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Turkey Boom Most Since Ataturk Lets Erdogan Take Up Masterpiece  
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By Emre Peker and Steve Bryant

Aug. 24 (Bloomberg) -- At the height of his power in a country he has transformed, Turkish Prime Minister Recep Tayyip Erdogan is positioned for the first time as an anchor of stability and economic growth both in Europe and the Middle East.

Erdogan's brand of moderate Islamist politics -- his Justice and Development Party, or AKP, calls it "conservative democracy" -- has won admirers across the region, Bloomberg Markets magazine reports in its October issue.

From the North Sea to the Persian Gulf, they watched as Erdogan, first elected in 2003, turned a nation addicted to unstable coalition governments into one whose political system is seen as a potential model by the Arab spring countries of North Africa and the Middle East.

Under Erdogan, the Turkish economy has posted achievements that are the envy of its neighbors. In the first quarter of the year, gross domestic product expanded by 11 percent on an annualized basis, faster than in China or any other developed economy.

That followed an 8.9 percent expansion in 2010 as Turkey bounced back from the global financial crisis. The performance of the \$740 billion economy, the world's 16th largest, has been "magnificent," Erdogan, 57, told party members three weeks after the June 12 election in which the AKP won 327 of the 550 seats in the Grand National Assembly.

The size of the expansion under Erdogan is the biggest in the history of the republic, founded in 1923 by Mustafa Kemal Ataturk following fighting after the collapse of the Ottoman Empire.

#### A Few Obstacles

"God willing, we'll keep up the momentum and reach our goal of a \$2 trillion economy by 2023," he said.

The prime minister's optimism overlooks a few obstacles standing in the way of smooth progress.

First, Erdogan's final term started with an unprecedented legislative boycott in which 169 opposition deputies refused to take their oath of office in parliament.

They did so to protest decisions by judicial and electoral authorities that barred some deputies-elect from taking their places in the national assembly on grounds of previous convictions or trials under way for alleged links to terrorism or plots to overthrow the government.

Even after the main opposition bloc, the Republican People's Party, or CHP, relented and joined the legislature, 35 pro-Kurd lawmakers continued the boycott.

Second, with a current account deficit of about 10 percent as of June, the Turkish economy risks falling more out of balance as weak spots elsewhere, especially in Europe, hurt Turkish exporters and as prosperity-fueled domestic demand for imports continues to rise.

## A Secular State

Third, tensions have flared up between the military, which has traditionally seen itself as the guardian of a secular state, and those who advocate freedom of religious expression, including the AKP.

The chief of Turkey's armed forces, General Isik Kosaner, together with the heads of the navy, army and air force, resigned in July in protest over the arrests of dozens of generals as suspects in an alleged plot to overthrow the government.

Finally, Turkey's bid for European Union membership looks further away than at any point in recent years; weighing against Turkey are local politics in Germany, France and other EU member states, not to mention the thorny issue of Cyprus.

The island republic, an EU member, is effectively partitioned, with Turkish Cypriots controlling the smaller, northern region and Greek Cypriots dominant elsewhere.

## Grand Plans

Erdogan's response to these scattered signs of adversity is typical: to plow ahead with grand plans for a new constitution to replace the one written after a military coup in 1980. Hoping to build a consensus in parliament and overcome the boycott, the prime minister has argued for a document that would widen civil liberties and express them in language that's simple and easily understood.

The existing charter puts protecting the state and public order above the rights of individual citizens, according to the AKP. The constitution is riddled with "buts and however," Erdogan said in July. "We want a shorter, more concise constitution that everyone can call their own," he said.

Erdogan was a member of an Islamist party that was shut down by the Constitutional Court in 1998 for allegedly breaching the constitution's secular provisions. He served four months in jail in 1999 after being convicted of having incited religious hatred by reading an Islamic poem at a rally in the southeast of the country.

## Step Toward Peace

In 2001, his response was to establish the AKP, which rejected the Islamist label. In 2008, he won a legal battle against judges who tried to outlaw the AKP as a threat to the state's secularist system.

Erdogan and his supporters say a new constitution could be a step toward peace in the mainly Kurdish southeast corner of Turkey, where an armed insurgency has resulted in 40,000 deaths since 1984.

Kurds say the current charter marginalizes their culture by establishing Turkish as the official national language and making it illegal to express views that threaten the state's "indivisible integrity."

The EU has stipulated changes in the current constitution, including greater protections of civil liberties, as a prerequisite to Turkey being granted membership. Turkey has long sought to deepen its ties to the EU, its largest trading partner.

## Rolling Crisis

It applied for full EU membership in 1987. Formal accession talks began in 2005. Turkey's bid is now faltering in the face of rising nationalist sentiment in Europe.

What's more, Erdogan said in July that Turkey's relations with the EU "will be completely frozen" if Cyprus assumes the rotating EU presidency. Cyprus is set to do that in the second half of 2012, before a deal reunifying the ethnically split island is reached. Erdogan has said he favors a federal solution in which the two nationalities can coexist.

The Cyprus question may be a moot point. The EU is in the middle of a rolling crisis that threatens the euro and calls into question the relevance of the EU.

"We are getting to a stage where you can see a reappraisal of the whole relationship," says James Ker-Lindsay, a fellow and EU specialist at the London School of Economics. "At some point, there will need to be a proper sit-down to decide where this is going and what does Turkey ultimately want. Maybe Turkey is just getting to the point of saying, 'We don't want to join the European Union.' Frankly, if you look at the mess that the EU is in at the moment, it doesn't look that alluring."

#### Slide Into Recession

Europe's sovereign-debt crisis now threatens Erdogan's economic successes. The economy was already in urgent need of cooling or the twin goals of price and financial stability would be threatened, said Melissa Ball, an economist at Lombard Street Research in London, in a report published on July 29. On Aug. 4, with the prices of Italian and Spanish debt tumbling, the Turkish central bank said the economy risked a slide into recession.

In June, the cumulative 12-month current-account deficit had more than doubled from a year earlier to \$72.5 billion, the biggest gap since monthly records began in 1984, according to the central bank. The likely slowdown ahead, combined with falling oil prices, will bring about a "rapid and sizable" improvement in the trade gap, the central bank said.

The bank kept the benchmark one-week repo rate (the discount rate at which a central bank repurchases government securities from the commercial banks) at 6.25 percent from Jan. 1 to Aug. 4, when it cut the rate to 5.75 percent, an all-time low in the 88-year history of the Turkish republic.

#### Fresh Downturn

In keeping interest rates below the rate of consumer inflation, which stood at 6.3 percent in July, central bank governor Erdem Basci's objective is to keep the domestic economy healthy while the developed world enters a fresh downturn. To keep the local market in check, he's hitting the forces he believes are fueling growth: the country's lenders.

Basci has more than doubled the amount of money that banks are required to set aside as reserves, reducing the pool of cash available to lend to local consumers and businesses.

Even though the strategy is likely to reduce bank profits this year by as much as 20 percent, according to the Banks Association of Turkey, it hasn't yet slowed growth. "In the end, interest rates are too low for a country like Turkey," says Lutz Roehmeyer, who helps manage about \$17 billion at Landesbank Berlin Investment GmbH.

## Another Notch

The Turkish economy should not be viewed in isolation from Turkish society, says Vassilis Karatzas, managing director of Levant Partners Greece SA, an Athens-based hedge fund that has invested \$125 million in Turkey and the Middle East.

"You can't have a country progress economically as far as Turkey has without having the institutional structures keep up the pace," Karatzas says. "Ideally, it would be through a process of consensus, but the chances of that seem slim. The society is still polarized."

Under those circumstances, if Erdogan can achieve a broad parliamentary support for a new constitution, he'll add another notch to his list of achievements. He has presided over the strongest economic expansion of any Turkish leader since the republic's founding.

During his eight years in power, \$94 billion in foreign investment has flowed into Turkey, an increase of more than 10-fold from the previous decade, according to Turkish Treasury data.

## Erdogan's 'Masterpiece'

In the eyes of his admirers, Erdogan has also won acceptance for Turkey as a candidate for EU membership, reined in the military's influence in politics and bolstered civilian control of the government. When he campaigned for his third term, Erdogan called the first two terms his "apprenticeship."

The third, he says with characteristic immodesty, will be his "masterpiece."

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