

## Briefing Note

**Rauf Gönenç**, Economist, Scientific Committee Member of Institut du Bosphore

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# REAL EXCHANGE RATE AND INTERNATIONAL COMPETITIVENESS: TURKEY SHOULD LEARN FROM SOUTHERN EUROPE

## SUMMARY

This note argues that Turkey must avoid the trap that eroded Southern European competitiveness before the 2010-12 Euro crisis. In Italy, Spain, Portugal and Greece, a polarised and heterogeneous business sector — polarised between a modern, high-productivity core and a low-productivity, frequently semi-informal periphery — kept unit labour costs above productivity gains and drove persistent real exchange rate appreciation. Competitiveness losses deepened trade deficits, weakened public finances, and forced unsustainable debt accumulation. The eventual adjustment imposed severe social and macroeconomic costs.

Turkey's business sector exhibits a comparable structure with three important differences: productivity gaps and informal sector weight are larger, EU's competition and governance standards are absent, and Turkey's floating exchange rate allows nominal adjustment — a less brutal mechanism than the internal devaluations imposed on eurozone members. These differences make Turkey's situation both more fragile and potentially more correctable.

Against this backdrop Turkey should keep its real exchange rate on a trajectory that is neither excessively overvalued nor excessively undervalued. Such a framework should draw on (i) state-of-the-art international research on real exchange rates' supply-side effects, (ii) the practical experience of successful trading economies that have maintained competitive real exchange rates, and (iii) the ECB's in-depth analyses of the Southern European crisis. Compensatory measures — selective subsidies and credits, tax breaks, differential exchange rates — are a poor substitute for a stable real exchange rate path: they foster rent-seeking and delay structural transformation and should be avoided.

## I. THE STAKE: WHY THE REAL EXCHANGE RATE MATTERS FOR TURKEY

A deliberate, well-calibrated real exchange rate path is essential for Turkey's macroeconomic resilience, current-account sustainability and long-run growth. Over the past five years the Turkish lira has undergone sustained real appreciation. The resulting pressure on trade-exposed sectors has worked its way gradually from the weakest firms toward more productive exporters, unsettling their strategic outlook and challenging the future viability of their investments. Both domestic and foreign investors have good reason to ask whether Turkey risks replicating the Southern European experience.

## II. SOUTHERN EUROPE: STRUCTURAL POLARISATION AND COMPETITIVENESS LOSSES

### Product and labour market rigidities have weakened the business sector

The diagnosis of Southern European difficulties before the 2010-12 Euro crisis — developed in a large body of scholarship on Italy, Spain, Portugal and Greece — centres on the interaction between a polarised business sector and a gradually appreciating real exchange rate. The architecture of this trap is worth reconstructing because Turkey's situation mirrors it closely:

- Regulatory barriers and political practices shielded large incumbent firms from competition in many product and service markets, allowing rents to form and weakening productivity incentives. EU legislation was unable to discipline these arrangements.
- In labour markets a sharp divide separated *insiders* — workers on well-paid, highly protected open-ended contracts, often in large or sheltered firms — from *outsiders* employed in weaker businesses under far less protected conditions.
- When insider wage standards and employment contracts were generalised across the economy by law, less productive firms faced a stark choice: exit the market or operate at least partly outside the legal framework. Duality deepened. Research published in 2024 with a novel methodology found that the informal economy reached still 31% of GDP in Italy, 36% in Greece, and around 24% in Spain and Portugal in 2020 — far above the 6-9% shares recorded in Scandinavia (Pappada and Rogoff, 2024).

### The downward competitiveness spiral

The wage-productivity wedge that duality generated drove unit labour costs above productivity gains. In a monetary union this caused persistent real exchange rate appreciation. The IMF and ECB analyses conducted after the Euro crisis confirmed that this gap — rather than any cyclical factor — was the structural root of the problem. The ECB's sectorally disaggregated analyses were particularly telling: Southern European economies ran persistent trade deficits not only in cost-sensitive sectors (where they had long lost competitiveness) but also in product-differentiated sectors (where they had hoped to compensate). The strategy of upgrading to higher value-added activities, which they assumed would operate and offset their cost-competitiveness losses, failed to materialise.

Labour and capital did not shift swiftly toward more productive activities. Obstacles to competition, labour market rigidities, and the allocation of part of investment funds via politicised channels perpetuated 'structural

stickiness'. The entrapment of resources in low-productivity activities undermined aggregate productivity, eroded the tax base and made fiscal balances chronically vulnerable.

### **The debt wall and internal devaluation**

As Southern European economies' domestic supply capacity fell behind private consumption and public investment trends, both private and public debt accumulated. This was eased by low capital costs in the eurozone. When debt burdens crossed sustainability thresholds, risk premia surged and refinancing became prohibitive. As monetary union membership closed the nominal exchange rate channel, the only path to restoring competitiveness was internal devaluation—via freezes and cuts to nominal wages and prices. This is a technically very demanding, socially contested and macroeconomically dangerous avenue: it distributes adjustment costs unevenly between actors with and without price and wage bargaining power, while amplifying the debt burden of the most vulnerable.

The resulting social and macroeconomic damage was severe. Public sector wages were cut sharply or frozen, widening the gap with the private sector and destabilising the quality and credibility of public services.<sup>1</sup> Inequality of access to private education and health care, coupled with cuts to social transfers, generated a new sense of injustice. Weakened public finances failed to meet the investment needs of the digital and green transitions. As frustrations mounted, political conditions shifted: parties with heterodox programmes gained ground and participated in power across all Southern Europe.

### **Reforms and road to recovery**

Post-crisis reforms, backed by massive technical cooperation and financial support from the European Union - including fiscal and pension reform, more flexible wages and prices, stronger product market competition, and improved prudential supervision - have yielded results (see Appendix). However, long-entrenched rigidities take time to overcome. Experience suggests (including the recent Greek and Spanish cases) that reforms proceed more effectively under stronger macroeconomic conditions than those initially imposed on these countries.<sup>2</sup>

## **III. TURKEY: A COMPARABLE STRUCTURE WITH THREE KEY DIFFERENCES**

Turkey's business sector exhibits a very polarised structure comparable to that of Southern Europe. Productivity gaps between firms, and disparities in workers' employment conditions are however deeper. Micro-enterprises and low-skilled labour-intensive activities account for more than half of private-sector employment, a higher share than in Southern Europe. The semi-formal segment of the economy is also larger. Mechanisms linking this polarisation to competitiveness losses, real appreciation and fiscal strains are similar to those in Southern Europe.

Three key differences define however Turkey's specific situation:

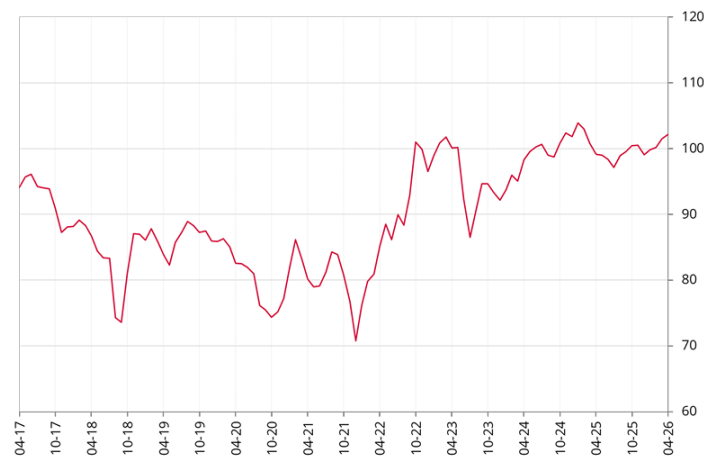
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<sup>1</sup> For example a high number of public sector health professionals emigrated from Southern Europe between 2010-2015.

<sup>2</sup> Greek Prime Minister Mitsotakis' comment to The Economist : "Even now, European liberal circles — of which I am also a part — do not accept, or do not want to accept, that the grievances fuelling populist backlash are real and genuine. The praise your magazine has given to Greece will mean nothing if the economy does not grow and cannot generate the resources required by health and education reforms" (Mitsotakis, 2024).

- First, the EU provides a transparent regulatory framework that—notwithstanding its limitations, such as the bureaucratic enforcement of certain costly regulations—offers Southern European firms a modern and evolving institutional environment. This framework draws on the collective experience of 27 member states, including highly successful small open economies like Denmark, Finland, and the Netherlands. Such an institutional infrastructure is largely absent in Turkey. The stalling of the EU accession process since 2005 halted Turkey’s institutional modernization momentum, leaving product, service, and labor markets exposed to political distortions. Consequently, Turkey has fallen further behind on most dimensions of public governance.<sup>3</sup>
- Second, Turkey is outside the monetary union. A floating exchange rate allows corrections when macroeconomic imbalances build up. If output, employment and net exports fall durably below potential, the exchange rate can adjust to restore competitiveness without recourse to the brutal arithmetic of internal devaluations. This is a fundamental difference from Southern Europe.
- Third — and this qualifies the previous point —Turkey's exchange rate regime does not automatically stabilise real exchange rate misalignments. Swings in international capital flows, political pressures on banks and financial institutions, and sudden inflation surges prevent the real exchange rate from settling on an equilibrating trajectory.<sup>4</sup> The lira's real exchange rate trajectory over the past 30 years shows no tendency to mean-revert toward any equilibrium path. Over the past decade It remained stronger than the level consistent with external balance (Chart 1).

**Chart 1 – Turkish Lira’s real exchange rate over the long-run**  
(Domestic Producer Price-Based Real Exchange Rate, 2003 = 100)



Source: CBRT Electronic Data Delivery System (EVDS).

<sup>3</sup> The 2021 OECD Economic Survey of Turkey had reviewed a comprehensive set of public governance indicators in international comparison and documented significant gaps (notably in the rule of law, policy consultation, transparency, and predictability, as well as a heightened vulnerability to private interests and rent-seeking). Recent developments suggest these trends have not improved.

<sup>4</sup> In the heterogeneous business sector the exchange rate operates also through different channels and at times in conflicting directions — depending on whether firms serve domestic or foreign markets, price their products in Turkish lira or foreign currency, and carry debts denominated in domestic or international currency.

## IV. NEED FOR A SUSTAINABLE REAL EXCHANGE RATE CORRIDOR

There is now international consensus —both from academic research and the experience of successful trading economies — that real exchange rate misalignments impose permanent supply-side damage. Overvaluation stifles high-potential export firms and ventures. Excessive depreciation traps resources in lower-productivity activities and impacts are long-lasting.<sup>5</sup> The challenge is to maintain a real rate trajectory that is neither excessively overvalued nor excessively undervalued.

### What the corridor should reflect

The appropriate exchange rate corridor should track the economy's productivity gains relative to competitors. While it should facilitate the contraction of low-productivity activities, the path must be sufficiently gradual to avoid employment shocks. Unlike macroeconomic shocks which cause irreversible breaks in growth and permanent output losses, a moderate appreciation path is productivity-enhancing. A wide body of academic research and the historical performance of successful trading economies bear out this finding.

Focus should remain on aggregate macroeconomic performance rather than isolated firm-level experiences. While individual instances of export market share gains - achieved through quality improvements or unit labor cost compressions - may be inspiring, they cannot serve as reliable policy benchmarks. This distinction is crucial in an economy where the bulk of the workforce remains concentrated in low-skilled, price-sensitive activities.

Different components of the business sector are unevenly affected by real appreciation. Domestic-market-oriented businesses and banks benefit from lower input costs, increased local purchasing power and strengthened balance sheets. In contrast, export-oriented enterprises in agriculture, industry and tourism face adverse effects: firms billing in lira suffer losses in competitiveness and market share, while those pricing in foreign currency face squeezed profit margins and diminished investment capacity. Threshold effects are also significant: in the textile and apparel markets international buyers reportedly tolerate price increases of 10–15% before switching suppliers. Furthermore price pressures are migrating from low- to medium-technology activities. In industries such as shipbuilding and machinery - where market responsiveness and service quality of Turkish suppliers once buffered against exchange rate shifts- price competitiveness losses are becoming more damaging.<sup>6</sup>

### Three pillars for policy

A more carefully designed and enforced exchange rate policy should rest on three anchors:

- State-of-the-art cross-country research on the supply-side effects of real exchange rates. Recent heterogeneous-agent models - moving away from representative-agent frameworks - reveal important specificities in different types of actors' responses to exchange rate changes.<sup>7</sup> Turkey's policymakers would benefit from a more granular understanding of these transmission channels.

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<sup>5</sup> For a detailed review of the related literature Gönenç (2025), subsequent references are in the attached bibliography.

<sup>6</sup> For a review of related cases Gönenç (2025).

<sup>7</sup> Skilled high-productivity firms are found to respond by raising prices and margins, while lower productivity enterprises appear to seek competitiveness gains and higher export volumes (Berman et al., 2012). Exchange rate elasticity of trade is, as a result, higher in less sophisticated economies (Berthou and Dhyne, 2018).

- The experience of successful small open economies demonstrates that even highly skilled, high-income exporting countries ensure that their real exchange rates do not drift beyond the bounds of stability.<sup>8</sup> Furthermore, nations that adhere to international norms avoid unilateral actions that may trigger retaliation. In designing its policies, Turkey should build on recent international experience and make use of established consultation channels.<sup>9</sup>
- European Central Bank's in-depth analyses of Southern European competitiveness losses and their consequences. These provide the most pertinent empirical grounding and analytical guidance for Turkey and Turkish policymakers should capitalise on them.<sup>10</sup>

### What should be avoided

Discretionary government measures to offset excessive currency appreciation through other instruments — subsidies, concessional credits, differential exchange rates for exporters etc. — are frequently proposed as remedies for entrenched exchange rate misalignments. They are very poor substitutes and should be avoided. They are susceptible to political patronage and rent-seeking, they fail to address the pressures bearing on the entire economy and produce inconsistent effects through value chains. A balanced real exchange rate is superior on all these counts.

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<sup>8</sup> An empirical regularity observed in approximately twenty developed countries shows that when the real exchange rate appreciates by more than 10% within a six-month period, it consistently reverts toward its average trend—a pattern primarily attributable to deliberate policy interventions (Başçı and Caner, 2005).

<sup>9</sup> The IMF has issued 'Institutional Views' on exchange rate misalignments caused by international capital flows and potential policy responses in two major installments (IMF, 2012; IMF, 2022). For Turkey's purposes, the 2012 analysis was more comprehensive than the 2022 updates. Additionally, the OECD's Capital Movements and Invisible Transactions Committee monitors member countries' exchange rate policies regarding their capital account liberalization commitments (Crescenzo, Lepers and Fannon, 2021; Gori et al., 2020). Among international cases, Peru's exchange rate stabilisation policies are frequently cited as both effective and compatible with international obligations (Hasegawa, 2023; Armas and Vega, 2019).

<sup>10</sup> A stark warning regarding Southern Europe's competitiveness losses was issued by the European Central Bank prior to the Eurozone crisis (Papademos, 2007). ECB staff analyses confirmed that labor costs rising faster than productivity gains constituted the core problem. Furthermore, the sectoral structures of these economies failed to adapt to shifting global demand due to rigidities in resource allocation. The aspiration of policymakers to upgrade supply performance by transitioning to high-productivity and high-value-added activities largely failed to materialise. Local authorities were seeking two mechanisms: i) wage growth trailing productivity gains to contain unit labor costs (ULC), and ii) offsetting ULC increases through enhanced product and service quality. ECB analyses measured separately the net contributions of cost-competing versus product-differentiation-competing sectors to trade balances. They found that Southern European countries not only failed to offset deficits in cost-competing activities with surpluses in product-differentiation sectors, but were locked in structural imbalances by running enduring deficits in both (ECB, 2012). Applying this methodology to monitor Turkey's trade performance would be highly informative.

## APPENDIX – REAL EXCHANGE RATE APPRECIATION AND COMPETITIVENESS LOSSES IN SOUTHERN EUROPE AND THEIR CONSEQUENCES BEFORE THE EUROZONE CRISIS

The so-called "Mediterranean model" (first formulated by Sapir, 2006) has been further investigated in the wake of the Eurozone crisis. An extensive body of research in academia and in international organisations re-examined the distinct microeconomic, macroeconomic and institutional characteristics of Italy, Spain, Portugal and Greece. A schematic summary of these analyses is presented below:<sup>11</sup>

- Product and service markets in Southern Europe had remained sheltered from full competition over an extended period. Regulatory barriers and political practices shielded public and private enterprises in many markets from new entries. Large rents accumulated and productivity incentives stayed weak.
- Employment rules created a divide between "insiders" and "outsiders". "Insiders" hold well-paid, open-ended contracts which are costly to terminate and carry various other benefits. "Outsiders" are employed under far less protective conditions.
- "Insiders" work generally in firms possessing strong technological resources and/or operating in markets closed to competition. If wages and employment conditions offered by these enterprises are generalised by law to the entire economy, weaker firms either exit or are forced to operate partly outside the legal framework. A divide forms between these two worlds.<sup>12</sup>
- Public finances adapt to this duality. Corporate and income taxes are collected chiefly from insider firms and workers, while outsider firms and workers pay them at lower rates. If this gap widens too much, public finances must rely more heavily on indirect taxes (as seen in Portugal and Greece).
- Financing of the real sector mirrors this duality. Private banks and formal capital markets generally finance transparent "insider" firms on the basis of economic criteria. More peripheral and semi-formal firms resort more frequently to financing sources partly exempt from standard financial disciplines. These sources are susceptible to political patronage and to other sorts of mismanagement and may grow large enough to acquire a significant foothold in the financial system.
- When unit labor costs rise due to wage-productivity divergence - driven by the gap between high- and low-productivity firms, while wage growth stays relatively aligned under statutory minimum wages

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<sup>11</sup> In addition to OECD's biannual Economic Surveys and IMF's Article IV Consultation Reports of Italy, Spain, Portugal and Greece, the following sources were used: Alborni et al., 2023; Afonso, 2019; Asen, 2019; Bennett et al., 2008; Bentolila et al., 2011; Boeri, 2019; Boeri, 2012; Boltho, 2020; Bulfone and Tassinari, 2021; Cirillo and Guarascio, 2015; Garcia, 2011; Giannone et al., 2009; Gopinath et al., 2015; ECB, 2012; Elsen, 2019; Hassel, 2014; Infante and Piazza, 2014; Jaumotte and Leigh, 2023; Kollintzas et al., 2012; Matthijs, 2014; Pellegrini and Zingales, 2017; Perez and Matzaganis, 2019; Ritzen and Haas, 2016; Sapienza, 2004; Sapir, 2006; Schivardi and Schmitz, 2020; Tiffin, 2014.

<sup>12</sup> Research published in 2024 utilising a new methodology indicates that this duality in Southern Europe is more pronounced than previously assumed. The informal economy was estimated to have reached 31% of GDP in Italy in 2020, 24% in Spain and Portugal, and 36% in Greece. Corresponding figures were significantly lower in Northern Europe, standing at 9% in Denmark and 6% in Sweden (Pappada and Rogoff, 2024)

and/or collective agreements - the real exchange rate appreciates and the economy's competitiveness deteriorates.

- Labour and capital resources do not shift naturally from low-productivity to high-productivity activities. Obstacles to competition, market power of incumbents in product and service markets, rigidities in labour markets, and the allocation of investment resources partly by non-economic criteria perpetuate this "structural stickiness".
- These dynamics erode average productivity, undermine international competitiveness, depress GDP growth and narrow the fiscal revenue base. Trade and fiscal deficits can persist as long as they are financed by borrowing, but the economy is trapped in a pattern of spending beyond its means. This pattern becomes embedded in social expectations.
- As private and public debt levels breached sustainability thresholds, funding pressures intensified. Investors' risk perceptions hardened, risk premia surged and refinancing costs escalated. Debt crises ensued.
- Membership of the monetary union foreclosed the exchange rate channel of adjustment. Currency depreciation as a tool for restoring competitiveness and reviving growth was not available. 'Internal devaluations' through nominal price and wage freezes and cuts were the remaining avenue of adjustment. This is a technically demanding and macroeconomically hazardous process. Its burden falls asymmetrically on insiders and outsiders (which have uneven price making and wage bargaining power) and ensuing deflation amplifies the debt burden of vulnerable firms and households.
- The insider-outsider polarisation also shaped the unequal capacity of these economies to adapt to new waves of global structural change — from digitalisation to decarbonisation. Without robust public support, the skills and investment capacity of the weaker segments of the business sector fell short.
- Vulnerable businesses and social groups perceived the disruptive risks of these global changes much more acutely than the opportunities they opened. This gave rise to new demands on governments for economic security guarantees and unorthodox policy interventions. Political landscapes shifted and populist parties made significant electoral inroads.
- After the Eurozone crisis a historical advantage of Southern European countries has been their access to the EU solidarity mechanisms. Large-scale EU technical cooperation and financial transfers followed. Southern countries were the primary beneficiaries of the EFSF (European Financial Stability Facility) and ESM (European Stability Mechanism) schemes.<sup>13</sup> The subsequent EUR 750 billion Recovery and Resilience Facility (RRF) channelled also significant resources to Southern Europe through a wide range of public and private modernisation projects.<sup>14</sup>

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<sup>13</sup> Greece was the largest recipient and received approximately EUR 289 billion (120% of its GDP in 2008). Portugal obtained EUR 75 billion. Spain received EUR 41 billion for the recapitalization of its banking system. Italy did not draw direct funding but its sovereign bond market was stabilised by ECB's Outright Monetary Transactions (OMT) scheme which provided a backstop without a formal bailout.

<sup>14</sup> Italy was the largest beneficiary of RRF with around EUR 191 billion in grants and loans. Spain received EUR 163 billion through both channels. Greece received EUR 35 billion and Portugal EUR 22 billion.

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## RAUF GÖNENÇ

*Economist, Scientific Committee Member of Institut du Bosphore*

Rauf Gönenç was born in 1957. After completing his secondary education at Galatasaray High School in Istanbul, he graduated from the Paris Institute of Political Science and the Faculty of Economics at the University of Paris X. He earned a PhD in Economics at the same University under the supervision of Prof. Michel Aglietta.

He was a member of an academic group that contributed to drafting the Plan Filière Électronique in France after the 1981 elections. He joined the OECD Secretariat in 1982, where he authored OECD's first studies Software: An Emerging Industry and Venture Capital in Information Technology. He was subsequently in charge of the sections on Financial Markets and Social Policies of OECD's comprehensive analysis of 1980s economic liberalisation reforms, Structural Adjustment and Economic Performance.

He then took a sabbatical in Turkey and worked at the Turkish Privatization Agency on privatization projects in air transportation.

Upon returning to the OECD, he authored and co-authored the Organisation's studies on Air Cargo and Air Passenger Transportation. The econometric methodology developed for the study Regulation, Market Structure and Performance in Air Passenger Transportation was subsequently widely utilised in international research on air transportation.

He later moved to Country Economic Studies at the OECD, where he served as Head of Desk for Slovakia, the Czech Republic, Hungary, Austria and Turkey. He was responsible for short-term macroeconomic projections and biennial structural analyses for these countries.

He retired from the OECD in 2022. The opinions expressed herein are personal and do not engage the responsibility of the OECD.

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