

January 10, 2012

# TURKISH MODERNIZATION AND STRATEGIC CHOICES





On January 10, 2012, a distinguished group of European and Turkish businessmen, policy makers, former government officials, diplomats, academics and opinion leaders gathered on the historic grounds of the Sakıp Sabancı Museum in Emirgan, Istanbul to discuss Turkey's economy, energy security and institutional development. Co-organized by Istanbul Policy Center (IPC) and the Nexus Forum, the one-day conference, "The Turkey Nexus," laid out the formidable challenges in each field and explored the avenues for a deepened cooperation among Turkey, the European Union (EU) and Turkey's neighbors to overcome some of these challenges. The participants identified a number of key issues that needed to be resolved urgently to sustain the steady growth of Turkish economy and political stability within Turkey and the region. In the energy sector, ambiguities particularly over nuclear energy linger. In the aftermath of the Fukushima disaster, the unrelenting position of the government insisting on the construction of Turkey's first, Russian-powered nuclear plant deserves a great deal more public attention and debate. Similarly, Turkey's strategy to diversify its energy basket must have clearly defined goals on supply and transit of gas and oil, as well as on the clean and renewable sources. Furthermore, Turkey needs solid regulatory agencies to assuage investors' concerns over its energy market and to attract more foreign capital to this sector.

Turkish economy, on the other hand, shows signs of an impending slowdown. The ballooning current account deficit is a source of great anxiety among those who keep a close tally on Turkey's growth engine. Worse, that portfolio investments from abroad are the primary source of capital, rather than domestic savings, sends alarm bells ringing for a few foresighted economists, who urge for a radical shift from policies supporting cheap capital to increased domestic productivity and savings.

The lack of a consolidated institutional approach to these problems is likely to exacerbate economic and energy challenges Turkey will face in the near future. The need for consolidating institutions across the board—from political to economic, regulatory to technological areas—is almost intuitive. The current institutional framework has serious shortcomings in addressing the most basic regulatory issues ranging from safety of nuclear plants to proper conduct of domestic markets. The most important institutional change, however, discussed throughout the day, mandates transition

from an all-powerful leader to strong and independent institutions. Without this institutional evolution, Turkey risks remaining increasingly exposed to the ills of political and economic storms brewing outside its borders.

## **Current Challenges and the Future of Turkey's Energy Security**

In the aftermath of the Fukushima disaster, the safety of nuclear energy has come into question around the world. Germany, a leading country in nuclear technology, suspended the licenses of eight reactors. Chancellor Angela Merkel declared that Germany would abandon nuclear power in the near future. Siemens, Europe's largest engineering company, in tandem with the German government's policy, announced that it will also quit the nuclear power business. Across the Atlantic the United States discovered that six of its 104 reactors are identical to the one in Fukushima. Japan, in turn, canceled fourteen planned reactors.

Against this backdrop, Turkey charges full speed ahead with building its first nuclear plant in Akkuyu, a small town in the Mersin province of southern Turkey. The advocates take none of these arguments and argue vehemently that nuclear power will continue to be part of the future. The Turkish government in effect has contracted the project to a Russian company, Rosatom, the sole bidder for the contract. The use of Russian technology and the lack of an efficient regulatory institution are the chief causes of concern among experts representing a broad range of interests from energy to business, government to NGOs. For many, the Russian technology cannot be trusted. The contenders of this view are mostly concerned that Rosatom's reactor will be technologically inferior to and less safe than an American-built or German-built reactor. Some of the participants who were familiar with the negotiation process noted that Turkey had to settle for the Russian deal because no other country at the time was able to offer a similar package. Ankara certainly did not have the 25 billion dollars

to commit to building and operating the power plant. Nor were the Germans, French or Americans in a position to make such an offer, especially during the global financial crisis. Moscow, on the other hand, would underwrite the cost and handle commissioning, decommissioning and waste management of the reactor. Little do people know, the proponents say, that the technology is not a hundred percent Russian. As a matter of fact, the Russians have closely cooperated with Siemens to a large scale in manufacturing key components for their reactors.

However, none of this relegates the importance of having the right institutions in place to ensure that the plant is safely run, regulated and that the nuclear waste is safely transferred to secured caches. In this regard, Turkey has a few shortcomings. Most important, it lacks a credible and efficient institutional body to assess the transaction costs associated with going nuclear and depending on a sole bidder. The capacity of the Atomic Energy Agency (Türkiye Atom Enerjisi Kurumu) in Ankara to deliver on these goals is dubious at best. In an environment where there is no such thing as ideal technology, the right source of management, dependable government structures to run the risks of going nuclear,

and best practices from different countries are indispensable. At such a vital crossroads, the EU safety standards provide Turkey with valuable guidelines. Ankara thus should pay close attention to the best practices of its European neighbors.

The participants also agreed that the process of regulating nuclear power and distribution of electricity was a delicate matter and would take time to develop an efficient system. The decision-making process on both issues involves tremendous complexities. Financing is one of them and must be managed with great diligence and care. It is essential that any action on the supply side be closely linked to the developments in electricity markets. A unique characteristic of Turkey's approach to nuclear energy in this regard is that the Turkish model gives rights to build, operate, and run the plant to the successful bidder. Accordingly, Rosatom is granted the full rights of financing, constructing, and operating the Akkuyu reactor. And that sends shivers down the spines of industry analysts and non-governmental organizations that concern themselves with best practices, regulation and environmental issues.

It is a gamble at best to entrust these rights to a foreign company while the necessary regulations

and monitoring bodies are hardly in place. Furthermore, drawing attention to the difficulty of attracting private sector investment, one participant underlined the fact that 51 percent of the ownership would belong to the Russian company. That would leave 49 percent of a multibillion undertaking for other investors to finance. The lack of interest from other companies in Turkey and abroad towards investing in the remaining 49 percent raises several vital questions. The most important one is, in return of bearing the financial costs and underwriting formidable financial losses accrued in the process, what will the Russian actors get out of this deal? The only viable answer seems to be a political cut. The next question then is, knowing that this is a political deal, how will Turkey manage this process?



A few discussants pondered whether Turkey traded its unequivocal support for the South Stream pipeline in return for the robust Russian investment in its nuclear power sector. The same group also pointed to the fact that Turkey already imports most of its natural gas from Russia. With the nuclear deal going through, it will become even more dependent on Russia. The discouraging track record of Russian companies on commissioning nuclear reactors on time is a further cause for concern regarding Russia's dependability for delivering physically and financially sound project on time.

Despite the prevailing skepticism over Russia's reliability and capacity to deliver on its commitments, some participants warned against jumping to hasty conclusions about the monopolistic implications of the Russian involvement in the Akkuyu project. As one participant argued, the successful construction and operation of the reactor in Akkuyu may attract Western investors to the second and third reactors planned for the future. Those who agreed with this projection emphasized that the lack of a functioning regulatory agency was the main disincentive for the Western companies that were interested in the Turkish nuclear power market. Many of these companies have chosen to wait until an efficient regulatory agency is in place. They are interested in seeing, before they get involved, what mandate this agency will have, under what rules it will operate, and how it will perform. Participants also pointed out the importance of communicating

as clearly as possible who is in charge of issuing the nuclear license and who would draft the regulations. The government needed to deliver on institutionalization before such nuclear power industry giants as the GE, Mitsubishi, and Areva would invest in the Turkish nuclear sector.



Today, the growing energy consumption that accompanies an impressive GDP growth necessitates alternative sources of energy. Turkey considers new alternatives such as nuclear reactors and renewable sources of energy, such as solar, wind and hydro power. Nevertheless, even in the most optimistic scenarios, renewables are not expected to make up more than 30 percent of Turkey's energy basket by 2023. Prospects for nuclear energy are also equally dim, nuclear power generation accounting for no more than 5 percent of the

energy basket by the centennial of the Turkish Republic. While it is uncertain that nuclear energy is *the* future under these circumstances, there is very little doubt among experts that natural gas and coal will be the principal commodities powering the Turkish growth engine for the next decade and on. Of the two, natural gas is the most stable and feasible for domestic power generation. However, the fact that Turkey imports close to 60 percent of its natural gas from Russia once again brought the discussion to Russia and Caucasus. Turkey is now a party to three transit projects that affect European energy security one way or another. The most significant of all is the Nabucco pipeline. Nabucco was created to provide Europe with alternative sources of natural gas and transit routes to the Russian gas and transit systems. The architects of Nabucco have sought to diversify Europe's gas supply and offer competitive prices to the European markets. The South Stream pipeline, on the other hand, is overwhelmingly perceived as a political project initiated by the state-controlled Russian gas cartel Gazprom. The South Stream traverses the same territories as Nabucco. That brings up serious questions regarding the economic feasibility of the pipeline that is largely viewed as a political weapon to consolidate Russia's leverage over several Eastern European countries and to maintain Europe's dependency



on Russian gas. Many analysts are convinced that Russia intends to use the pipeline to kill Nabucco and force Ukraine and others to cede control of their pipeline networks to Russia. In addition to Nabucco and South Stream, Turkey has also made a commitment to support the Trans-Anatolian Pipeline according to the Memorandum of Understanding the Turkish and Azerbaijani officials signed in December 2011.

Several questions at the conference were focused on the relationship between Nabucco and the Trans-Anatolian Pipelines. The participants wanted to know whether the two projects were complementary or competitive. Also on the agenda was the possibility for them to merge in the near future. The prevailing view is that Turkey as a partner to Nabucco wants it to go on, but it also realizes that this depends on the supplier countries as much as it does on itself. Although both projects are unlikely to merge in the near future, experts signaled that it is too soon to rule this out completely and that the two projects had the potential to merge into a single one.

The disconnect between the interests of suppliers and markets continues to haunt the Nabucco project. A cause of grave concern among analysts is the capacity of Nabucco suppliers to meet the growing demands of European markets. The

proponents of this argument support projects such as the South Stream on the premise that there will be enough demand for the gas delivered by both pipelines. However, this does not alleviate the anxiety on the consumer side whether the second and third phases of the Nabucco pipeline will have enough gas to meet the demand. Without the Trans-Caspian Pipeline connection to carry Turkmen gas supplies westward, there will not be enough gas to sustain Nabucco's full capacity. Nor does it seem likely to supply Nabucco from other connections, given the uncertainties in the Middle East. Egyptian gas via pipeline through Syria looks highly improbable at present as does gas supplied through Iranian pipelines. Connection to Iraqi sources, being developed at present, will take time, given jurisdiction and security issues. Although the Turkmen would like to sell their gas to the European markets that pay higher prices than the Chinese, it is unlikely that the Trans-Caspian outlet would be built against Russia's objections. Another impediment to the project is Turkey's perception and interests. Some of the experts stated that Nabucco must have concrete contributions to Turkey's energy security before parties could expect Turkey to play a more active role in the Nabucco project. So far the Turkish officials have been put off by the lack of interest by their European counterparts in Turkey's energy

security. Similarly, the Azerbaijani view of Turkey as being merely a transit country leads to frictions between Ankara and Baku. Ankara asks for a 15 percent lift-off from the gas delivered via the Turkish segment to strengthen its negotiating hand against the Russians, whereas Baku sees the pipeline just as a cost-effective shipping route. The consortium not only rejects Ankara's proposed lift-off, but it also counteroffers that Turkey buys the Nabucco gas on Baumgarten prices of approximately 400 dollars per a thousand cubic meters (tcm), plus the transfer fee. These are hardly the circumstances that encourage Turkey to fully commit its support to Nabucco.

This bleak picture, however, does not mean that the curtain has come down on Nabucco. On the contrary, the project can still be resuscitated. To achieve this, first and foremost, there must be clear understanding among all parties that the fundamental principle behind Nabucco is not to transfer 31 bcm gas to Europe, but to transfer 31 bcm non-Russian gas. Second, Europe must understand that although they have enough gas to meet internal demand at the present, this will not always be the case. According to Fatih Birol, the chief economist of the International Energy Agency, Europe's annual production capacity equals roughly 170 bcm a year. Birol warns us that in ten year this volume will decrease by

100 bcm, and that the need for gas and reliable pipelines will significantly increase. Third, Turkmen gas should not be ruled out as a reliable source to sustain the second and third phases of Nabucco. One participant underlined that it may take time to bring in the Turkmen; nevertheless, it is not as unlikely as the picture painted by the skeptics. As a matter of fact, the expert said, the Azerbaijanis and Turkmen are already negotiating and driven closer to one another as Russia intensifies its threats on both. Neither Azerbaijan nor Turkmenistan wants to live under constant threat from Moscow. The evident excitement in Azerbaijan about the surplus of gas coming from Turkmenistan attests to the availability of Caspian gas for Nabucco. Last, limited regional pipelines such the Turkey-Greece-Italy Interconnector and Trans-Anatolian Pipeline can be integrated into Nabucco. In other words, these projects are abridged versions of Nabucco. When the demand for gas increases, the existing infrastructure through these pipelines can be fed into the Nabucco system. In fact, the two-thirds of the initial phase of Nabucco will be constructed with the Trans-Anatolian Pipeline.

In the end, Nabucco can come back from the dead only if all parties acknowledge that it is in the greater interest of Europe. It must also be accepted that even though Nabucco is not a Russian project, it is not against Russian interests either. In the words of one distinguished European diplomat who attended the meeting, “Russians are realists, and they took the point in advance.” Although the South Stream will never be a viable alternative for Nabucco, Europe’s growing appetite for gas will require dependable alternatives for all the other Russian pipelines traversing European territory. Through the harmonization of interests of supplier and transit countries, Nabucco promises to be the reliable carrier of the Caspian gas into Europe.

## **Forecasts on the Sustainability of Turkish Economic Growth: Scenarios of Hope and Peril**

Increasing demand for energy is a telling indicator of Turkey’s impressive economic expansion in the last decade. The steady growth of Turkish GDP against the backdrop of financial meltdowns in Europe and the rest of the world is cause for cautious optimism. While the short-term upbeat economic data boosts market and investor confidence, the question in everyone’s mind is whether

this trend is sustainable. The participants of the Turkey Nexus elaborated on the sustainability issue, charted a few obstacles along the path, and offered policy recommendations to overcome those probable barriers.

The deliberations yielded that 2012 will be a turbulent year for Turkish economy. Although GDP will continue to grow, the percentage of growth is likely to be modest compared to previous years. In spite of the slowdown, Turkish economy is not expected to plunge into recession. However, the government must be watchful of the ballooning current account deficit. Expansion of Turkey's trade deficit is a vital risk that needs to be addressed urgently. The assets that have so far protected Turkey against external shocks also contain risks. For instance, Turkish growth is predicated on internal demand, which is likely to be the driver of growth for the next few years. Internal demand absorbs exogenous asymmetrical shocks. That is, stagnating global demand will not affect Turkish growth rate in the same way as it does China's growth.

This, however, does not attest to the sustainability of the Turkish growth model, which is also predicated on the availability of cheap capital, informal economy and dual structures. It leaves Turkey heavily skewed

towards capital deepening. Turkey's external financing requirement for the next year is projected to reach 200 billion dollars. Turkey will not be able to raise this money on a reasonable cost. Therefore, the role of FDI in financing this gap is tremendously important. The more FDI in the financing mix, the better the outcome will be in the long term. Yet, today the FDI makes up for only 20 percent of the foreign capital in Turkey; short term capital accounts for the majority share of financing. As a result the economy faces further risks. In other words, Turkey is obliged to feed cheap capital into its growth engine, and to do so, it has to import capital one way or another.

In brief, to meet internal demand, Turkey needs foreign investment either in the form of foreign direct investment or portfolio investments. Without cheap capital, Turkey will not be able to sustain its economic growth it has enjoyed over a



decade. Some of the discussants praised the AKP government's strategy to sustain this growth model without resorting too much to high interest hot capital.

The participants unanimously agreed that tampering with institutional development in Turkey also creates serious impediments against economic growth. Turkey's all-powerful leader culture may have perks, such as passing contentious bills with relative ease; nonetheless, it interferes with the autonomy of principal government agencies whose integrity is essential for pursuing sound economic policies. The Central Bank is one of these key institutions. The Central Bank has to remain autonomous to maintain its control over the banking sector. As soon as politics infiltrates Central Bank decisions, we will find ourselves spiraling down to the heart of an economic unraveling. It should be kept in mind that the strong leadership actually comes at the expense of retarding institutional development, as well as adversely affecting the mature institutions that exist in Turkey.

For a while, the objective to join the European Union provided a reliable anchor for institutional development in Turkey. The process has also provided Turkey with an actionable blueprint for the institutional reforms it would be required to undertake. With the accession negotiations having come to a halt, Brussels no longer has the type of leverage that would influence Turkey to take on pending structural reforms with zeal and commitment. With a weakened EU influence Turkey must nevertheless find ways to implement the much needed second generation reforms to enhance its growth capacity.

## **Conclusions and Recommendations**

The participants of the Turkey Nexus have agreed that Turkey should address the following issues and undertake the subsequent reforms not only to better respond to looming political and economic challenges, but also to continue on its steady path of growth:

- Turkey must implement a broad range of institutional reforms to insulate itself against asymmetrical economic shocks and to maintain a transparent energy market that attracts diverse sources of foreign investment.
- An efficient regulatory board with a clear mandate and objectives should be established to

ensure proper functioning the transparency of the Turkish nuclear power market. Delays in setting up the nuclear watchdog, which partly resulted from bureaucratic infighting and political gaming, have deterred international operators. This is crucial for attracting not only Russian investors, but also leading Western companies such as the GE, Mitsubishi and Areva.

- The government must be more transparent about the Akkuyu nuclear plant deal and its transactions with the Russian company that is contracted to commission and operate the reactor.
- Turkey should invest more in the alternative and renewable sources of energy. Hydropower and wind power already represent about half of the new licenses granted in 2011. However, both sectors need further investments to offer viable alternatives to hydrocarbons. Furthermore, solar energy is also a strong substitute for conventional sources. An important incentive for potential investors is the fact that Turkey has the same solar mapping as Spain.
- Turkey should also resort to its own resources, chief among which are lignite and shale gas, to diversify its energy basket. Privatization in the coal industry should help



- spur the use of Turkey's significant lignite reserves, reduce the use of hard coal and Turkey's dependence on Russian natural gas.
- The alternative transit routes carrying Caspian gas into Europe such as the Trans-Anatolian and Turkey-Greece-Italy Interconnector pipelines are complementary to the greater Nabucco corridor. Both Trans-Anatolian and TGI platforms can be tapped to form the initial phase of Nabucco, when the time is ripe to realize the latter.
- The Nabucco pipeline is not yet dead. On the contrary, it is the real, non-Russian alternative to Europe's energy security. Growing demand from European consumers and increased cooperation between key suppliers such as Azerbaijan and Turkmenistan promise great potential for this corridor to live up to its purpose. Nonetheless, both supplier countries and consumer countries must also be sensitive to the energy security of the transit countries, and grant them privileges on the gas they help transit.

- The independence of Turkish institutions is important. The all-powerful leader culture is detrimental to institutional maturity and a sound checks-and-balances system. Although historical and cultural characteristics of Turkish politics, which vest significant power in the ruling elite, come with certain advantages (as witnessed during the recovery period in the aftermath of the 2001 crisis), authority and autonomy of key institutions must be reinstated. The strong leadership under the current AKP rule may deter international medium-size businesses to invest in Turkey. Under these circumstances, they would be inclined to feel more vulnerable to sovereign risk than larger companies. Contrary to small-to-medium size businesses, global operators do not perceive the current leadership as a source of instability.
- Second generation reforms are needed to continue with substantial growth levels and to deepen the transformation of the Turkish economy. Based on cheap labor and access to cheap capital, Turkey's development must go over a qualitative step with structural reforms in various sectors of economy. Turkey ought to strengthen its market mechanisms, particularly in the energy industry. Reliance on foreign direct investment alone can hardly be sustained in the current environment.
- Public and private sector must act quickly and decisively to implement these suggestions, as Turkish growth is expected to run out of steam in the short term. With the recent de facto devaluation affecting disposable incomes, the role of domestic demand as the driving force behind growth in Turkey may further weaken.
- Compounding the need to redesign Turkey's growth model is the deterioration of relations with the EU, especially since the modernization that has resulted from adopting EU legislation needs to be pursued further.



İPM | IPC

**Karakoy Headquarters**  
Bankalar Caddesi,  
No: 2 Minerva Han  
34420 Karakoy  
Istanbul - TURKEY

T: +90 212 292 4939/1413  
F: +90 212 292 4957