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Emerging markets' currencies are crashing, and their central banks are busy tightening policy. Who is to blame for this?



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Turkey failed to escape the middle-income trap from a failure to effectively manage the global integration process

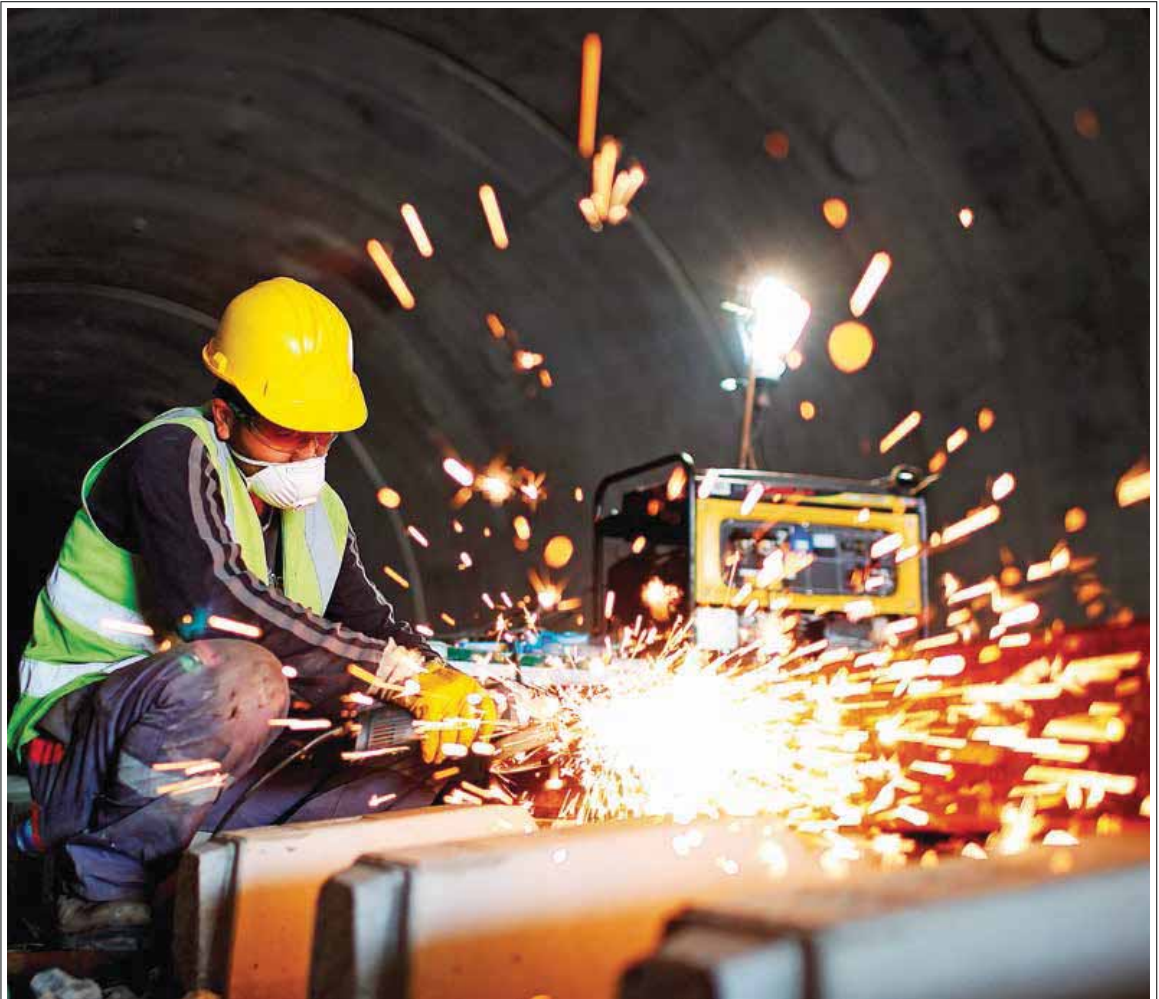
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TODAY'S ZAMAN SPECIAL SUPPLEMENT FOR IFS'13

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PHOTO □ TODAY'S ZAMAN, MEHMET ALI POYRAZ



IS TURKEY BACK ON TRACK?

For Turkey, which has attained a continuous expansion of GDP for nearly four years, financing further growth under new liquidity conditions is a question that remains unanswered

▶ The Turkish economy grew 4.4 percent in the second quarter of this year, easing concerns of deceleration amid a persistent global economic crisis. The latest numbers, announced by the Turkish Statistics Institute (TurkStat) last week, mean that Turkey has achieved 15 quarters of uninterrupted growth, enough to make a number of eurozone countries jealous.

The higher-than-expected second quarter growth in gross domestic product (GDP) is an outstanding success,

especially given the overall poor conditions in the global economy. But considering the dynamics of this growth, some economists are still unconvinced that the performance of the Turkish economy has the hallmarks of sustainability. Many others, however, believe that Turkey's economic revival will continue. A July 2013 report by accounting firm Ernst and Young, for instance, suggests that Turkey's sustainable growth will be outstanding among emerging countries. **BY İBRAHİM TÜRKMEN** CONTINUED ON PAGE 08

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The heart of global finance beats in İstanbul

Since it erupted five years ago, the global economic crisis has been among the top agenda items at any major finance event. First, economists spent months discussing what factors triggered this fallout and then they started deliberations over ways to thwart the worst of it and possible solutions to overcome it. Then, the attentions turned to austerity measures and to sturdy armors donned by particular countries to save themselves from contamination. The US Federal Reserve's (Fed) actions to stimulate its economy relieved global trade to a considerable extent and worked like a healing potion. Today, as the Fed is poised to slowly halt feeding the markets with liquidity, economists are anxiously waiting on the edge of their seats to see if this quantitative easing was really a curative or just a painkiller.

İstanbul Finance Summit's (IFS) meeting this year coincided with this critical tipping point of the financial crisis. It will deal with the role of finance in sustainable growth in particular, without neglecting the bigger picture.

With an objective to make İstanbul a respectable center in finance, the IFS has grown as an important platform for discussions in understanding the global financial conditions amid the crisis. The IFS has marked İstanbul's rising significance in the financial world, with particular emphasis on the Turkish government's strategy to make it a financial hub in the region and the world, an alternative to Davos.

In its first convention in 2010, the IFS brought together more than 100 prominent figures in finance, including government and nongovernmental institutions, bankers, private sector pioneers, international institutions and academics, from 20 countries. In 2011, its main agenda was the path to a global recovery, looking primarily at the experiences of different countries. In 2012, it convened with a theme of "finance in a fragile world." This year, it is gathering around 1,000 participants from 27 nations.

Today's Zaman wishes success for the IFS, which is taking firm steps toward its aim of becoming a respectable platform of financial discussions as İstanbul gradually gains a more important stronghold in its region's finance market.

İbrahim Türkmen

Fourth IFS meeting discusses finance for sustained growth

As the İstanbul Finance Summit convenes for the fourth consecutive year, the realm of global finance remains one of anxieties, hopes and opportunities.

With the Federal Reserve preparing to adopt a normalized monetary policy, other parts of the world, especially emerging economies, are feeling pressure to adapt to the new environment. The adjustment process has begun sharply and painfully with changes to stock exchanges and currencies.

However, the Fed's policies are not the only determinant of the new environment. Japan is experimenting with Abenomics, which is not quite parallel to the Fed's course of action. Europe, on the other hand, has continuing issues with certain sovereigns and a generally ailing economy.

Political problems, such as the recent reversal of democratization in Egypt and the ongoing internal conflict in Syria, with the loss of many innocent lives, are not helping the already jittery markets.

The immediate financial picture is thus uncertain, even worrisome. Consequently, policy makers, bankers and corporations are facing these short-term challenges with anxiety. They must navigate their ships through stormy and shallow waters while preparing for the future.

In line with its tradition, this year the İstanbul Finance Summit will take on the full spectrum of global financial issues; discussions will cover short-term policy responses, including those by central banks, commercial banks and capital market professionals, as well as medium-term issues such as development finance and prospects for financial centers.

It will be a demanding but exciting two days in İstanbul. In the last few years, the İstanbul Finance Summit has nurtured a tradition of convening bankers, regulators, central bankers, corporations and capital market professionals under one roof. It is all of these that make the Summit a unique financial platform.

We are looking forward to hosting some of the major figures of global finance and economics in a fine İstanbul event.

Murat Yülek



For emerging economies, the current situation is a new way of economic development. But it is also a new deal for them.

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A recent report by NIC suggests that no single superpower will prevail by 2030. Global power will be shared by information networks.

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SUSTAINABLE GROWTH, FINANCE AND THE MIDDLE INCOME TRAP IN TURKEY

Despite the fact that five years have passed since the outbreak of the global economic crisis in the last quarter of 2008, we are still experiencing and discussing different aspects of its persistently negative repercussions, such as stagnating economies in the developed world, weak growth in developing countries, chronic unemployment, a fragile global financial structure and a loss of fiscal discipline in developed countries and recently in emerging market economies as well.

What is the position of Turkey in this context? It is obvious that within the current interdependent global economy, in terms of production, consumption, trade, finance and logistics, it is difficult for a single country to decide and affect its destiny on an individual basis, that is to say, independent of the world. However, we can still discuss and evaluate the nature and quality of this dependency, which brings positive returns just as much as it brings vulnerabilities and frailties to many countries.

The empirical evidence suggests that the positive and negative effects of globalization are not evenly distributed as, *ceteris paribus*, it is predicated upon the ability of countries to effectively react to its processes. For instance, depending on their capacity to adapt during an expansion or boom of the global economy, developing countries such as Turkey may try to assimilate and internalize positive elements of the environment to attain a path of sustainable development, through the mobilization of domestic resources such as human capital, savings, organizational capability and so on.

In contrast with the boom period, however, during periods of contraction or bust, countries will try to sidestep the negative effects of crises, as we are witnessing now. It is quite realistic to expect that the extent of their globalization during boom periods will determine how effectively they can decouple from

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the ebbs of a negative global phenomenon.

The first observation that should be made at this stage is that the global economy is expected to normalize and revitalize without any major changes in the basic architecture that has been in place since the early 1980s. This suggests that the sources of expected recovery will come not from new rules of the game, new organizational adjustments and regulatory frameworks, but from an unfair redistribution of income and global assets in favor of the most powerful lobbying sector, which is clearly the financial industry.

For instance, the recent "normalization" in the US economy has come through the conversion of huge private debts into public debts, the loss of millions of jobs and excessive monetization of the economy through a record level of quantitative easing. All these measures resulted in asset repricing, asset transfers across different segments of the society and thus a redistribution of wealth. Now it is time to reverse the situation so that the conventional game repeats itself again.

Within this context, Turkey has three major aims: To keep growth at an acceptable level, to lessen the ever-rising current account deficit and to stop inflation, which is still resisting control. For this, total-factor productivity (TFP) must be fostered, overall competitiveness should be improved and reliable sources of finance to help the long-term target of economic transformation need to be ensured by both local and external resources.

Although Turkey has taken several steps to reform the economy after the domestic crisis of 2001, we cannot argue that Turkey has taken convincing steps to change its path for long-term growth so that the level of potential growth rises in a sustained manner. It is true that the country has achieved relatively good economic performance in parallel with certain structural reforms and greater political stability, the EU membership bid and the stimulus of the expanding global economy. However, this performance sent the false message that Turkey had broken the vicious cycle of its previous economic regime and that growth would continue on a steady path.

However, recent developments in the post-crisis era have revealed that the Turkish economy's transition is incomplete, inconsistent and far from being a full-fledged restructuring. To give some insightful analysis, from the early 1970s until today, Turkey's potential growth level has been fluctuating at an average level of around 5 percent, measuring by five-year periods. From 2002-2006, average growth was recorded at close to 7 percent. Parallel to negative developments in the external environment, with the exception of a high but obviously unsustainable growth performance between 2010-2011, Turkey's growth performance decreased below 4 percent, so that a decade of average growth has conformed with the historical pattern of 5 percent.

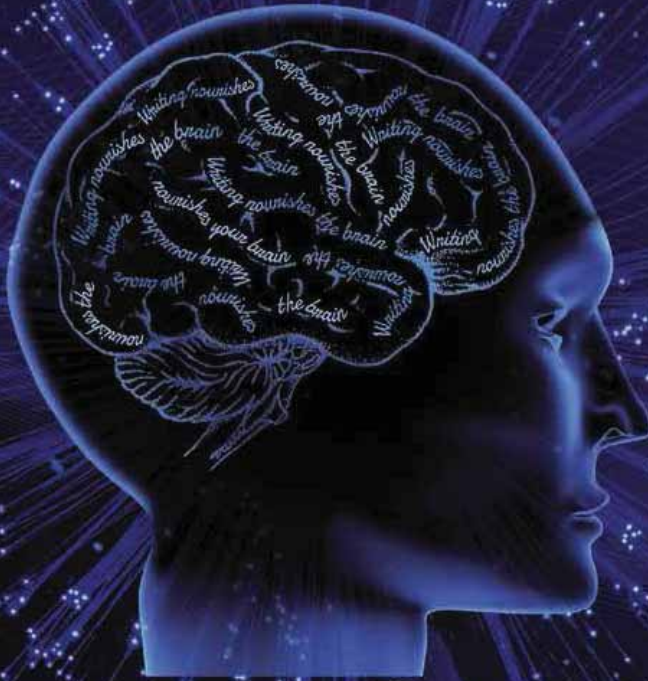
As a result, with the exception of South Korea and previously Japan, like several other developing countries of earlier times, today Turkey failed to escape the middle-income trap from a failure to effectively manage the global integration process with a comprehensive industrialization strategy, high-quality education reform and a financial sector strategy combining the elements of fostering national savings and channeling financial resources to long-term dynamic and developing modern industries.



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BACK ON TRACK?

CONTINUED FROM PAGE 1

The report predicts that the economy will continue to pick up speed in the medium term. In "Rapid Growth Markets," Ernst and Young says that the Turkish economy will outpace its counterparts in Europe, the Middle East and Africa with an annual GDP growth rate of 5.4 percent in 2014.

Despite concerns over fallout from geographical tensions -- particularly the Syrian civil war -- and some internal political disputes, the report said, the Turkish economy has strong potential to sustain its growth. The easing of crisis conditions in major European countries will boost Turkish trade with Europe, and Turkey will be among the few emerging nations that continue to attract foreign direct investment, according to the report.

So is Turkey back on the open highway of fast-paced growth, or has it been arbitrarily hitting the gas on a bumpy back road? And more importantly -- is the engine of Turkey's economy capable of such speeds? Can it upshift smoothly into high gear, without shaking and jerking, and keep it up? If the answer is yes, here's another question: Is it properly built for safe travel at high speeds? All these questions boil down to a single question: To what extent is Turkey's enviable growth rate sustainable?

Sustainability means the ability of an economy to overcome persistent imbalances that impede long-term growth. Naturally, this ability varies depending on the geographical and sociopolitical conditions of a country, as well as what economists like to call "initial conditions," i.e., the country's level of development, infrastructure, business culture, natural and national assets, etc.

In his famous 1996 empirical field study "Deter-

minants of Economic Growth," which involved 100 countries, Robert Barro found that growth is positively correlated to education levels and life expectancies in a society, as well as to improvement in savings, economic openness, financial system development, capital formation, foreign direct investment and real interest rates.

On the other hand, the study found that economic growth is negatively correlated with a higher level of GDP per capita as well as increasing government consumption, inflation, budget deficits, fertility, population growth, unemployment and current account deficits.

Barro's study, which was later supported by scores of others, clearly lays out the conditions of sustainable growth. In a nutshell, a nation must have sufficient infrastructure, the first condition for achieving unwavering long-term growth. The second most important qualification is a sound level of savings capable of fueling economic growth. So analyzing whether Turkey meets these basic conditions should help us understand its ability to achieve sustainable growth.

Looking at Turkey's growth rates at periodic intervals over the last 25 years provides insight about the country's long-term performance. Turkey's average GDP growth rate was 3.6 percent between 1988 and 1995. The average deteriorated to 2.9 percent between 1995 and 2002, when Turkey was constantly struggling with political problems and economic crises. After 2002, when a single party government started leading the country while implementing a series of reforms, the average rose to 5.2 percent. So Turkey's long-term growth potential is somewhere around 4 percent. Further proof is that Turkey's average growth rate was roughly 5 percent between 1924 and 2012.

High growth certainly sounds desirable, but it is

neither easy nor free of social costs and side effects if it is unsustainable. That is to say, although Turkey wants to reach an annual growth rate of around 7 percent -- which it has to achieve to reach its ambitious goals for 2023, the centennial of its foundation -- its current economic structure is unlikely to allow this. The Turkish economy is like a car designed to travel at an average of 40 miles per hour at the highest in long-distance travel, and any attempt to raise its speed to 70 mph will probably cause a breakdown -- and maybe even a crash.

To be precise, under existing macroeconomic and structural restrictions, economic growth radically above Turkey's long-term growth potential cannot be sustained without doing serious damage to the economy.

In the past, these problems usually came in the form of budget deficits. In more recent times, the major side effect of excessive growth has been a current account deficit. This means that as Turkey stretches its potential, it either increases public spending or boosts imports. In other words, high growth rates are fueled not by the economy's core dynamics, like domestic savings, but by either public spending or external funds.

Therefore, if Turkey wants to upgrade its potential above current levels, the country needs to renovate its economic vehicle to make it capable of safely reaching higher speeds.

It has to increase domestic savings, which will improve the economy's ability to make long-distance journeys without fear of getting stranded in the middle of the road. Turkey needs to give its engine more horsepower by improving domestic demand and foreign trade, and strengthening its research and development capacity. And its hood and fuselage must be reinforced with structural and legal reforms so that it won't break apart.

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SUCCESS TO BE MITIGATED BY FAILURE TO REFORM

**SEYFETTİN
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More than 10 years ago, precisely following the Nov. 3, 2002 elections, the Justice and Development Party (AK Party) came to power. At that time, AK Party won 35 percent of the vote, but as only two parties (AK Party and Republican People's Party-CHP) were able to beat the very high electoral threshold of 10 percent, AK Party won the majority of seats in Parliament. In the following elections, those of July 22, 2007 and June 11, 2011, AK Party consolidated its one party government through sizable increases in its electorate each time, reaching 50 percent of the vote in the last elections.

The years of high growth

How this quite singular political success in the history of democracies has been possible? Needless to say, various factors, economic as well as political ones, contributed to this success. For example, the complete defeat of the traditional center right in November 2002, held responsible for the mess of 1990's -- 3 economic crisis accompanied by political instabilities -- as well as the support of liberals to AK Party in its fight against the military tutelage, played certainly some role in this success. However, I believe that the decisive factor of the success has been the economic performance. AK Party came to power while Turkey was struggling to exit painfully from its worst-ever economic crisis. In 2001, the IMF stand-by agreement, based on exchange rate targeting, was out of order; the Turkish lira was depreciated by 100 percent; inflation reached triple digits; half of the banks failed and, finally, gross domestic product (GDP) contracted by more than 5 percent. The three-party coalition was literally failing, and Kemal Dervis, the World Bank vice president, was nominated for the post of economic minister. He took charge, with the support of the Turkish economic bureaucracy and IMF staff, of the realization of radical economic reforms. In the second half of 2001, a new stand-by agreement was signed with the IMF, implementing a new economic regime based on floating exchange rates, an independent central bank, restructuring of banking system and, last but not least, a severe fiscal discipline program requiring a primary surplus (budgetary balance without interest payments) at 6.5 percent of the GDP.

The critical choice to be made by the newly elected AK Party government was whether or not to continue with the IMF program. It preferred to continue, and succeeded in applying strict budgetary discipline to an extent that had not been seen since 1970's. The primary surplus targets have been almost achieved until the international economic crisis started in 2008. Nowadays, abusive austerity programs are blamed in Europe, assessing that they make worse the already existing recession. This was not the case in Turkey.

Fiscal discipline did not turn into an austerity since public expenditures have not been obliged to be cut. High primary surpluses have been realized thanks to increasing tax revenues originating from high growth and from improvements in tax collection. Indeed, the fiscal discipline increased the confidence among economic actors, slowly but surely. Inflation fell below 10 percent in 2006, as did real interest rates that were evolving above 20 percent! A real consumption and investment boom followed, pushing GDP growth to 6-7 percent level. Then, high growth allowed high increases in the tax revenues. Needless to say that the per capita income increased significantly, almost doubled in Dollar terms and more than 50 percent in real terms.

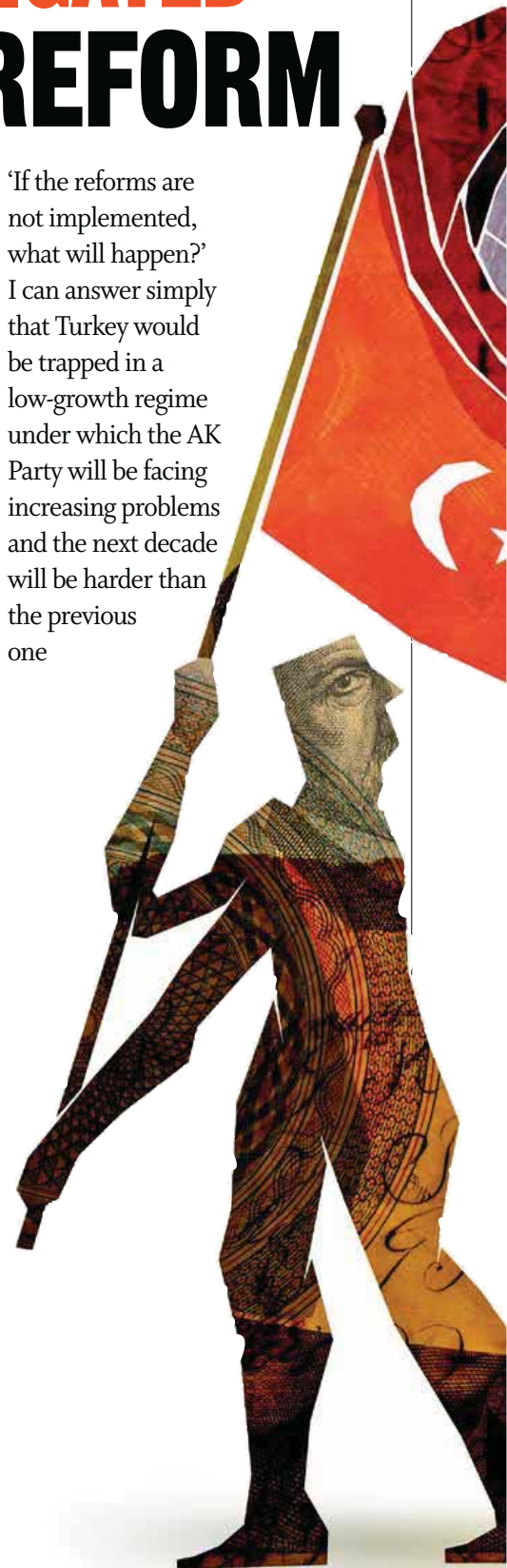
However, we have to note that the domestic-led growth accompanied by an appreciation of Turkish lira increased the current account deficit (CAD). However, the deficit was easily financed by the abundance of international liquidity, as well as by a booming foreign direct investment following the start of the EU-Turkey membership negotiations in October 2005, one of the most important achievements of AK Party Government. So, it was not surprising that AK Party increased its vote support in July 2007 up to 46 percent, thus consolidated its power.

A rapid, strong recovery in the aftermath of the global crisis

When the global crisis struck, growth of GDP was already decelerating due to a getting out of breath of the domestic demand, since it has been increased too rapidly during the precedent years. Turkish economy went into a recession in the last quarter of 2008 following the international financial crisis. The recession lasted for a year causing a rather strong contraction of Turkish economy and taking up unemployment rate from 10 percent to 14 percent. Nevertheless, the recovery has been rapid and muscular. During 2010 and 2011 the GDP grew respectively by more than 9 and 8 percent, making Turkey the second best growth performer after China in the World. I would like to note that this high growth allowed unemployment to decrease at its pre-crisis level. Then, AK Party success in the elections of June 2011 can easily be explained.

There have been mainly three factors behind this muscular recovery. First, public debt ratio to GDP has been already decreased below 40 percent thanks to fiscal discipline, as explained above. Low public debt gave a room to maneuver for the public finances, making possible a slight increase in public expenditures. As a matter of fact, budget deficit increased moderately without jeopardizing the fiscal discipline. Second, Turkish Central Bank (CBRT) seized the occasion presented by the global recession to reduce interest rates further without increasing inflation risk. The real interest rates paid on Treasury Bonds declined around 1 percent, helping fiscal discipline and encouraging investment. And finally, Turkish banks that stood out of the western financial mess, thanks to a close monitoring since the 2001 bank failures, increased easily the volume

'If the reforms are not implemented, what will happen?' I can answer simply that Turkey would be trapped in a low-growth regime under which the AK Party will be facing increasing problems and the next decade will be harder than the previous one



Domestic demand has come under control -- maybe too much so -- and growth has been based on net exports, exports increasing more than imports. As predicted, CAD began its decline along with the growth regime switch. The CAD ratio to (GDP) declined down to 6 percent from its pick of 10 percent. So far so good, but the cooling of domestic demand has been revealed to be rather excessive since it has stagnated in 2012. The growth, based exclusively on net exports, declined to 2.2 percent. Now, the Government was expecting at least 4 percent as it was targeted in the Medium Term Program. This was certainly an insufficient growth regarding the fight against unemployment. The decline of unemployment stopped definitely and signs of rise appeared.

Before to discuss the challenges that Turkey is facing nowadays, let's make a brief evaluation of the AK Party decade from a social perspective.

Welfare improved, particularly among the poor

I tried to evidence above the macro economic performance of AK Party rule during the last decade. This is certainly a successful performance despite the persistence of some unfixed structural problems, like low domestic savings and lack of competitiveness, but what about the social outcomes? According to Income and Living Conditions Surveys (SILC) of TurkStat published since 2006 and covering the period of 2005-2010 (the last available data) a decrease in income inequality as well as in poverty have been achieved.

Let's consider two most popular measures of inequality, the Gini Coefficient (GC) and Relative Poverty Head Count Ratio (RP). Between 2005 and 2010, GC decreased roughly from 43 percent to 40, and PR from 25 percent to 23. Admittedly, those are modest improvements and income inequality stands still a high level comparing with European Countries. However, it should be underlined that this decrease in income inequality has been realized parallel to a significant increase in the real income per capita, as noted above. This means that the welfare improvement has been stronger in the lower segments of the society than the upper segments. A direct measure of poverty, namely the state of material deprivation in Turkish society proves also this welfare improvement. In a recent study (to be published in July) Bahçeşehir University Center for Economic and Social Research (Betam), using the SILC data, computed the poverty rates according to three basic needs, namely, inability to eat every second day meat, chicken or fish, to worm properly the home and to replace used clothes by the new ones. The share of households unable to satisfy all those three needs was 25 percent in 2006, but declined to 19 percent in 2010.

There has been also significant improvement in the supply of public services which are not considered in the computation of income inequality and poverty that are based on disposable incomes. For example the share of education in the budget increased from 10 percent in 2002 to 15 percent in 2011 and the share of health expenditures from 2.6 percent to 5.8 percent. Since in the mean time Turkish GDP increased in real terms by more than 50 percent, it should be underlined that the

increase of education and health expenditures in real terms was well higher than the increase in shares.

The challenges Turkey faces

Undoubtedly AK Party decade has been globally positive for Turkey. Political stability has been secured, economy became stronger and social welfare improved significantly. AK Party rulers claim that Turkey emerged as a regional power during this decade. I think that this claim is not yet fully confirmed since many political and economical problems remain unfixed. The main political challenge is the deepening and stabilization of the democratic regime. This requires a new constitution based on a consensus as large as possible and on the solution of Kurdish problem by democratic means. Needless to say that these two issues are closely linked, one to other. What might be said at the moment is that drafting a new constitution supported by a large consensus seems very difficult, if not impossible and the peace process with PKK is underway but its achievement depends from the implementation of radical democratic reforms.

Turkish economy is also facing important challenges. I have already noted that the high growth days are over reaching its natural limits because of the domestic led growth that caused a high current account deficit. Recent works of economists estimates the potential growth rate of Turkish economy at 5 percent and this rate is also admitted in the Medium Term Program as the official growth target. This level of growth is also needed in order to decrease the relatively high unemployment rate, at 10 percent, given the rapid increase of labor force. However, as long as economic growth is based on domestic demand, 5 percent growth is not sustainable since the current account deficit will in this case be on an increasing path. And Turkish economy can not sustain an increasing current account deficit since the foreign private debt is accumulating dangerously and since the deficit is mostly financed by hot money and foreign credit. Turkish economy needs a balanced growth with more exports and less imports. This depends on a less valued Turkish lira in real terms as well from more rapid productivity gains in the manufacturing sector and from a higher appetite for savings. Nevertheless, the depreciation of the Turkish lira will unavoidably have an adverse affect on inflation that is currently still far from its target of 5 percent.

Then, the question is: What to do? The recipe is not very complicated but very difficult to implement. Radical reforms in the labor market, in the fiscal system, in various product markets and in all stages of education are needed in order to accelerate productivity increases, to cut production costs and to encourage domestic savings. At the same time the state should spend more on R & D, more on education and more on infrastructure without jeopardizing the fiscal discipline. At the moment I see no willingness for those reforms in AK Party Government. AK Party is more focused on establishing a presidential system that would make Erdoğan a powerful president in the next decade than on a reform agenda. One can say that all urgent reforms are considered from the prism of this presidential ambition and from its eventual effects on AK Party's vote support in the coming elections; local elections will be held in March 2014, and then Turkey will elect a president of Republic by popular vote for the first time, in July 2014.

The last but the most critical question is: "So, if the political and economical reforms are not implemented, what will happen?" I can answer simply that Turkey would be trapped in a low growth regime under which AK Party will be facing increasing problems and the next decade will be more difficult than the previous one.

of their loans, fuelling the domestic demand boom.

However, this high growth episode attained rather quickly its limits since it was exclusively based on the domestic demand. The current account deficit reached by 2011 its historical pick at 10 percent, breaking out a world record. Admittedly this was not a sustainable situation, given also the fact that Turkish lira was appreciating dangerously under the pressure of excess capital inflows. A sudden stop of capital inflows, able to cause an exchange rate shock, could have occurred at any moment. Turkish economy truck was going at full speed towards the wall, and something had to be done. So, CBRT and AK Party Government have been quite wise deciding a cooling down operation called, "rebalancing of the economy".

Attempts at 'rebalancing'

2012 has been the year of "rebalancing," in other words, the year of the correction regarding the macroeconomic imbalances. CBRT task was not easy since there were multiple goals to achieve, like cooling loan expansion, depreciating the lira without losing control of inflation expectations and switching growth from a domestic demand led growth to an export led growth to narrow the huge CAD. The central bank was obliged to develop a new monetary framework with new tools.

Central bank policies worked quite well.



EMERGING MARKETS' EURO NEMESIS

DANIEL GROS*

Emerging markets' currencies are crashing, and their central banks are busy tightening policy, trying to stabilize their countries' financial markets. Who is to blame for this state of affairs? A few years ago, when the US Federal Reserve embarked on yet another round of "quantitative easing," some emerging-market leaders complained loudly. They viewed the Fed's open-ended purchases of long-term securities as an attempt to engineer a competitive devaluation of the dollar and worried that ultra-easy monetary conditions in the United States would unleash a flood of "hot money" inflows, driving up their exchange rates. This, they feared, would not only diminish their export competitiveness and push their external accounts into deficit; it would also expose them to the harsh consequences of a sudden stop in capital inflows when US policymakers reversed course.

At first sight, these fears appear to have been well founded. As the title of a recent paper published by the International Monetary Fund succinctly puts it, "Capital Flows are Fickle: Anytime, Anywhere." The mere announcement that the Fed might scale down its unconventional monetary-policy operations has led to today's capital flight from emerging markets.

But this view misses the real reason why capital flowed into emerging markets over the last few years, and why the external accounts of so many of them have swung into deficit. The real culprit is the euro.

Quantitative easing in the US cannot have been behind these large swings in global current-account balances, because America's external deficit has not changed significantly in recent years. This is also what one would expect from economic theory: in conditions approaching a liquidity trap, the impact of unconventional monetary policies on financial conditions and demand is likely to be modest. Indeed, the available models tell us that, to the extent that an expansionary monetary policy actually does have an impact on the economy, its effect on the current account should not be large, because any positive effect on exports from a weaker exchange rate should be offset by larger imports due to the increase in domestic demand.

This is what has happened in the US, and its recent economic revival has been accompanied by an expansion of both exports and imports. The impact of

Unless the US resumes its role as consumer of last resort, the latest bout of financial-market jitters will weaken the global economy again. And any global recovery promises to be unbalanced -- that is, if it materializes at all

the various rounds of quantitative easing on emerging markets (and on the rest of the world) has thus been approximately neutral.

But austerity in Europe has had a profound impact on the eurozone's current account, which has swung from a deficit of almost \$100 billion in 2008 to a surplus of almost \$300 billion this year. This was a consequence of the sudden stop of capital flows to the eurozone's southern members, which forced these countries to turn their current accounts from a combined deficit of \$300 billion five years ago to a small surplus today. Because the external-surplus countries of the eurozone's north, Ger-

many and Netherlands, did not expand their demand, the eurozone overall is now running the world's largest current-account surplus -- exceeding even that of China, which has long been accused of engaging in competitive currency manipulation.

This extraordinary swing of almost \$400 billion in the eurozone's current-account balance did not result from a "competitive devaluation"; the euro has remained strong. So the real reason for the eurozone's large external surplus today is that internal demand has been so weak that imports have been practically stagnant over the last five years (the average annual growth rate was a paltry 0.25 percent).

The cause of this state of affairs, in one word, is austerity. Weak demand in Europe is the real reason why emerging markets' current accounts deteriorated (and, with the exception of China, swung into deficit).

Thus, if anything, emerging-market leaders should have complained about European austerity, not about US quantitative easing. Fed Chairman Ben Bernanke's talk of "tapering" quantitative easing might have triggered the current bout of instability; but emerging markets' underlying vulnerability was made in Europe.

The fickleness of capital markets poses once again the paradox of thrift. As capital withdraws from emerging markets, these countries soon will be forced to adopt their own austerity measures and run current-account surpluses, much like the eurozone periphery today. But who will then be able -- and willing -- to run deficits?

Two of the world's three largest economies come to mind: China, given the strength of its balance sheet, and the eurozone, given the euro's status as a reserve currency. But both appear committed to running large surpluses (indeed, the two largest in the world).

This implies that, unless the US resumes its role as consumer of last resort, the latest bout of financial-market jitters will weaken the global economy again. And any global recovery promises to be unbalanced -- that is, if it materializes at all.

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IS THERE A HOUSING BUBBLE ON THE HORIZON FOR TURKEY?

MUNİSE ÜLKER

One of the current popular questions today in one of Turkey's growth-engine sectors, housing, is whether it is possible for the industry to experience a real estate bubble like the one the US suffered back in 2007. What prompts the housing industry players to ask this question is the recent increase in real estate prices, seen by many as "artificial."

According to data from the Turkish Contractors Association (TMB), the growth in the Turkish real estate market declined to 5.7 percent and 8.1 percent in 2007 and 2008, respectively, from 18.5 percent growth in 2006. The decline in real estate growth was due to global fluctuations but this decline is relatively lower when compared to the US, where housing prices are still falling in most states.

The growth in the real estate market jumped to 16.1 percent in 2009 and 13 percent in 2011, the same data show. The Turkish gross domestic product (GDP) grew by 12.7 percent in 2008 over the preceding year to reach approximately TL 950 billion. In 2007, the real estate sector had a 4 percent share of the gross national product (GNP), compared to 3.7 percent in 2006.

This figure presents the findings of an in-depth intelligence and analysis of the real estate industry in Turkey. International investors have many reasons to invest in emerging markets like Turkey; there, the middle class, with relatively better incomes, is growing, boosting demand and sales.

Mortgage default rates

The 2007 mortgage crisis in the US was due to sub-prime mortgage lending and lenders ignoring the ability of borrowers to repay their loans. The buyers were interested in purchasing a house at a very low interest rate, hanging on to it for a while and selling it for big profits after appreciation. But when the market went south, most of them had to let go

of their properties. But since they did not put down large deposits, the only things that were damaged were credit histories and the psychology of buyers.

On the other hand, Turkish mortgage lenders require at least a 25 percent down payment, which is currently planned to be increased to as high as 40 percent. Even though this may slow down the mortgage market, it will make it safer for banks and eliminate a future crisis in lending. The mortgage default ratio, which is 3.6 percent, is smaller than credit card defaults and other individual loans.

Mortgage rates widely differ from each other. This was how the system worked before the 2007 crisis: The US funds its own mortgage sector by creating government bonds, selling them to different countries like China and lending the money to Fannie Mae and Freddie Mac. After adding its own margins to this, Fannie Mae and Freddie Mac pass on this amount in smaller chunks to US banks. This was how the US was able to provide loans with low mortgage rates.

The Turkish government, however, does not play a role in the interest market. Private banks support or find funds from international banks like Europe.

But when we look at the picture globally, the Turkish lira loses value more than the US dollar. When a 10-year mortgage is considered, this high interest rate may not be that bad compared to US rates. Turks do not prefer to take out a mortgage; compared to many developed countries, the percentage of borrowers is very low. Still, mortgage borrowing leads other loans with a 9.1 percent share.

Real estate executives cite the liberalization of the country's property rights, the acceptance by Turkish courts of foreign arbitration as well as trade laws that make it easier to import goods into Turkey, which reassure international retailers that they can lease space stores.

In addition to a housing boom, hotel investments are a hot topic in Turkey right now. There are

many international investors looking for opportunities not just in İstanbul or Ankara but in other cities with a population over 1 million.

Financial openness permits foreign savings and foreign direct investment (FDI) inflows into member countries and augments countries' capital stocks. As a consequence, loanable funds increase, credit interest rates decrease and investment increases. Financial openness permits the inflow of FDI, which brings in financial resources and transfers skills, knowledge and technology, increases the efficiency of financial intermediation and permits cross-border risk sharing.

"Turkey has improved its economic position over the past 10 years and this transformation was accelerated by the global financial crisis. Turkey now has normalized interest rates and has brought down the real cost of borrowing. It is now a completely different country from that of four years ago," said Yapı Kredi Bank's chief economist Cevdet Akçay.

Small business growth

There has been a big increase in small business openings, many grants are available and loans are now being advertised specifically for small business owners. This seems great for the economy right now, but many people may not know how to run a business. Banks should encourage them to take a course on basic accounting, entrepreneurship and economics to prevent future delays in repayments. The development of the small businesses sector significantly supports real estate growth. Rent and sales prices of commercial buildings have been increasing, especially in bigger cities.

Turkey's credit problem, accompanied by high inflation and the eroding value of its currency, is creating difficulties for its economy. If Turkey does not continue to sell dollars and does not show more caution in granting loans, its economy is liable to collapse. The beginning of 2012 indicates that Turkey is aware of the dangers and is acting to reduce them.





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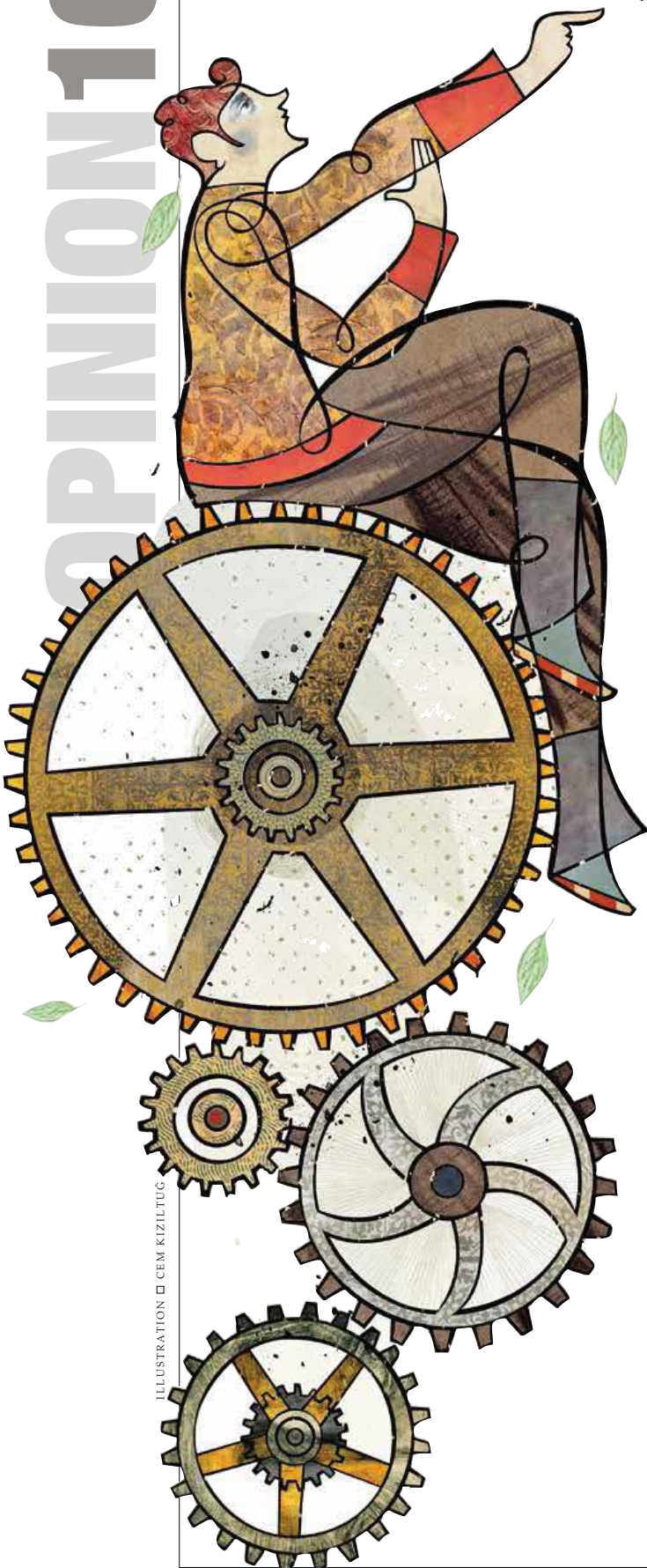


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NIRVANA LOST

ANDRES VELASCO*

SANTIAGO — In the 1970s, the great Yale University economist Carlos Díaz-Alejandro used to say that the combination of high commodity prices, low world interest rates, and abundant international liquidity would amount to economic nirvana for developing countries. Back then, no sensible economist believed that such a state of grace could ever arrive. Yet arrive it did, and over the last decade commodity-rich countries like Brazil, Indonesia, Russia, and South Africa enjoyed its abundant benefits with abandon.

But now nirvana seems to be ending: commodity prices are down, and the mere possibility that the US Federal Reserve may end its policy of quantitative easing has raised market interest rates in the rich countries and sent funds fleeing from once-fashionable emerging markets back to safe havens in the North. Stock markets and currencies are plunging, and not just in commodity-rich emerging countries, but also in others, like India and Turkey, that had sucked in huge flows of foreign capital. Pessimists are already seeing a replay of the late-1990's Asian crisis or, worse, an emerging-market echo of the 2008-2009 crisis in the advanced countries.

What the hardest-hit economies have in common are large external deficits. Abundant capital inflows caused their exchange rates to appreciate, making imports cheap and unleashing consumption (and sometimes investment) booms that eroded their trade balances, even as rising commodity prices boosted the value of their exports. Now the cycle is being reversed and exchange rates must depreciate to facilitate external adjustment. Anticipating that change -- and the prospect of higher interest rates closer to home -- foreign investors are taking flight, hastening and sharpening the exchange-rate plunge.

That is the bad news. The good news (fingers crossed) is that a full-fledged emerging-market financial crisis is unlikely. For one thing, this time was different with regard to fiscal behavior, as Luis Felipe Céspedes and I show in a recent paper.

Commodity-rich governments did not spend the entire windfall and more, as they had done during earlier commodity booms. So government debt and the resulting financial vulnerability are not as high as they were in the past. These countries' private sectors have borrowed significantly; but, as the Nobel laureate economist Paul Krugman has been pointing out, leverage and dollar debt are lower (as a share of national income) than they were at the outset of the 1990's Asian crisis -- and at the start of the 1980's Latin American crisis, for that matter.

So, in my view, the question is not whether these countries' financial sectors will explode, but whether their growth trajectories will implode.

When commodity prices are sky-high

and money is cheap and plentiful, economic growth is almost inevitable. Now that nirvana is over, where will growth come from? To answer that question, it helps to note, as Harvard University's Ricardo Hausmann has done recently, that some of the emerging economies' recent growth was illusory. Wall Street became enamored with the rapidly rising dollar value of these countries' national income, but that rise had more to do with strong commodity prices and appreciating exchange rates (which raised the value of their output when measured in dollars) than with sharp increases in actual output volumes.

During the boom years, structural transformation in many emerging economies, particularly in Latin America, was limited. Countries like Ireland, Finland, and Singapore -- and also South Korea, Malaysia, and Indonesia -- export different goods (and to different markets) than they did a generation ago. By contrast, Chile's export basket is pretty much the same as it was in 1980.

There is nothing wrong with exporting copper, wine, fruit, and forest products. But economic history suggests that countries seldom -- if ever -- get rich by doing just that. Commodity-rich advanced economies like Canada, Norway, or Australia export lots of natural resources, of course, but they also export many other goods and services.

To make matters worse, unlike their Asian counterparts, Latin America's economies are not integrated into regional and global value chains. A producer in Indonesia, Malaysia, or the Philippines can easily take advantage of the local currency's depreciation to sell more electronic components to an assembly plant in China with which it has a long-standing and well-developed supply relationship. A business in Concepción, Arequipa, or Medellín, by contrast, must seek new customers in new countries, which takes time and money -- and may not succeed.

Latin American governments could have used the opportunities afforded by the global commodity and liquidity booms to diversify their economies, working with local business communities to move into new products and sectors. They did not.

In some of these countries, conservative governments viewed industrial promotion as some dirigiste relic from the past, and avoided it. The time has come to pay for these mistakes.

"Nirvana" is defined as the state of freedom from suffering. For emerging markets, that state is over; but, in some cases, their citizens -- still feeling rich from cheap money and high export prices -- have no inkling of the suffering that may be upon them. For the sake of political stability, governments would be well advised to inform them.

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ANALYSIS17

NEW DEAL FOR EMERGING ECONOMIES

In one of its recent issues, tilted “The Great Deceleration,” The Economist does important analysis on emerging economies.

The cover story’s subhead: “The emerging-market slowdown is not the beginning of a bust. But it is a turning-point for the world economy.” It is true; for emerging economies, this isn’t the beginning of a bust. It might seem surprising to you, but we could say that for emerging economies, the current situation is “a new way of economic development.” But, taking history into account, we could also call this new state of affairs “a new deal for emerging economies.”

At the start of the Great Depression in 1929, President Herbert Hoover thought that the US would be able to deal with the crisis by reliance on “classical” economic policies. He believed in a balanced budget; he increased taxes and restricted investments; but things got worse because the crisis revealed itself after the financial crash in the form of high unemployment. Hoover then asked capitalists not to lay off workers and put up with lower gross profits. As you might expect, this is the last thing one should ask of a capitalist. Of course, the unemployment rate kept increasing. Back then, John Maynard Keynes was working on his “General Theory of Employment, Interest and Money.” Hoover was defeated in the 1933 election by Franklin D. Roosevelt. There was one thing that President Roosevelt knew: he wouldn’t do what Hoover had done.

Keynes published “The General Theory” in 1935. And the US became the first country to test Keynes’ theories. Roosevelt’s Keynesian policies were implemented starting in 1935 with the enactment of new laws and the creation of new institutions. For instance, the Tennessee Valley Authority Act was a general planning bill regulating the financial and banking systems. Another impor-



tant institution was the Public Works Administration. Back then, it was one of the most important institutions dealing with unemployment.

On the other hand, there was also the National Industrial Recovery Act. This important bill defined the New Deal. Through this law, huge infrastructure investments that would raise the amount of profits in leading sectors were made; the law also increased competition in the economy and regulated the labor market. The law introduced ground rules for enhanced competition in all sectors. In fact, it was a paradoxical situation. On the one hand, the state regulated the economy to create employment; on the other, the state cleared the way for open competition.

For this reason, we cannot possibly call Keynes’ theories and President Roosevelt’s New Deal policies purely statist. These were multidimensional policies of renewal developed to deal with the crisis. However, they were for developed nations only, and of course they weren’t applicable to the US alone. The New Deal would play a huge role in the reconstruction of Europe and its transition to the welfare state. The US promoted New Deal policies for Europe in the aftermath of the war, and these policies reconstructed and revived Europe.

Let’s turn to emerging economies. These countries are transferring huge amount of funds to the West regardless of whether they suffer from foreign trade deficits. For instance, China finances the US economy by

purchasing US dollars and bonds with money generated by its foreign trade surplus; on the other hand, countries like Turkey that have foreign trade deficits work to attract short-term capital through high interest rates. This is unsustainable, of course. Now The Economist prints a headline, “The Great Deceleration.” It is an economic decline that could lead to a great collapse for developed countries.

For instance, China has become a global power by implementing policies it developed at home.

It liberalized central decision-making processes. It implemented commercial regulation and control mechanisms. World Trade Organization standards were implemented. It partially liberalized its currency. It introduced strong and useful foreign capital investment incentives. As a result of these measures and lower wages, labor from rural areas generated a huge force of production. At this stage, China has come to the end of the road, where its economy will slow down. The new process that The Economist defines as the Great Deceleration will take hold. Like Roosevelt did with the New Deal, China will make labor markets more flexible and take wages to a higher level, promote competition among sectors and move from intensity of labor to intensity of knowledge.

At this stage, capital turnover is too slow for the global economy. I’m not talking about financial capital here. I’m talking about surplus value accumulation in the form of fixed capital. The accumulation of fixed capital in capitalist economies and the breakdown of the production cycle is not something that can be addressed by preserving the existing state of affairs or palliative financial measures. However, capital turnover is slow in developed countries. At this stage of history, emerging economies are building a new mode of existence. Hence, this cannot be called a deceleration. Maybe this could be a new deal for emerging economies.

The NIC report indicates that the US will no longer stay as a global power by 2030, that the notion of global power will go through some changes and that the notion of hegemonic power will disappear and that global power will be shared by information networks, different coalitions in a multi-polar world

ESER KARAKAŞ*

Turkey is not a country that is able to take a look at the issues from a long- or mid-term perspective for a series of reasons. The probable reason for this unpleasant state of affairs is the unbearable weight of the short-term agenda. By a long-term perspective, I am not referring to a notion of planning; I have always found the logic of planning as slightly non-democratic. I am bothered by the selection of economic and social planning projects and the election of a chief of staff who would come to office in 2018 by a public institution. Such a selection or election means that we do not take the public authority of 2018 seriously. However, opposing the notion of planning does not prevent the adoption of goals and projects for the near future, say, this year or in 2030. I find Prime Minister Recep Tayyip Erdoğan's setting goals of per capita income by 2023 pretty important and useful, despite some practical challenges.

I have a copy of a publication by the famous National Intelligence Council (NIC) published in December of last year, "2030: Global Trends," which I find very interesting and significant. You can access the English version of this report at www.dni.gov/nic/globaltrends. As the title indicates, the report presents the predictions and alternative scenarios of the NIC on the global trends in 2030. Turkey is mentioned frequently in the report, but as you may conclude, the major emphasis is on the US, China, India and Russia.

A quick review of the report reveals that there are four major trends and five threats to these trends in 2030. In the end, the report offers four potential scenarios or four different images of the world for 2030. Such reports may raise some questions on how objective they are given that they were drafted by an American official body that is pretty close to the CIA; we may have concerns as to whether they might be manipulative. However, a careful analysis of the report suggests that there are different scenarios prepared by reliance on scientific methods. I have just made reference to the Internet address of the official version of the report; readers may have access to it freely and develop their own opinion on it. The first major trend identified in

the report on 2030 is the inescapable rise of the middle class. There are a series of factors that would lead to the rise of the middle class. The urban population, which constituted 25-30 percent of the world's population in the 1950s will become 60 percent by 2030; in other words, even this development alone will contribute to the rise of the middle class -- but this is not the real reason. It is very likely that there will be huge problems in regard to the distribution of global income in the world in 2030; however, these global income distribution issues will not mean that there will not be an increase in the per capita income. The overall trend shows that it is certain the per capita income will be significantly higher than the current figures. This indicates that poverty will decline to a certain level. The increased size of the urban population, the increase in the per capita income, the decline of poverty to a certain level, the improvement in education levels accompanied by the decline of poverty, better access to health services, the rise of technology and access to advanced technology will lead to the rise of a middle class that is more free and a typology of such middle-class membership. The rising middle class and the freer individual is referred to in the report as the major trend and key notion for the year 2030.

US will not remain global power by 2030

The second major trend seems to be the distribution of global power as a result of the first trend. The NIC report indicates that the US will no longer stay as a global power by 2030, that the notion of global power will go through some changes and that the notion of hegemonic power will disappear and that global power will be shared by information networks, different coalitions in a multi-polar world. But me who is penning this column (or maybe we should say who is typing) believes that the US power will increase by 2030. Knowledge will determine the global power in

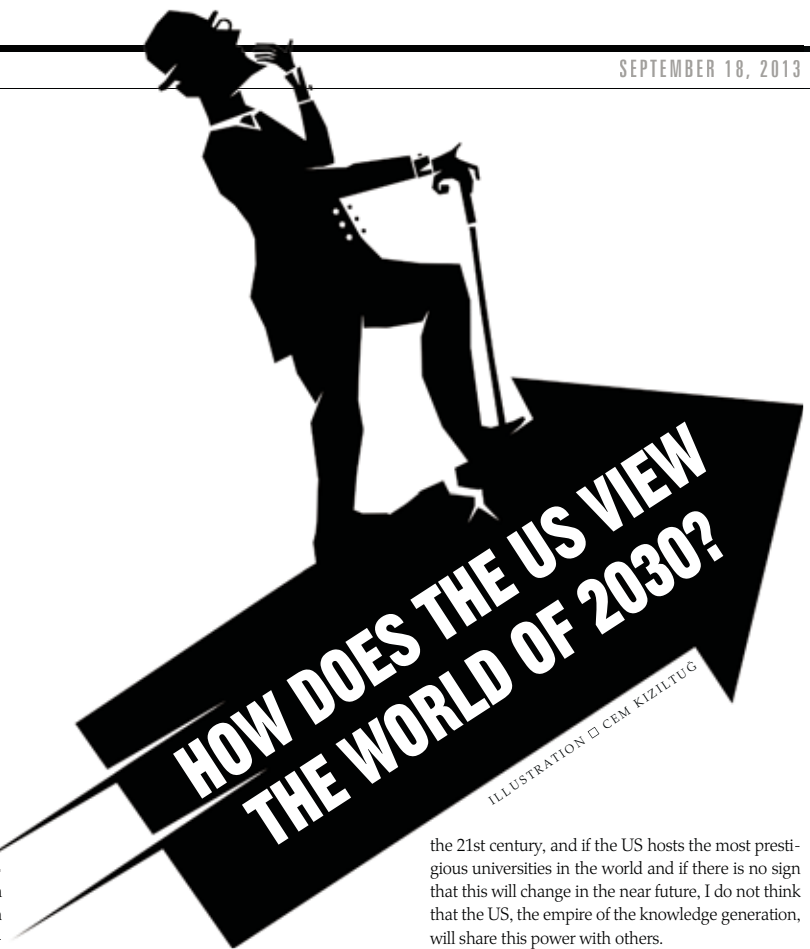
the 21st century, and if the US hosts the most prestigious universities in the world and if there is no sign that this will change in the near future, I do not think that the US, the empire of the knowledge generation, will share this power with others.

The third major trend is related to the demographic trends; by 2030, the world will become a place where 60 percent of the global population will live in urban areas and the aging problem will be observed. This trend of aging will have significant impacts upon the economy, efficiency and social security systems; these impacts will determine the balances in the world in 2030. However, migration flows towards developed countries experiencing aging problems will change some balances positively, particularly in the US. The last major trend indicates that in the world of 2030, food supplies, water and energy will become more significant than they are now; demand for food, water and energy will rise significantly because of the growing population. It is obvious that world leaders will need to find an answer to this question and problem.

Let me come to the growing threats by 2030; the first major threat before these four major trends is a potential global crisis; the second is the inability of political administrations to adapt themselves to the conditions in the world; the third is the growing number of conflicts. These could be domestic wars that will be fought within the boundaries of nation states, but they could also be interstate wars as well. The fourth important threat factor is the possibility that the differences between regions may lead to serious imbalances. The fifth factor is the possibility that technological advances may lead to some problems; in other words, this refers to the possibility of detachment of social welfare from technological development.

I am aware that I have exhausted the space limit for my piece; I hope that I will keep writing on this matter in another column and explain four potential world scenarios as well. I wish we could, in addition to setting goals for 2023, design alternative scenarios for the future as well.

*Eser Karakaş is a professor of economics and the head of Bahçeşehir University's European Union department.





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