort of a saving investment gap



To sum up

- Low level of domestic savings and low level of financial integration could only raise the importance of policy consistency
- Rapid modernization of the Turkish economy & the accompanying risks
  - → mitigates through productivity gains
  - → exacerbates through sectoral transformation
  - → unemployment, creative destruction and policy consistency risk

Some questions…

- How can you ignore high levels of deficits with still low levels of financial integration?
- How can you manage the animal instincts of the portfolio managers if the adjustment is not complete?
- Is the appreciated exchange rate a strong driver of the sectoral transformation process?
- Is there a role for Industrial policy to guide sectoral transformation process?
- Could the importance of the EU as an anchor be ignored?