FINANCIAL CRISES IN TURKEY AND THE ROLE OF THE IMF

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MASTER OF PHILOSOPHY

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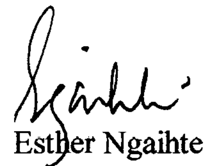

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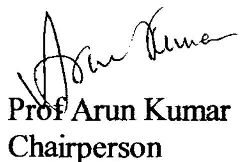

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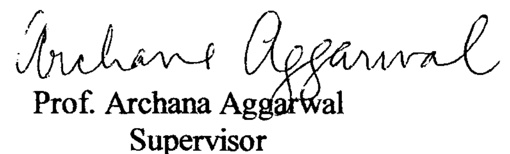

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Chapter 1

Introduction

Since the 1980s Turkey, in the process of trying to integrate with globalization has always been troubled by the problems in macroeconomic balance. In 1994 crisis arose out of the deficit in the balance of payment and while discussions concerning this and the possible effects of the East Asian crisis was underway a comprehensive crisis emerged in Turkey in late 2000 and early 2001

Throughout the period the economy has been troubled by persistent annualized inflation remaining for the most part in double digit and public debt accumulation. So in order to check these, in December 1999, the Turkish government launched an exchange rate based stabilization program with the support of the IMF. The program appeared to be on course in the subsequent 9 months but started running into a problem in Autumn 2000 necessitating a large IMF bailout. It was clear that the program was not viable. The currency overshot, interest rose, the stock market, employment, production, finance and the Turkish lira went into a downward spiral. After another bailout package from the IMF though, post crisis stabilization came quickly and the finance and currency market stabilized, employment and economic activity remained depressed.

Literature on the financial crisis in Turkey is vast and has concentrated on the cause and structural weakness of the disinflation program.

The first set of articles concentrate on the macro economy over the years and try to link the crisis with structural weaknesses and fragility of the Turkish financial and fiscal system. Then there are articles that attempt to evaluate the disinflation program. The third set of articles concentrate on crisis in detail and try to argue the disinflation program fails to deliver its promise. Some articles have made an assessment of the IMF stabilization programs for developing countries.

- Ertuorul and Selcuk's article 'A brief account of the Turkish economy, 1980-2000' provides a brief account of the Turkish economy for the last twenty years.

- Yenturk's article 'Short-term capital inflows and their impact on macroeconomic structure: Turkey in the 1990s' looks at the macroeconomic impact of capital inflows, capital inflows into Turkey in the 1990s and their linkages to the 1994 crisis.

- Ertugrul and Yeldan's article 'On the structural weaknesses of the post-1999 Turkish disinflation program' highlight the structural weakness of the exchange rate backed disinflation program as manifested in its liquidity creation mechanism in a small and fragile financial system such as Turkey. The article documents the fragility indicators of the Turkish banking system, and show that the disinflation program led to an increase of the vulnerability of the banking system throughout 2000/2001. The article also argued that given the structural characteristics of the Turkish banking system, the orthodox policy of fully connecting the monetary expansion and liquidity requirements of the domestic economy exclusively to the

short-term capital flows was clearly a design flaw, overseen by the IMF's technical expertise.

- Yeldan's article ‘ On the IMF- directed disinflation program in Turkey: A program for stabilisation and austerity, or a recipe for impoverishment and financial chaos?’ attempt to evaluate the theoretical foundation of the disinflation program and highlight the structural weakness in the light of the international stabilisation experience. Here the author highlights the role of the IMF in the emancipation of the financial crisis. Thus the paper includes the main ingredient of the 2000 disinflation program, the main mechanism of liquidity generation, a tabulation of the macroeconomic performance the economy. The author argues that the program has resulted in an increase of external fragility of the Turkish economy, which set the stage for a full financial crisis.

- Akyuz and Boratav's article ‘ The making of the Turkish financial crisis’ by looking at the macro economy and the crisis in detail tries to argue that the stabilisation program formulated and launched with strong support from the IMF failed to deliver its promises, plunging the economy into an unprecedented crisis, in large part because of serious shortcomings in its design as well as in crisis intervention which appear to have drawn no useful lessons from the recent bout of crisis in the emerging markets. The paper includes the build up of imbalances: inflation, debt and capital flows; the stabilization program; crisis mark 1; crisis

mark 2; accounting for the crisis: omission or commission, standing still and moving forward.

- Cizre and Yeldan's article 'Turkey: economy, politics and society in the post crisis era' argues that contrary to official wisdom, the current economic and political crisis is not the end result of a set of technical errors or administrative mismanagement unique to Turkey, but is the result of series of pressures emanating from the process of integrating with the global capital markets. It is an attempt to see how far the integration with the global capital market affects the growth process.

- Boratav's article' Notes on Turkey and Europe: contradictions of opening up' tries to argue that it would have been much better if Turkey had never applied for full membership to the EU. The author first looked at an overview of the post 1980 Turkish economy, the changing patterns between the 1980s and 1990s, the financial crisis and crisis management in 2001-2002.

- Yeldan's article 'Behind the 2000/2001 Turkish crisis: stability, credibility and governance for whom?' documents the fragility indicators of the Turkish financial and fiscal system, and show that the disinflation program led to an increase of the vulnerability of the financial system throughout 2000/2001. The papers also argues that the recent wave of the structural reforms destined for stability and

credibility, serve, in fact, mainly the interest of the foreign financial capital, and primarily aim at securing the debt obligations of the Turkish arbiters.

- Civcir's article ' Before the fall was the Turkish lira overvalued?' examines the validity of the purchasing power parity to evaluate whether the Turkish lira was overvalued on the eve of the 2001 crisis using multivariate and univariate time series technique.

- Celasun's article ' Before and after the 2001 crisis: a macroeconomic and financial evaluation' is an overview of the macroeconomic and financial development, the crises, the stabilization program, the weaknesses of the programs and finally the possibility of a recovery from the crises.

- Daniel Leigh and Marco Rossi's paper ' Leading indicators of growth and inflation in Turkey' investigates the predictive performance of economic indicators for inflation and real output growth in Turkey

- Serin and Arican's article 'An assessment of the IMF stabilization programs for developing countries examines how successful IMF supported programs are. It is a comparative study on the effects on Turkey, Argentina and South Korea.

Then there are a number of literatures on financial crisis in general.

- Stiglitz speech ' Must financial crisis be this frequent and this painful?' present three points. First, the search for something to remedy the frequent crises is a big challenge. Second, the economic theory of imperfect information provides an economic rationale for public action at the national and international levels, to mitigate some of the major international economic problems. Third, this economic rationale can be used as the basis for designing feasible policies to help prevent crises and respond to them better when they do occur.

- Ajit Singh's article 'Capital account liberalization, free long-term capital flows, financial crises and economic development' argues that a multilateral agreement on investment which denies countries the discretion to regulate FDI, will not be in the interest of the developing countries

- Schroeder's article ' A Minskian analysis of financial crisis in developing countries provides a framework for examining developing –country's financial crisis, based upon Hyman Minsky's financial fragility thesis.

The dissertation aims to look at what impact the IMF program had on the economy and polity, whether it was responsible for the financial crisis with the kind of fragility in the financial structure or whether the financial system itself was responsible for the crisis.

Chapter 2 will concentrate on the Turkish economy from the 1980s to 1990s i.e. the various macroeconomic indicators over the period after a brief analysis of the features of financial crisis,

Chapter 3 will look at the build up of the imbalances, debt and capital flows, the crisis, and the stabilization program. It will be a detail study of the economy focusing on the period since the 1990s, the crisis and the IMF stabilization program

Chapter 4 will analyze the impact of the IMF stabilization program to see whether this was responsible for the crisis and what impact this has on the post crisis economy and polity.

The last section will be a summary of the paper and will try to draw a relevant conclusion on what lessons can be learned by other developing countries from Turkish experience

CHAPTER – 2

What is financial crisis?

Experiences suggest that a financial crisis comprises broadly of a combination of a currency crisis and a banking crisis. A currency crisis is said to occur when a speculative attack on the exchange value of a currency results in a devaluation or a sharp depreciation of the currency or forces the authorities to defend the currency by expending large volumes of international reserves or by sharply raising interest rates (IMF, World Economic Outlook, 1999). Therefore, the conditions which lead to such situations where investors start speculating on the depreciation of the exchange rate and the currency succumbs to the volatile psychology of the speculation need to be identified. Those conditions normally take the form of some common trends in certain macroeconomic variables within and outside of the economy. The most significant variables and trends in this context are enumerated below.

- A large inflow of short-term capital (portfolio investment), which tends to be largely speculative in nature, involving bets on the future values of currencies or other financial instruments or derivatives.

- A significant appreciation of the exchange rate, which attracts foreign investor to invest in domestic currency denominated assets. Since in the long run it is difficult to sustain this appreciation, expectation of a depreciation build up among portfolio investors leading to speculation

- Domestic as well as foreign interest rates, which play a vital role in the determination of currency stability. A high differential in interest rate, with a higher domestic rate, attracts foreign investments. On the other hand a narrowing of the differential, especially through a rise in the foreign interest rate, triggers an outflow of capital. Therefore a declining trend in the interest rate differential is a good indication of a possible speculative attack on the currency.

- A large current account deficit, which is difficult to manage in the long run especially for developing countries with limited foreign exchange reserves. Such deficits are often caused by a large inflow of foreign capital.

When movements of the kind discussed occur in the variables mentioned above, the likelihood of currency crisis increases. Often these tendencies are associative of other indicators of a failure of the domestic financial system or of a banking crisis.

A banking crisis refers to a situation where actual or potential bank runs or failures induce banks to suspend the internal convertibility of their liabilities or which compels the government to prevent these by extending assistance on a large scale. A banking crisis may be so extensive to assume the form of systematic financial crisis. Systematic financial crises are potentially severe disruptions of financial markets that by impairing the markets' ability to function effectively can have adverse effects on the real economy. A systematic financial crisis may involve a currency crisis but does not necessarily

involve serious disruption of the domestic payment system and thus may not amount to a systematic financial crisis (IMF, 1999).

In practice a range of conditions seem to precede the spate of banking crises witnessed in recent times. These include broadly the following:

- A larger induction of private players into the domestic financial system through privatisation and liberalization of the condition of entry by foreign participants.

- A gradual shift of domestic credit from the hands of the public to the private sector, with the latter using such credit either for the purpose of consumption of foreign goods or for investments in the real estate and speculative assets. Most of the countries that have suffered a banking crisis have been characterized by lending by banks for speculative investments in risky projects and assets, resulting in a boom in real estate prices and stock exchange indices.

- A high differential between domestic and foreign interest rates is also a condition that increases the potentiality of banking crisis. The lower foreign interest rate encourages domestic bankers to borrow on a large scale and finance very risky business operation in the domestic market.

These characteristics of the environment surrounding a currency crisis and a banking crisis suggest that we cannot compartmentalize the two. Every characteristic that causes a currency crisis does adversely affect the banking sector as well. General experience has been that these trends precipitate a currency crisis before a banking crisis, making a currency crisis the precursor of a collapse in the domestic and financial and real sector.

In this context it must be mentioned that in comparing industrial and emerging market economies, it appears that industrial countries had fewer currency and banking crises than emerging market economies during the Post-Bretton Woods era. The IMF estimates that the incidence of currency crises in emerging market economies was double that in industrial economies and the same was the case with banking crises too, though the latter have occurred more than twice in the industrial economies.

The difference in the proneness to crisis between developing and developed countries stems from a number of factors. The size of the developing countries financial market is small, so that entry or exit of medium-size investors from developed countries is capable of causing considerable price fluctuation, even though their exposure in these markets account for a small percentage of their total portfolios. Secondly, differences in the size, maturity period and currency denomination of the external debt play a crucial role in generating crises in developing countries. The vulnerability of developing countries is greater because of their typically higher net external indebtedness, the shorter maturity of their debt and the higher share of such external debt denominated in foreign currencies.

Finally the vulnerability of the domestic financial system is increased further when the private sector rather than the government owes much of the external debt.

Turkey in the 1980s

The history of the Turkish economy for the last 20 years has often been separated into 2 distinct periods:

- 1980-1988: a period of export led growth

- 1989-2000: beginning with capital account liberalization, a period of volatile growth during which the economy became dependent on short term capital flows or hot money.

The economy over the period has always been characterized by a relatively high inflation, with an inflation rate of 20% in the 1970s, 35-40% in the early 80s, 60-75% in the late 80s and around 80% in the 1990s until the government launched another disinflationary program in 1998 (Ertuorul and Selcuk, 2001)

The present section will provide a brief account of the Turkish economy in the first sub period.

1972-1979 was a period of the deepening of the industrialization strategy based on import substitution. The late 1970s was characterized by the implementation of a public

investment program, which aimed at expanding production capacity in heavy manufacturing and capital goods. In 1980 liberalization attempts with an export led growth policy were made with an aim to maintain external balance. The main characteristics were export promotion with a strong subsidy component, gradually phased import liberalization, managed floating of the exchange rate and regulated capital movement.

The early phase of financial liberalization turned out to be a painful process. The speedy lifting of controls on deposit interest rates and allocations of credit in mid 1980 led to a financial scandal in 1982. Till the late 1980s the policy pendulum moved between re-regulation and deregulation but the trend was definitely towards the establishment of a liberalized domestic financial regime. (Ertuorul and Selcuk, 2001)

The post 1980 Turkish adjustment path started with an orthodox stabilization policy, which incorporated the first structural steps towards a market based mode of regulation. The shock treatment of 1980, which incorporated various forms of nominal anchoring and monetary tightening, was to a large degree successful in terms of its own policy goals. The economy experienced a relatively high growth rate of GDP, a healthy balance of payment situation and relatively low inflation in the early 1980s. The rate of inflation, which had almost reached three digit figures in 1980, was reduced to an average of 33.2%in the following two years. Liberalization of domestic markets eliminated the shortages in basic commodities and a major realignment in relative prices took place relative smoothly (Boratav and Yeldan, 2001).

The first phase of reforms was followed by a gradual move into trade liberalization in 1984 and liberalization of the capital account in 1989. With this banks were allowed to accept foreign currency deposits from residents and to engage in specified external transactions. The Central Bank's control over commercial banks was simplified with a revision of the liquidity and reserve requirement system. An inter bank money market for short term borrowing facilities became operational in 1986. In 1987 the central bank diversified its monetary instruments by starting open market operations. During 1983-87 export revenues increased at 10.8%p.a and GDP rose at 6.5%p.a (Ertuorul and Selcuk, 2001) .The severe deterioration of public sector balances of the late 1970s could have been relatively brought under control during the 1980s.

However 1983-87 was also characterized by continued erosion of wage income. The share of wage labor in manufacturing value added declined from an average of 35.6% in 1977-80 to 20.6% in 1988. Thus according to Boratav and Yeldan (2001) the impressive export boom of the 1980s was essentially based on the productive capacities established during the preceding decade. In addition capacity constraints and limited technological up gradation contributed to the overall deceleration of export growth of manufactures during 1989-2000. The export led growth path which was dependent on wage suppression, depreciation of the domestic currency, and extremely generous export subsidy reached its economic and political limit by 1988. The only way out seems to be the liberalization of capital account.

The full convertibility of the Turkish lira was realized at the beginning of 1990. The disinflation effort started in late 1980s pronounced itself strongly especially after 1989. However the government did not take the necessary measures on the fiscal front and the disinflationary attempts proved futile. So that according to Akyuz(1990) & Balkan and Yalden (2001) the Turkish experienced did not conform to the Mckinnon-Shaw hypothesis of financial deepening with a shift of portfolio selection from unproductive assets to those favoring fixed capital formation. Throughout the course of the events Turkish banks became detached from their conventional functions, started to act as institutional rentiers, and made huge arbitrage gains when conditions were appropriate but became extremely vulnerable to exchange rate risk and to sudden changes in the inflation rate.

Thus according to Boratav &Yalden (2001) during the 1980s the linkages between capital flows and growth appear to be in the direction of growth→current deficits→capital inflows i.e., a given growth rate generates current deficits which have to be covered by a somewhat larger margin of capital inflows from non-residents. The 1990s appear to have transformed the direction of the forgoing linkage into capital inflow→ growth→current deficits. So that, during the 1990s changes in the level and direction of capital movements generated a financial cycle of boom-bust-recovery which in turn resulted in rising volatility of the growth rate. The post 1990 years exhibits four downturns 1991, 1994, 1998-99, 2001 and four booms 1990, 1992-93, 1995-97 & 2000.

Macroeconomic development: 1980-2000

a) The growth performance

The IMF hailed the export led growth strategy of the early 1980s as a success. The average annual rate of growth of GDP was 5.8% between 1981and 1988', and the economy did not experience any recession. However from 1988 the economy entered into a new phase and growth performance has been sluggish since. The annual real GDP growth average 3.7% during the period with 2 minor and 2 major recessions. In the 1990s with a low average growth rate and high volatility the exemplary economy became according to Ertuorul and Selcuk (2001) a textbook case of boom-bust growth performance. After 1987 there were 4 recessions in Turkey and the 1991 and 1994 recessions were both preceded by a substantial appreciation of the Turkish Lira. The last recession in 1999 was said to be caused by the response of the monetary authority to the Russian crisis in late 1998 and two devastating earthquake in 1999.

b) External balance:

In January 1980 an outward oriented development strategy was adopted with the introduction of a complete stabilization program. With this external balance became an important concern of the government. In the early stage of its implementation the export led growth policy was considered a success. The openness of the economy increased and during the period 1980-88 the total export-GDP ratio increased from 4.1% to 13.3%. The total import-GDP ratio also increased but at a lower rate- from 11.3% to 16.4% for the same period. The external deficit-GDP ratio went down from a deficit of 7% in 1980 to a surplus of 1% in 1988.

However the policy reversal in 1987 had an adverse effect on the external balance. The Turkish lira appreciated in real terms by 22% in 1989 and continued to appreciate but at a lower rate in 1990. Consequently with the appreciation of the domestic currency, the rate of increase in the total export slowed down and that of imports jumped up. The external deficit-GDP ratio increased to 2% in 1989, 4% in 1990, and although there was a slight decrease in 1991 and 1992, it reached 6% in 1993. Towards the end of 1993 it was clear that both fiscal policy and external balance were not sustainable. In 1994 the Turkish lira was devaluated twice because of a panic in the financial market which led to an increase in export and contraction in imports.

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As a result the external balance was positive at 1% of GDP in 1994. According to the national income statistics, the external deficit was 5% of GDP in 1995 and 6% in 1996 and 1997. The figures were low for 1998 &1999. Total export has been stagnant for the last few years and it is change in total imports that has been dominating the current account dynamics. It can be seen from the capital account of the balance of payments that the economy has been dependent on short-term capital flows, especially after 1989. Foreign direct investment was extremely low until 1988. From $100 million in 1987 the FDI increased to $800million in 1992. The FDI never crossed the one billion mark for the entire period. Since 1996 the private sector has started increasing its external borrowings. Total outstanding external debt was US$79.6 billion in 1996 and increased to US$106.9 billion in 2000 (Ertuorul and Selcuk, 2001).

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Capital account liberalization in 1989 lifted restrictions on capital movements and on foreign borrowing by residents. This resulted in a rising gap between non-resident inflows and the current account, especially in the 1990s. The cumulative current account deficit during the 1990s equaled $14.1 billion; whereas Turkey's external debt during the same period has risen from $ 42 billion to $ 102 billion far in excess of the financing requirements of the current account.

The balance of payments identity is defined as: NKF (nr) plus NKF(r) plus EO plus DR plus CA equals zero where the terms represents respectively net capital inflows from non residents, residents net flows, net errors and omissions, changes in reserves and the current account balance. Table 1 shows the changes in these as a result of the liberalization of the capital account in 1989.

A negative value for NKF(r) signifies recorded capital outflows by residents. During the 1990s with the exception of the crisis year of 1994, the figure for this was negative throughout. In relative terms their drain on the capital account was particularly heavy during the financial bust in 1998. Comparing 1980s to 1990s it is observed that capital controls really make a difference.

A negative EO figure is considered as capital flight. During the 1980s the net balance of the EO item was positive. The 1990s reversed the direction of the flight by changing the cumulative EO item into negative values and residents' unrecorded capital movements as a ratio of total nonresidents flow was minus 6%.

Another distinguishing feature of the 1990s is the increasing magnitude, both in absolute and relative term of 'hot money' flows. Short-term hot money inflows include short term foreign credits obtained by the banking sectors, inflows due to securities sales of residents abroad, securities purchases of non-residents in Turkey. It was predominantly these short terms, arbitrage seeking capital movements that were affected by capital account liberalization in 1989. There was wide fluctuation in net portfolio investments, the figure for which were $3.9b, -$6.7b, -$4.5b for 1993, 1998 and 2000 respectively. The cumulative net flows of securities by residents and nonresidents in Turkey for 1992-end to 2001 was -$15.9billions. Thus between 1990 and1996 Turkey suffered from an excess of speculative capital inflows, mostly portfolio investment and short term flows. For the period 1991-1995 average gross inflows of speculative hot money exceeded the total real production of agriculture and industry in Turkey.

c) Fiscal balance and domestic debt

The public sector borrowing requirement (PSBR) in Turkey consists of: central government, extra budgetary funds, local authorities, state economic enterprises, social security institutions and revolving funds. Following the 1980 export-led development program the PSBR as a percentage of GDP decreased from 9% in 1980 to less than 4.5% in 1981. After 1986 the PSRB started to increase and reached 12% in 1993. The ratio continued an upward spiral except for a brief period of deceleration in 1995 and 1997 and reached over 15% in 1999.

After 1987 there was a change in the deficit financing policy of the government. The share of domestic borrowing in PSBR financing kept increasing and the share of foreign borrowing declined. After 1993 the share of foreign borrowing in PSBR financing was negative. Consequently the domestic debt started to increase. Total domestic debt of the government, which was a mere $4 billion, reached $53 billion in 2000. The ratio of domestic debt to GNP also increased from 6% in 1988 to 30% in 1999. Before 1990 the public budget deficit- GDP ratio was around 3%, by 1993 this has risen to 7%. Interest payments as a percentage of GDP doubled in 1990 and tripled in 1996. The share of domestic borrowing is always greater than foreign borrowing to finance public deficit. In other words public sector began to finance the deficit through domestic agents that increasingly borrowed from abroad. The domestic-GDP ratio, which was 6.3% in 1989, rose to 13.9% in 1994 and 18.4% in 1996 (Yenturk, 1999). Turkey was thus trapped in a Ponzi situation, whereby rising interest payments could only be met by issuing new debt instruments, with net new borrowings reaching 50% of the existing stock of securitised debt.

d) The development in the Turkish banking system:

The 1980 Structural Adjustment Program aimed at the liberalization of the repressed financial system. Consequently the government started to liberalize the foreign exchange regime, remove certain restrictions on capital movements, and provided the convertibility of the Turkish lira. And with removal of restrictions on interest rates, a short-term money market was created and the Central Bank was allowed to engage in open market

operations. Most of the regulations concerning the financial market were eliminated which speeded up the linking of the domestic financial market with the rest of the world.

The first phase in the development in the Turkish banking system can be linked to early liberalization efforts in the 1980s and the developments especially after 1987 leading to the 1994 crisis. The 1980s Structural Adjustment Program brought about substantial changes in the banking sector. The total assets of the banks increased from $18.5 billion in 1980 to $134 billion by end of 1999. The total deposit-GNP ratio also increased from 15.4% to 61% during the same period. During the period the market share of the state banks gradually decreased from 44% to 35% and the share of private banks increased from 41% to 50%.

The program also created important structural changes in the banks' balance sheet. The relative share of non-deposit funds in total liabilities of private banks permanently increased and reached a peak in 1993. The share of foreign currency denominated assets and liabilities started to increase. The share of foreign currency denominated assets in total assets increased from 26% in 1988 to 38% in 1999 and the share of foreign currency denominated liabilities in total liabilities increased from 25% in 1988 to 48% in 1999. In private banks the shares of foreign currency denominated deposits in total deposits reached 72% in 1999 (Ertuorul and Selcuk).

Short term borrowing based deficit financing policies of the government increased the interest rates and encourage short-term flows into the country. The deficit financing and

reserve accumulation policies led commercial banks to open short position in foreign currencies and to change their assets management policies. They shifted from direct loan extension to purchasing government securities. The banking system became increasingly vulnerable against foreign exchange and interest rate risks. On the one hand, though, the higher interest commitment on domestic assets, lower depreciation rate and increase in public sector borrowing requirements built up the foreign exchange reserves of the Central Banks, on the other hand they opened up the banking sector to speculative attacks.

Thus the question of the sustainability of the external balance policy based on short-term capital inflow arises. With the removal of the restriction on capital movements in 1989 the Central Bank also launched a new monetary program, which prevented easy access of the public sector to the Central Bank's credit line. However with no measures taken in the fiscal area, the treasury kept getting involved in internal as well as external borrowing activities.

The financial environment between 1989 and1994 was typically characterized by high interest rates, lower depreciation and heavy internal and external short-term borrowings. The private owned banks were made weak in managing in market risks with a lower credit risk and high rate of return on government bonds. They began changing their global assets management strategies and started to operate in short position in foreign currency denominated assets since the existing policy provided large profit margins for

them. And because of this profitable short position the dollarisation in the banking system started to increase.

However within this kind of situation between 1989 and 1993 the capital adequacy ratio remained at an internationally acceptable level with a relatively higher return on domestic assets which helped to increase retained earnings and consequently the net worth of the banking system. By the end of 1993 the policy of the government reversed towards a lower interest rate, higher depreciation policy and the cancellation of the treasury auctions. These could have been what eventually led to the crisis in 1994.

CHAPTER - 3

The Crises

Globalization or the integration of the developing economy into the world financial system is achieved through a series of policies aimed at liberalizing their financial sector. Though the aim of financial liberalization is to restore growth and stability through increased savings and improved economic efficiency, most of these economies have been exposed to speculative short-term capital movements leading to financial instability (Boratav and Yeldan, 2001). This resulted in a series of financial crises in these developing countries. And contrary to expectations, post liberalization economies often see a divergence of domestic savings away from fixed capital investment towards speculative financial instruments. Thus economies with weak financial structures suffer from increase volatility of output growth, shortsightedness of entrepreneurial decisions and financial crisis with severe economic and social consequences.

Turkey post 1980 has suffered from wide fluctuation in national income with conflicting policy adjustments. By 2000, the economy was plagued by problems of

- Persistent and rapidly expanding fiscal deficit
- Marginalization of labor force with deterioration of economic conditions of the poor
- Severe erosion of moral values with increased public corruption.

The posts 1990 years exhibit four downturns (1991, 1994, 1998-9, 2001), the latter three of which incorporated financial crisis of different intensity and four booms (1990, 1992-3, 1996-7, 2000) (see table 2). It would be impossible to diagnose the underlying cause of the financial disturbances without observing the volatility of capital flows. Capital inflows refer to the acquisition of domestic assets by non-residents. Capital outflows refer to the acquisition of foreign assets by residents. (UNCTAD, 1999)

1994 seems to exhibit the most volatile impact. Net inflows by residents were reversed into outflows reaching 4.8% of GNP. The hasty adjustment in 1993 led to the rise in demand for foreign currency. In January 1994 the Turkish lira was devalued by 13% but did not help much to curb the demand for foreign currency. The devaluation destroyed the balance of the commercial banks and to alleviate their short position the Central Bank and the state banks started to sell foreign currency to the privately owned banks. After 3 months the government launched a stabilization program in April and devaluated the currency by another 65% in nominal terms. But in spite of the substantial measures taken the burden of the crisis was heavy. Capital adequacy ratios of all banks declined and state banks lost 90% of their net worth and non-performing loans increase to 65%. What was striking about the 1994 crisis was the net reversal of both residents and non residents flows compared to 1993 figures (by -$12billions) (see table 3)

The 1998 bust also incorporated comparable reversal in capital movements. Throughout 1998, non-resident flows continued to be positive but registered a substantial decline compared to 1997. The difference between 1997&1998 figures for NKF (nr) is -

$7.6billions, and for NKF(r) is -$417millions. The Russian crisis in August 1998, the general election in April 1999 and two devastating earthquakes in August and October 1999 led to a deteriorating fiscal balance of the public sector. The relative share of primary surplus in GDP declined and the public debt-GDP ratio kept increasing. Government debt had grown rapidly over the preceding decade exceeding 60% of GDP at the end of 1999, and two-third of this was domestic debt. The PSBR was over 24% of GDP, with 22% taken over by interest payments and 2% by primary deficits (IMF, 1999). By contrast the external sector looked relatively healthy with sustainable balance of payment situation and stable exchange rate. With interest rates exceeding inflation by more than 30%, fiscal sustainability could not be secure without lowering inflation. The extremely fragile banking system has come to depend on high inflation and high interest rate by lending to the government, which has become the most important borrower in the domestic market.

In December 1999 the Turkish government launched an exchange rate based stabilization program with the support of the IMF in order to bring down inflation and check public debt accumulation. The program appeared to be on course in the subsequent nine months but started running into problem in autumn 2000 necessitating a large IMF bailout. The program achieved some improvements concerning the inflation rate and fiscal imbalances but could not relieve the pressure on the interest rate. It was clear that the program was not viable and with massive attack on the currency and a rapid exit of the capital, the currency peg which had been maintained had to be abandoned in February 2001 and replaced by a regime of free floating exchange rate.

What set off the crisis could have been the Turkish Prime Minister's remark of 'a very serious state crisis'. The currency overshot, interest rose, the stock market, employment, production, finance and the Turkish lira went into a downward spiral and GDP shrunk by 7.4% over the year (Akyuz and Boratav, 2001). The real gross domestic product which had fallen by 5% in 1999, expanded at a rate of 7.4% in 2000; but drifted into negative quarterly rates of growth following the first quarter of 2001 (Yeldan, 2002). Despite the competitive depreciation of the Turkish lira the annual rate of growth of exports was not meaningful at 7.4% and imports lessened by as much as 24.8%. As a result, following the contraction in the demand for foreign exchange from the real sector the current account balance tilted to a surplus reaching 1.4% of GDP. Important indicators of the crisis of the financial markets were the rapid rate of depreciation of the currency and the sudden hike of the rate of interest on government debt instruments (GDI). From the second quarter of 2000 the nominal parity of the US dollar – Turkish lira increased by quarterly rates of 96.5%, 116.5%, 114.5% and stabilized only in November 2001. And the rise in the real rate of interest of GDIs reached 117.5% in the first quarter of 2001. After another bailout package from the IMF, though the finance and currency market stabilized, employment and economic activity remained depressed.

The Turkish crisis had a number of features common to crisis in emerging market that implemented exchange rate stabilization program. These programs typically used the exchange rate as a credible anchor for inflationary expectation and rely on capital inflows attracted by arbitrage opportunities to finance growing trade deficit. Such programs had

often been criticized on the ground that they were launched without adequate attention to the potential problem of real currency appreciation and without a clear exit strategy as to when and how to alter the currency peg or the regime and realign the exchange rate (Eichengreen).

The Turkish difficulties arose because the program was launched in the face of structural problems and fragilities especially in the banking sector and public finances. The banking sector was heavily dependent for its earnings on high yielding T-bills associated with rapid inflation and thus vulnerable to disinflation. Thus there were inconsistencies in the policy since much of the fiscal adjustments were predicted on declines in the very nominal and real interest rates on which many banks depended on their viability. While the program incorporated a pre announced exit from the crawling peg after 18 months, it failed to meet its inflation target despite full implementation of the monetary and fiscal policy. The program backfired and persistently high inflation and widening current account deficit fed into the expectation of the sharp depreciation of the currency.

According to Boratav and Akyuz (2001) the shortcoming in the design of the program could be the reason why crisis broke out before inflation was brought under control. Another important factor could be the mismanagement in crisis intervention because this has been premised on restoring confidence maintaining capital account convertibility and meeting the demands of the creditor through fiscal and monetary tightening. Abandoning the peg and moving to free floating under full capital account convertibility and extensive dollarisation aggravated the difficulties of both public and private sectors. The collapse of

the currency hit hard those sectors with high exposure to exchange rate risk encouraged. Public finance was squeezed from rising external and domestic debt servicing obligations. This along with monetary tightening served to deepen recession.

The target of the stabilization program was to bring down WPI and CPI from 68.8% and 62.9% in December 1999 to 20% and 25% respectively by 2000 end and to a single digit by end of 2002. The inflation target was anchored to a pre announced crawling peg set in terms of a basket made up of the dollar and the euro i.e. it programmed a 20% rise in the nominal Turkish lira price of a basket of 1US$ and 0.7 euro, a declining monthly rate starting with 2.1% for the first quarter and going down to 1% for the last three months of the year. A gradual shift towards a more flexible exchange rate regime was to begin in October 2001 (Boratav and Yeldan). The upper limit for the net domestic assets of the Central Bank was set and the monetary base was to be totally dependent on the purchase of foreign currency by the central bank. A preannounced exit strategy was implicitly built into the Turkish stabilization program because of the need to avoid the potential problem currency appreciation and movement away from the soft peg.

The conditionalities set by the IMF were

- Rationalization of agricultural policies and pension system
- Improvement in fiscal management and tax administration
- Privatization of state owned enterprises including in particular the Turk telecom.

- Strengthening of the banking system and banking regulation according to the regulations and standards of the Basel committee.

The program appeared to be successful in the first ten months of its implementation. Monetary, fiscal and exchange rate targets were attained. During 2000 the targets for nominal exchange rate, net domestic assets and primary budget deficits were all attained, but prices proved to be stickier than expected. Though domestic price movements decelerated significantly from February onwards, the decline in inflation rate was behind the targeted rates of change of price indices and of nominal exchange rates. Between the last weeks of 1999 and 2000, the exchange rate basket rose by 20.3% but rate of change in the wholesale price index (WPI) and the consumer price index (CPI) were 32.7% and 39.0% respectively. At the end of December 2000, the year-to-year change in the consumer price index was 39% while the average inflation as a whole reached 55% compared to 65% in the previous year (IMF, 2000)

The reasons could be

- A tradeoff emerged between fiscal adjustment and inflation since reducing losses of state owned enterprises required increases in their prices.
- Wage increases in the public sector often exceeded inflation target by a large margin, because of implementation of collective agreements reached in the previous years while private sector wage settlement continued to be based on backward indexation.

- Certain components of CPI, notably rents, rose much faster than inflation targets. (Akyuz and Boratav, Boratav and Yeldan, 2001)

Interest rates fell faster than the rate of inflation, annualized rate on 3-months treasury bills averaged around 38% in January-November 2000, compared to over 100% in 1999. The average T-bills real interest rate was negative both in forward looking and backward looking terms (IMF, 2001). These brought considerable relief to the budget and also restrain debt accumulation. The primary surplus reaching 2.8% of GDP against a target of 2.2% was an impressive improvement in the budget. For the first 3 quarter of 2000 there was a fine balance between rate of interest and inflation.

Another significant feature accompanying the appreciation of the currency was the explosion of capital flows by nonresidents, which reached $15.5billions during the first ten months of 2000. These private capital inflows along with large scale borrowing by the treasury were more than sufficient to meet rising current account deficit, resulting in large increase in international reserves, which reached some $24 billion exceeding the year-end budget of the program. And with no sterilization policy, this meant considerable expansion of domestic liquidity. This together with shifts in government borrowing from domestic to international markets lowered interest rates.

But there was a net acquisition of assets abroad by residents. Foreign exchange deposits held by residents in domestic banks also rose both in absolute terms and as a share in total commercial deposits. Rate of interest in foreign exchange remain unchanged, but

there was sharp drop on the lira deposit rates. And 90% of the net capital inflows were debt creating which were mostly, international bonds issued by public sector, short-term bank credit from abroad and long term bank credit.

Disinflation, currency appreciation and exceptionally low interest rates generated a strong domestic demand led recovery. There were surges in gross fixed capital formation. Together with the appreciation of the currency and a rising oil import bill, there was a surge in imports, which increased by 35% in 2000 while export growth remained at 7%. The trade deficit doubled to more than $ 20 billion pushing the current account deficit to 5% of GDP, 3 times the level targeted. The boom in capital inflows lasted much shorter and the crisis broke out before any significant progress could be made in disinflation. During the second half of 2000 the slow down of economic reforms in general and the opposition to privatization of certain state enterprises from inside the government increase the suspicion of the market that the program was about to end.

The first sign of trouble came in September 2000 when net capital flow turned out to be negative because of large net security acquisition by residents aboard. In November there was rapid exit of capital, unexpectedly high monthly trade deficit, political difficulties encountered in privatization, worsening relation with the EU, the economic situation in Argentina, disclosure of irregularities in the banking system, criminal investigation into several banks taken over by the non-resident. In November the withdrawal of capital by nonresidents reached 5.2 billion US dollar. And by December 2000 the ratio of short-

term debt to international reserves, which had stood at 101% at the inception of the program, jumped to 152%.

A sudden outflow due to nonresidents liquidating their treasury bills and equity assets started a run against the Turkish lira in November. Additional foreign exchange demand resulted in the erosion of the Central Bank reserves by nearly $7 billions whose net external assets declined by 52% in two weeks after mid November (Akyuz and Boratav). The macroeconomic impact was chaotic. The failure to meet inflation target reinforce the expectation of a sharp depreciation at the time of the preannounce exit date leading to an earlier attack on the currency (Boratav and Yeldan, 2001).

The Central Bank of Turkey, which was assigned the role of a de facto currency board under the program, was faced with a dilemma of either to defend the monetary rule i.e. the currency peg at the expense of a deep financial crisis or to act as a lender of last resort and inject liquidity into the system. It went for the latter and started supplying liquidity to troubled banks but this only served to accelerate the erosion of international reserve. It did not prevent contraction in the monetary base. So liquidity injection was discontinued and with reserve still sufficient to meet short-term external liabilities, capital outflows stopped but interest rates shot up with overnight rates reaching 4-digit levels.

In December 2000 a new agreement was signed with the IMF, which included a financial package of $10.5 billion including$7.5 from the Supplementary Reserve Facility. The commitments were- fresh spending cuts increase tax, dismantling agricultural support,

liberalization of key goods and services market, financial sector restructuring and privatization. By end 2000 the IMF support along with new commitments by the government stabilized currency and halt capital outflows.

By mid-January international reserves had been replenished, interest rates fell below 60%, imports slowed down with weakening of aggregate demand and inflation continued to fall. In November the IMF was confident that the program was working.

But external funds remained invested at extremely short maturity, maturities in T-bill started to shorten drastically in late January, interest rates shot up reaching 70% in mid-February. Situation of rising public debt, high inflation and continued appreciation of the currency created uncertainty over the sustainability of the peg. In the second half of February 2001 there was a political skirmish between the President and the Prime Minister to break the peg that led to massive flight from the Turkish lira despite rising rates of interest and rapid drying up of liquidity. The government was threatened with complete loss of control over monetary policy as well as a rapid depletion of international reserves, so was forced to abandon the peg and to float the currency with IMF support. Value of the lira against the dollar fell from TL 680 thousand per dollar to TL 960 thousand per dollar. Despite a sharp turnaround in current account balance brought about by the collapse in economic activity, reserves decreased as a result of rapid exit of capital. From the outbreak of the November crisis, net capital flows amounted to minus $17 billion, swing in net capital flows reached $28 billion, 14% of GDP (IMF, 2001),

about one-third of which was accommodated by a sharp turnaround in current account balance and the rest by changes in reserves.

As financial turmoil deepens, in May 2001 the economic team was changed and an agreement was reached with IMF on a new program called the Strengthened Program with an additional stand by credit of $ 8 billion. Targets for growth and current account deficit were significantly lowered while inflation and public debt targets were raised. Here the assumption was that the economy would stabilize and growth would resume in the second half of the year. All these were predicted with a strong fiscal adjustment i.e. cuts in public expenditure, employment and investment while monetary policy was to focus on control of monetary aggregates subject to a quantitative ceilings on net domestic assets of the Central Bank of Turkey and a floor on its net international reserves. Even though fiscal and monetary performance criteria were met stabilization and growth proved elusive. Inflation and interest rates remained well above projection. Though the projection was revised they were still off the mark and the exchange rate continued to overshoot under speculative pressure.

The macroeconomic implications that followed were dramatic. The high tempo of inflows by non-residents during the first ten months of 2000 generated a boom with unstable characteristics and as external agents perceived its unsustainability, capital flows were reversed. The magnitude and suddenness of the reversal determines the depth of the financial crisis and its incidence on the growth rates. Hence in 2001 the economy appears to be moving into a depression much more serious than those observed in the preceding

crises. By the second half of 2001, the annual decline in industrial production had exceeded the 10% threshold accompanied by massive layoffs, rising inflation, increased social unrest and generation of current surplus which was essentially due to import compression.

In spite of all these the main macro economic developments under the 2000 disinflation program were hopeful

- Disinflation was observed to have materialized.

- The monthly rate of change for both CPI and WPI decelerated especially after May, and hit its lowest in June 2000.

- The core inflation rate which is measured by change in private manufacturing industries prices has fluctuated around the aggregate CPI and WPI.

- The monthly rate of increased of all relevant price indices prevailed above the rate of depreciation of the currency basket.

The rate of growth of GDP increased from +5.6% in the first quarter of 2000 to +8.3% in the last quarter of 2000. There was an upturn in both investment and consumption demand. Commodity imports increased at a rate of 35.9% and export growth was at a rate of 7.9%. The current account deficit rose from $1.4billion in 1999 to $9.7billion in 2000

end. The rate of interest on government debt instrument dropped from 100-120% range to 30-40% range. This drop led to significant savings of fiscal expenditure. The rate of increase of budgetary tax revenue reached 18.3% and the realization of tax revenue exceeded target by 10.5%. However the overall budget continued to remain at around 10% of GDP, because of the continued increase of interest expenditure as a ratio of GDP.

Main element of the 2000 disinflation program

It covered a time horizon of 3 years till end 2002. Specific targets were set on monetary aggregates, daily depreciation of exchange rates and fiscal balance. The program was based on

a) Austerity of public expenditure subject to specific targets for non-interest fiscal surpluses
b) A preannounce calendar for the rate currency depreciation in line with the targeted rate of inflation.

c) A monetary rule which set the liquidity generation mechanism to the net foreign assets position of the Central Bank, forcing the Central Bank to act as a semi currency board.

The aim was to decrease inflation rate and to increase primary balance from a deficit of 2.8% to 3.7% of GDP. The expected revenue sources were revision on income taxes, increase rates on indirect and value added taxes and privatization operation especially of the Turkish telecom and airlines.

It adopted the monetary approach to the balance of payment which expect the real exchange rate to be in the long run equilibrium at its purchasing parity level and maintains that the domestic money supply be endogenised in a regime of open capital account. So the rate of currency depreciation would be set according to the preannounce calendar so as to break the inflationary inertia of 3 decades.

However containment of inflationary expectation using the exchange rate as a nominal anchor has their detrimental consequences- the unavoidable appreciation of the domestic currency during the course of the program together with the elimination of exchange rate risk give clear signal for increase foreign borrowing.

Now given the historical observation that the prolonged use of the exchange rate based stabilization program are associated with increased external fragility and unsustainable foreign indebtedness the Turkish disinflation program provided a strategy of exit. After the first eighteen months i.e. in July 2001 exchange rate basket would have been allowed to float within a crawling band. The tail of the band would be widened every six months by 15%. By end 2002, the limit of the band would have been completely dismantled and Turkey would switch to a regime of fully flexible exchange rate.

Liquidity generation under the disinflation program

In order to sustain the table on the exchange rate depreciation, the program limited the Central Bank's rule of monetary expansion only to change in the net foreign assets of its balance sheet. For this specific upper ceiling were set on the net domestic asset of the Central Bank. To be able to meet the liquidity need of the banking sector, the reserve requirement ratios were significantly lowered. The Central Bank would be allowed to change its net domestic assets position within a band of +/- 5% of the monetary base to be revised at three months internal.

Monetary base = net foreign assets+ net domestic assets. As a result of the restrictions set on the upper ceilings of the net domestic assets, the programs limit the monetary expansion only to the changes in the stock of net foreign assets. So the most important element to be able to sustain the liquidity needs of the economy would depend on the continuation of the foreign credit available to the system. Thus it was expected that the liquidity available in the domestic economy would be managed directly by the interest rate signals in a smoothly operating financial markets: rising domestic interest rates would invite foreign inflows allowing for monetary expansion. Excess liquidity would be signaled through lower rates of interest.

CHAPTER 4

Explanation for why the crisis broke out:

Several articles have identified a set of empirical regularities that arise during exchange rate based stabilization in high inflation countries commonly referred to as ERBS syndrome (Hamann, 2001). The main features of the syndrome are a boom bust cycle, consumption and sometimes also an investment boom, a pronounced real exchange rate appreciation, worsening trade and current account balance. In addition literatures point out that there is particularly high incidence of failure among ERBS in high inflation countries. All these features were experienced by the Turkish economy during the last twenty years.

Thus the present chapter will first look at the various explanations for why the crises broke out, the linkage between the structural weakness of the economy with the crises and also effect of capital flows, and whether there were inherent weaknesses within the system that was overlooked by the IMF's technical expertise or whether the Program itself was the cause of the crises.

The IMF explanations for the outbreak of the crises were:

1) There were slippage in the implementations of the policies agreed
2) Some adverse external development

i.e. the crisis was the result of the public sector's inability to maintain the austerity targets set by the IMF in December 1999 and the failure to fully implement the free market rationale of globalization. The genesis of the crisis derives from the incompetence of those managing public sector enterprises, so that during 2000, fiscal balance could not be brought under control, which led to the emergence of unprecedented current account deficit. Though the 2000 stabilization program was carefully thought and planned, yet Turkey failed to meet its target. The crisis is the end result of Turkey's failure to follow its program (IMF).

The second set of explanation has the following argument

Contrary to the IMF's explanation

a) Fiscal targets were reached throughout the period of program implementation
b) The central bank was successful in maintaining its monetary targets

The crisis in Turkey i.e. what is observed with capital flight – collapse of currency and hike in interest rate has appeared with greater force in Turkey because of the presence of additional problem of inflation. Another reason could be that the Turkish banking system was vulnerable.

According to Yeldan (2002) the current economic and political crisis is not the end result of a set of technical errors or administrative mismanagement unique to Turkey but is a result of a series of pressures emanating from the process of integration with the global capital market. The 2000 disinflation program has completely ignored the fragile conditions of the of the Turkish financial and assets market, and exclusively disabled both the monetary (Central Bank) and the fiscal (the Treasury) authorities from the utilization of their traditional tools of austerity by way of rendering them powerless against the speculative flows of the market.

However, to Mr. Kermal Dervis, 'with the implementation of a more stringent fiscal policy, the crisis might perhaps have been alleviated. Unfortunately, the fiscal policy has not been strong enough and the current account deficit has widened.' So it appears according to him the main cause of the crisis was the widening current account deficit. The deficit certainly has widened, from $1.3 billion in 1999 to $9.8 billion in 2000 i.e. 4.8% of GDP. The reason for this increase according to him is lax fiscal administration. However data from consolidated central budget and other fiscal account clearly showed that the public sector has not shown a deficit exceeding the planned magnitude and that the government in 2000 and 2001 had followed a strongly contractionary policy to meet its overall expenditure. Data on the 2000 and 2001 consolidated budget revenue and expenditure realizations disclose that fiscal accounts were in line with the targeted values. Fiscal data reveal that the realization of budgetary revenues exceeded their targets by 3.6% in 2000 and 5.1% in 2001. Expenditures, on the other hand, are observed to be

lower than their targeted limit by 0.2% in 2000 and exceeded their target only marginally, by 1.7% in 2001.

The crisis arose as a result of increased fragility of the financial system that was generated in turn by uncontrolled and excessively volatile capital flows and high-level of speculation. The following paragraph gives the fragility indicator of the Turkish economy. The economy rested on quite a shallow and unbalanced financial base throughout the whole 1990s.

One of the important elements of the culminating process of external fragility is the path of the ratio of foreign debts to the Central Bank's international reserves and is called 'the most robust predictor of a currency crisis' in Rodrik and Velasco (1999). In Turkey this particular ratio has never fallen below the 100% mark since the opening of the capital account in 1989. Thus the financial system had been operating constantly in the danger zone. And, the disinflation has actually severed the fragility as signaled in this indicator. The 2000 program, which aimed at disinflation and stabilization, caused an increase of external fragility with a rise of this indicator to 112% in June, and to 145% in December 2000.

Another indicator of the external fragility of the 2000 disinflation program was realized in the current account balance of the domestic economy. The ratio of current account deficit to the Central Bank's international reserves was 5.9% in end 1999. This increased

to 28% in June, and to 49.7% by the end of the year. As a ratio to the GNP the deficit in the current account reached 5% in 2000 from 0.7% in 1999

Another fragility indicator is the Ponzi finance attitude of the Turkish fiscal authorities. This is shown by the ratio of net new domestic borrowings to the domestic debt stock. Since 1995 the Treasury had been engaged in net new borrowing reaching almost half of its already incurred stock of debt. The transfer of the income to the rentier class is thus becoming apparent. The budget in Turkey is increasingly used as an instrument of transferring real resources to the financial sectors, rather than financing social infrastructure.

The main source of the fragility of the financial sector can be traced to the decision to fully open the capital account in 1989. This decision led the domestic assets markets to be fully dependent on short-term, speculative movement of foreign capital flows. Reversal of capital flows is often associated with deterioration in the macroeconomic fundamentals in the recipient countries.

This premature move towards convertibility and the opening up of the domestic market to international capital flow trapped Turkey into this fragile cycle. Without correcting the micro fundamentals or the prudential regulations of the banking sector, the domestic and assets market felt undue strains in adjusting to the volatile conditions of open international competitiveness.

The 2000 disinflation program had dispossessed the Central Bank of Turkey off its traditional tool of austerity by limiting the monetary expansion only to increases in the stock of net foreign assets. According to this rule, the liquidity generation mechanism available to the Central Bank practically meant a regime of semi- currency board in the monetary operation so that the monetary policy is restricted to the direction of the foreign exchange flows. As such, the most important element to be able to sustain the liquidity needs of the economy relied on the continuation of the inflows of speculative financial capital.

Along with these the Turkish Central Bank had lost control over its monetary policy instruments- the exchange rate and the interest rate. Thus it was trapped in a cycle of high rate of interest, appreciation of the currency and in flow of speculative short term foreign capital .To combat pressure against dollarisation or currency substitution the real rate of interest at home had to be increased over the international rate which generated opportunities for arbitrage gains for speculative financiers and short term capital inflows. The process continued till the international speculators interpret this as fragility. Then capital suddenly stopped flowing or turns into outflows, leaving the country illiquid. With the Central Bank having no control over the instruments it is unable to stabilize the economy.

The IMF led disinflation program has thus left the economy defenseless against a speculative run and a sudden stop, because it dismantled all tools of stabilization and

monetary control over the Central Bank. The main source of volatility of the growth rates of the economy is the availability of imports, financed by short-term borrowings.

Post 1989 the debt financed public deficit and rapid acceleration of private expenditure escalated inflows of short-term foreign capital and severely increased the vulnerability of the shallow banking system. As a result, the ratio of the short-term foreign debt to the Central Bank's international reserves rose regularly. Another factor putting pressure on the fragility was the public sector borrowing requirements, which relied exclusively on government debt instrument to the international market.

The public sector was trapped in a short-term rolling of debt, a phenomenon characterized by Ponzi financing. For the scheme to work, domestic financial market necessitated the continued inflow of short-term capital, to overcome the credit and monetary constraint of the monetary authority. With positive rate of interest and new possibility of foreign exchange accounts, financial deepening for the private households has led to increase foreign exchange deposits with substantial currency substitutions.

High rate of interest and overvaluation of the domestic currency generated disincentive to exporters and productive entrepreneurs and contributed to a widening current account deficit. Thus the cause of the February crisis can be regarded as the unavoidable offspring of the changing nature of a global network of finance i.e. the crisis did not cause the IMF's previous stabilization program to collapse, instead it was caused by the previous program which was fully implemented.

Given the structural fragile character of the Turkish financial system the orthodox policy of fully relying on speculative international capital flow for domestic finance and liquidity generation was clearly a design flaw, overseen by the IMF's technical expertise

A distinguishing feature of the economy when it was caught by the crisis was that the public debt burden and inflation appeared to be relatively high and the country was in the process of implementation of the IMF support program to recover from these problems. This is the reason why the IMF program has often been questioned. That is the IMF has not fulfilled a number of prerequisites for the exchange rate based inflation programs in economies with liberalized capital accounts. Celasun's (2002) summary of the principal weaknesses observed in the timing, design and implementation of the program are listed below.

First, if the balance sheet of the public sector banks could have been strengthened before putting the exchange rate based stabilization into effect in 2000, more suitable conditions could have been created for the fight against inflation. According to Akyuz and Boratav (2001) and Ozatay and Sak (2002), after adopting the implementation of a risky program, the regulation directed to strengthening the balance sheet of private sector banks and transferring seven banks that constituted a risk for the system, to the SDIF, created uneasiness and caused problems that hindered the fight against inflation.

Secondly, regarding the inflation targets and the exchange rate commitments, if the price and inflation rigidities in the non-tradable sectors are taken into consideration, it appears that the inflation target was unrealistic (Celasun, 2001). The rapid drop in the rate of exchange rate depreciation led to a rapid drop in the domestic borrowing interest rates, and this has been a source of pride for the economic management. Since inflation did not decrease at the same speed, the real exchange rate entered into an appreciation trend. The rapid decline of the interest rates has been a factor in the rapid increase of domestic demand in conjunction with the demand for imports, which had been postponed with the shock of the 1999 earthquake.

Thirdly, the role of the Central Bank has been reduced to one similar to a semi currency board, with limits imposed on their net domestic assets and interest rate determination left to the market. In the period when the capital inflows and net foreign assets increased, the expansion of the money base decreased the interest rate and limiting the use of the instrument of monetary control when net domestic assets could regress to a great extent constitutes a great risk.

Fourthly, the large number of structural measures envisaged in the program, which were not well prioritized, had been a source of the problem. The non implementation of the of a number of structural measures which had been considered very important by financial investors adversely affected the credibility of the program, despite the improvement realized in the non interest budget. The inclusion of a large number of micro level

structural measures, which had low probability of realization into the stabilization program increase the fragility of the program.

Fifthly, the increases observed in the real labor cost in the private and public sectors in 2000 indicate that the wages were not determined in a manner supportive of the reduction in inflation. Another weakness in the implementation program was that measures were not taken to prevent a boom in the current account deficit.

Turkish Economy in the post crisis period

The November and February crises did not only give deep shocks to the financial markets, but also devastated the balance sheets of both banks and private companies and brought about a deep recession in production and employment. During 2001 the crises management had been under the guidance of the State Minister of the economy Mr. Kermal Dervis. In May 2001 he presented the Transition Program for Strong economy (TPSE), prepared with the claim of being an entirely new program for Turkey to overcome the depression. The Program advocated that the depression would only be overcome by putting an end to the unsustainable domestic and foreign borrowing dynamics and by restructuring the state-economy relationships according to the market forces. The program included the standard IMF austerity measures such as drastic cut in public spending, monetary contraction, flexible exchange rate management, and reduction in wage remuneration and in public employment. In particular, the TPSE has targeted a primary fiscal surplus of 6.5% to the GNP every year until 2004, and aimed at

reducing the outstanding net stock of domestic debt to 40.9% and that of foreign debt to 40.3% as a ratio of GNP by the end of that year.

However according to official statistics issued by the State Institute of Statistics-since the announcements of the TPSE economic problems seem to have deepened, national income dropped by 8.5%, open unemployment rate increased to above 10%. Simultaneous with these developments there was a decrease in the social expenditure of the public sector and fiscal policies of the public sector were restricted to attaining the set targets of non-interest, primary surpluses. The Central Bank became incapable of making effective intervention in the foreign exchange market due to reserve losses and negative figures of net exchange position. Since November 2001 the CBT was restrained from providing direct or indirect resources to the public sector because of the policies of targeted disinflation and Central Bank's 'instrument independence from politics'

The program, which is planned to be in operation at least until 2004, is criticized heavily in that it gives priority to targets on fiscal debt rather than growth, and implements an implicit preference for finance over industry.

Between February 2001 and 2002 approximately 65 structural reforms have been issued, half of which was directly included in the 'structural adaptation' program (Boratav, 2002). And the new letter of intent presented to the IMF in January 2002 continue to aim that Turkey's integration to the world market will be in the form of peripheral economy.

It pursues a 'development' model proposed by the neo-liberal hegemony to the less developed countries.

This model depends on the contractionary monetary and finance policies and assumes an open economic structure ensuring the liberalization of the international capital flows. So the concept of stabilization would mean the establishment of an exchange rate system purified from devaluation risk, and to maintain a high real return in the national financial markets to attract the inflow of foreign capital. The Central Banks are thus set to be autonomous and their means of intervention in the economy are restricted, so that they would not undertake any role apart from maintaining price stabilization. Public sector fiscal policies are to be directly focussed on the objective of maintaining a 'budget with primary surplus'. As a result the boundaries of the public sector are restricted and their traditional social and economic infrastructural facilities are left to the strategic interest of the foreign capital at the costs of extraordinary cuts in public spending and investments.

Under these circumstances issues like long run industrialization of the Turkish economy, attaining development targets via acquiring new technologies and providing better allocation of income do not seem to be in the economic policy agenda. The severe contraction of GNP in 2001 (-9.4%) was triggered by a substantial reversal of foreign capital flows from $15.2 billions in the first ten months of 2000 to -$12.4 billions during the next eleven months. So the IMF's adoption of a severely contractionary stabilization package consists of a freely floating exchange rate, further fiscal tightening, tight monetary policy and further structural reforms. In return, substantial credits from the two

Bretton Woods Institutions are being allocated to reach $30 billions by the end of 2004. Currently the banking system remained paralyzed, credit lines are closed and the economy is in depression. In this state the economy generates a current account surplus, inflation start to decelerate and some form of stability prevail in the exchange and interest rates.

The Turkish society post crises is shaped by external agents- the BWIs in the economic and social areas and the EU in the political arena. The BWIs' management of the economic and social areas is built upon two pillars- a stabilization model and standard IMF/WB recipe on structural and institutional reform.

In an environment of globally mobile financial capital and an unstable international financial system, the main damages of financial crises are concentrated on the public; private and financial sector balance sheets. The sudden adverse changes of the stock variables, like assets and liabilities of the economy are in turn transmitted to the flow variables, such as expenditure and revenue, lowering production and employment performance. The increase in the public debt burden in the process of recapitalising the banking system, whose balance were damaged from the exchange rate and interest rate shocks of the February 2001 crisis, limits the use of the budget policies to stimulate aggregate demand and increase production. Moreover the credit mechanism, which in principal could be used as an instrument in the recovery of economies confronted with contractions, cannot be used effectively, due to the weakening of the loan providing capacities of the banks and loan payment difficulties of firms (Celasun, 2002).

As Turkey search for the growth perspective of the economy after 2001 crisis, it is confronted with a new kind of problems, policy regimes and institutional conditions. If a sound growth process can be attained in conjunction with institutional reforms without encountering new crisis and shocks, then the 2001 crisis would have created an opportunity for transformation. If new crises are encountered it will be apparent that sufficient lessons have not been learned.

Chapter 5

Conclusion

After the Second World War, the Bretton Woods accord was devised based on the thesis that free international mobility of capital is incompatible with the preservation of free trade and full employment. Accordingly, exchange rates were pegged and capital controls were considered necessary to combat currency speculation of a kind that was a threat to exchange rate stability. But in the 1970s the regime of pegged exchange rate was displaced by a regime of floating exchange rates, which was followed by a gradual dismantling of capital controls in a large number of developed and developing economies. In time the floating of exchange rate and the lifting of capital controls were considered essential steps in the establishment of an efficient international financial system.

Most of the financial crisis theories point out that it is the dependence on short-term capital that renders the economy vulnerable on the financial as well as the real sector fronts. First generation financial crisis theories argue that in a liberalized economic regime and in the presence of short-term capital flows, inflationary trends in the economy lead to a speculative attack on the domestic economy. Second generation financial crisis theories hold that within an open economic regime and in the presence of short-term capital flows, the fear of a speculative attack on the currency of a country limits the ability of the authorities to bring the economy out of a recession. But the reccessionary trend in itself soon triggers a speculative attack by foreign investors on the currency. Here also the short-term capital flows are considered the main culprit, and the agency for

any such sudden attack on the domestic currency as well as the financial system. The third generation crisis theories assume that short-term capital is the principal instrumentality for speculative lending and perpetuation of the moral hazard problems.

Other theories like that of Patnaik hold that the whole process of liberalization of the current account and capital account is detrimental to the health of developing economies. He argues that the current account adjust to the capital account rather than the other way round. In this context the role of short –term capital becomes crucial because it is driven by short-term opportunities. Any economy characterized by a large capital account surplus soon experienced a rise in the current account deficit in the balance of payments. However, when the deficit rises to levels considered unsustainable, a 'collapse of confidence' triggers an outflow of foreign capital that leaves the economy in a great financial distress. These theories and the history of financial crises point to the need for capital controls to contain the flow of short-term finance and reduce the degree of financial vulnerability.

Turkey was confronted with financial crises in an environment where the capital movements have been liberalized. The common characteristics of the crises are that in the years prior to the crisis there was a large amount of short-term capital inflows and in the crisis year the economy shrank due to the fleeing of large-scale capital. Foreign and domestic financial investors, whose main functional characteristics are to make use of the arbitrage opportunities, became apprehensive when the devaluation expectations rose in

Turkey and after the incident triggering the crisis; they suddenly transfer their capital abroad.

The prominent characteristic of the 2001 experience of Turkey was the fact that the crisis emerged in the process of applying an IMF supported program. And the main weakness of the IMF Program was that it was applied without strengthening the financial structure of the banking system. The nominal exchange rate increase were fixed according to unrealistic inflation estimates, the monetary base became dependent on capital inflows and outflows, and the forward-looking price and wage indexation with a conciliatory approach could not be realized in practice in a widespread manner.

In the application of the 2000 program, which has an excessive credibility requirement, the target of the reduction of inflation was put to the foreground and it was hoped that the interaction between public sector debt problem and the fragility of the banking system could be kept under control. Since the program was overloaded with structural regulation commitments and could not be fulfilled to a sufficient degree and in time, a decrease in the credibility and an explosion in the current account deficit led to the financial balances and the balance sheets becoming sensitive to the crisis

As the experience of Turkey shows, the economic difficulties confronting developing countries opting for varying degrees of openness of their current and capital accounts, and their subsequent subordination to the IMF and the World Bank policies indicate that the resort to current and/or capital account convertibility only serves the agenda of

international finance capital. It is for this reason that capital controls can be seen as a decisive tool for maintaining economic stability, especially for those who have been caught in the cobweb of the IMF's and the World Bank's orthodox economies.

Table I

CAPITAL FLOWS AND BALANCE OF PAYMENTS (Millions of dollars)					
	Net capital inflows	**Net capital outflows**	**Current account**	**Errors and omissions**	**Change in reserves**[a]
Cumulative					
1990-1993	24 536	-10 333	-9 782	-2 932	-1 489
1994	-6 259	2 409	2 631	1 766	-547
Swing					
1994-1993	-19 090	6 277	9 064	3 988	- 239
Cumulative					
1995-1997	26 173	-4 832	-7 454	-2 021	-12 866
1998	3 677	-3 453	1 984	-1 991	-217
Swing					
1998-1997	-7 623	-742	4 663	603	3 099
Cumulative					
1980-1989	15 529	-3 471	-10 408	2 910	-4 560
Cumulative					
1990-2000	74 654	-23 785	-23 746	-5 898	-21 226

Source: IMF, Balance of payments Statistics (various years)
[a] Minus sign indicates increase

TABLES

Table II

TURKEY: MACROECONOMIC INDICATORS,1990-2000											
	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
GDP growth rate	9.3	0.9	6.0	8.0	-5.5	7.2	7.2	7.5	3.1	-4.7	7.4
CPI (per cent change)	60.3	66.0	70.1	66.1	106.3	93.7	82.3	85.7	84.6	64.9	54.9
Interest rates a	51.9	109.6	97.8	90.3	150.6	136.3	143.6	119.2	115.7	96.6	37.0
Exchange rate	22.9	60.0	64.6	59.8	171.6	53.6	77.7	86.5	71.8	60.9	49.0
Public sector balance	-7.6	-11.3	-12.4	-13.1	-10.2	-6.4	-13.2	-13.1	-15.9	-24.5	-19.3
Of which: Primary balance	-3.6	-6.2	-7.0	-5.6	-0.2	2.7	-1.2	-2.1	0.5	-2.0	2.8
Net debt of the public sector	28.8	35.2	35.7	35.1	44.7	41.3	46.5	42.9	44.5	61.7	59.0
Of which Net domestic debt				9.4	14.0	12.3	20.7	20.8	24.5	41.4	39.1
Current account deficit	-1.7	0.1	-0.6	-3.6	2.2	-1.5	-1.3	-1.3	1.1	-0.9	-4.9
Gross external debt	32.6	33.0	34.8	36.9	50.1	42.4	45.3	47.0	51.2	55.6	57.1
Foreign deposits Billions of dollars	7.4	10.2	12.4	13.7	15.6	20.5	24.4	26.8	30.6	34.1	37.7
Per cent of total deposits	24.9	31.9	34.9	38.0	47.4	47.6	44.5	42.1	42.1	41.7	43.5

Source: IMF (2000 and 2001 c); OECD(2001); Central Bank of Turkey, Quarterly Bulletin, various issues; and Türkiye'nin GüçlÜ Ekonomiye Geçis Programi, 2001, Undersecretary of treasury.

[a] From 1990 to 1991: overnight interest rates, annual simple basis. From 1992 to 1997: Treasury bills, 3 months or close to maturity realised at Treasury auctions, compounded and weighted by net sales. From 1998 onwards: Treasury bills, up to 3 months traded in the secondary market, compounded and weighted by the volumes.

b Per cent change in the $/lira exchange rate.
c Per cent of GDP.

Table III

BLOOM AND BUST IN CAPITAL FLOWS IN THE TURKISH CRISIS (Millions of dollars)		
	January-October 2000	**November2000- September 2001**
Net capital inflows	15 179	-12 416
Net capital outflows	-2 707	-1 247
Total net capital flows	12 474	-13 663
Change in reserves[a]	-2 324	16 585
Errors and omissions	-2 550	-3 215
Current account balance	-7 598	293

Source: Central Bank of Turkey
[a] Includes IMF credit and changes in official reserves. Minus sign indicates increase.

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