TURKEY

PUBPOL542 International Finance
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I. INTRODUCTION

Prior to 1980, the government sector had played a key role in Turkey’s economy. The major part of the total output was being produced by state-owned enterprises and all the prices in the economy were being determined by the government. The main objective of the trade policies was to limit imports and to avoid trade deficit. The tariffs were very high for almost all goods except the unavoidable production needs of import substitute industries and besides the high tariffs on imports, there were lots of quantitative restrictions. Beginning from 1980, the transformation policies has moved the country from an inward-focused, import substitution-based development model toward export led growth and industrialization policies. In this period Turkey achieved the series of reforms which were designed to remove price controls and reduce subsidies, lessen the role of the government sector in the economy, emphasize growth in the industrial and service sectors, encourage private investments and savings, liberalize foreign trade, reduce tariffs and promote exports, ease capital transfer and foreign exchange controls, and encourage foreign investments.

The abolishment of the capital controls in 1989 was the last step of the transformation process in the liberalization period of Turkey. Therefore, in this paper, the analysis period was chosen as 1989-2001.

II. GENERAL OUTLOOK

After the liberalization of the economy, Turkey’s GNP has grown significantly except the years of 1994 and 1999 (see Graph 1 in appendix). Between 1980 and 2000, GNP per capita increased from US $1500 to $3000, exports and imports of Turkey rose from US $3 billions and $6 billions to $27 billions and $54 billions respectively. During that period, there was foreign trade deficit in goods, however due to the surplus in trade of service sector, the current account balance was not so much frustrating (see Table 1). On the other hand, the Central Bank’s foreign exchange reserves have increased continuously and on the average, around US $18 billions since 1995.

These indicators are all about the positive side of the effects of the policies that were applied after the transformation period. However, the other side of the picture was the problems that were brought about by this transformation process. During that period, Turkey has faced with some significant problems including high public sector borrowing requirement (PSBR), unsustainable domestic debt financing which resulted in high inflation, vulnerable exchange rate policy, growing foreign debt and unemployment. Also it is worth to mention that even though the current account deficit was not a general problem, it significantly deteriorated just before the crises so that it becomes a leading indicator, which signals the economic crises. In this manner, in 1993 and 2000, the years just before the crises, the current account balance worsened so much that the deficit increased by 560% and 616% respectively in those years.

In addition to the problems in external balance, the high public sector borrowing requirement and high inflation seem to be the main internal problems in Turkish economy. The high budget deficit and the inefficient methods that are used to finance the relevant deficit led to further increase in the inflation rate. Although the ratio of public sector borrowing requirement to the GNP fluctuated throughout the period between 1981 and 2000, its trend reflects a continuous increase in this respect. As a result of these developments, the average annual inflation rate has been around 75% in this period. Even though these circumstances did not resulted in a hyper-inflationary environment, the inflation rate couldn’t be decreased by the government policies.

III. THE MAIN PROBLEMS OF THE ECONOMY

Turkey has suffered from high and persistent inflation for more than two decades. This chronic inflation is explained by sustained fiscal deficits and their financing methods. As mentioned above, Turkey has high level of public sector borrowing requirement, this liability is due to inefficient tax
revenues and significant level of government expenditures (see Table 2). In this respect, the share of the unregistered economy in total was as an important reason of the inefficient tax system. In addition, the high agricultural subsidies via state-owned banks, large amounts of transfers to the social security institutions and deficits of the state-owned enterprises contributed in the huge level of government deficit as well. The Turkish government has financed its deficit through the domestic and foreign borrowings. But, the finance of the deficit has led to increase in the money supply in the economy (see Graph 2). The increase in the money supply has affected the economy via two channels. The first one is a rise in the price level due to the increased level of the aggregate demand and the second one is the depreciation of the Turkish Lira (TL) in foreign exchange market (see Graph 3). Furthermore, the high inflation rate expectations in the economy, due to the continuing expansion of money supply and the depreciation of the TL, resulted in high “nominal” interest rate (see Graph 4).

The exchange rate is being used as a policy tool to improve the current account balance and also to offset the negative effects of the high inflation rate on the current account, however, it also creates an increase in inflation rate in the economy. Because the Turkish industry is significantly dependent on imports, the depreciation of the TL leads to increase in the prices of the imports of raw materials and the intermediate goods which are used in the industry. This causes the increase in the prices of the final goods in the economy, thereby weaken the competitiveness of the Turkish products in foreign market and reduce the foreign demand for Turkish products. Thus, exports decrease and current account balance deteriorates.

Even though Turkey has been influencing the current account balance via the changes in the exchange rate, it has been facing with a significant level of trade deficit since it liberalized its foreign trade in the beginning of the 1980’s. The high level of trade deficit was, in fact, derived from Turkish industrialization policy that was followed after 1980. Since the export-oriented policies were adopted as a way of industrialization and the foreign trade liberalized, the producers started to import the raw materials and the intermediate goods from the countries, which produces these goods relatively cheaper. Then, throughout this period, combined with the increase in the imports of consumer goods, total imports increased enormously as compared to the increase in its exports. Furthermore, due to the establishment of the customs union with the European Union in 1996, the tariffs on industrial products were abolished between Turkey and EU. This made trade deficit of Turkey even worse. Although the trade deficit was sustainable in economy in non-crises times, it becomes very disruptive in the pre-crises periods, as it was in 1993 and 2000.

After 1980’s, one of the objectives of the transformation policies was to reduce the share of the state-owned enterprises, which were dominant in Turkish economy. However these enterprises that are still producing 35% of manufacturing value added, are actually making huge losses due to the political interference and mismanagement. As a result, there have been large amounts of transfers to these enterprises in each year to cover their loses, which have been creating a considerable burden on the government budget. In addition, government’s control over the key retail prices especially in the energy and utilities sectors such as electricity prices in the economy via these enterprises, also contributes to the market distortion. These prices are sometimes manipulated to meet political objectives. As a conclusion, despite the impressive reforms introduced since 1981, Turkey continues to suffer from an inefficient public sector and weak, often populist, political leadership.

Finally, the main problem, which actually makes the solution of the chronic economic problems in Turkey even much harder, is the unsuccessful policies themselves. Since, at the beginning of the transformation period, it was claimed that the public sector reforms, including privatization, rehabilitation of the social security system and tax reforms, and trimming of agricultural and other subsidy programs, were widely acknowledged as the key policies to resolve the economy’s problems. However the reform program of the 1980’s has been left unfinished. The trade regime and capital markets have been liberalized, but the government sector in the economy remained substantially large.
Turkey's perennial economic problems, large public sector deficits and resulting high inflation, have continued to worsen even as the economy recorded impressive growth rates.

IV. ANALYSIS OF THE ECONOMIC POLICIES

As presented above, Turkey's fundamental economic problem is permanently increasing budget deficits, which has led to high annual inflation rate in economy for last two decades. After 1980, this phenomenon became so common that; all of the agents in Turkish economy got used to operate in an inflationary environment. Then, the annual inflation rate was somewhat stabilized at an average rate of 70%, and the exchange rate policy was just applied to offset the disruptive effect of domestic price increase on the competitiveness of the Turkish products. During that period, the annual depreciation rate of TL has been almost equal to the annual inflation rate. By this policy, the real exchange rate of TL was aimed to be stable (see Graph 5).

It is obvious that the decrease of the inflation rate has been the first target to stabilize the economy. Therefore the Turkish government aimed to reduce the high inflation rate to abolish its disruptive effects on the income distribution in Turkey. Also, they have tried to decrease the inflation rate in order to satisfy the required criteria for being a candidate country for EU. For this reason, the government has attempted several times to decrease the high level of the inflation via the stabilization programs, which were also supported by the IMF. In this manner, the government has implied the inflation targeting stabilization policies by two channels. Firstly, the government has tried to tighten monetary and the fiscal policies. Secondly, it has followed the quasi-fixed exchange rate, which purposed to reduce the inflation rate by decreasing the upward pressure on domestic prices that would be otherwise caused by increasing the prices of imports in the case of the floating exchange rates.

In our analysis period, the Turkish economy has experienced with two major economic crises in 1994 and 2001, called as balance of payment crises. In the period before the 1994 crises, although the tight monetary and the fiscal policies were supposed to be implemented, neither one of them were successfully executed. So both the money supply and the government expenditure increased. During that period, while increasing real money supply created upward pressure (depreciation), the expansionary fiscal policy brought about downward pressure (appreciation) on the exchange rates. But the upward effect of monetary expansion on the exchange rate couldn’t offset the downward one due to two reasons; the faster dynamics of the asset markets than the output market and the continuous monetary expansionary policies. Thus, in the AA-DD diagram, while the AA was shifting to the right because of the increasing money supply, the DD curve did not shift as fast as the AA curve. This development would actually require depreciation of TL in the market but the government did not let the exchange rate to depreciate as much as it should be. At the same time the inflation rate couldn’t be reduced due to the unsuccessful monetary and fiscal policies. As a result the exchange rate depreciated less than the inflation rate, which made the TL overvalued against the foreign currencies.

The overvaluation of TL from 1989 to 1993 has become the most significant factor in the 1994 crisis. The trade deficit significantly increased which led to increase in expectations that the government couldn’t keep the exchange rate at its prevailing level. On the other hand, the central bank did not want to lose its control over the exchange rate. Therefore the central bank increased the interest rate in order to keep the exchange rate at its previous level. Hence, the increased depreciation expectations caused a gradual rise in interest differentials in the period preceding the crisis. However, at the end of 1993, the government thought that this higher interest rates on domestic borrowing could not be continued forever. And, in order to reduce the interest rate in domestic borrowing, it changed its deficit financing policy and started to use central bank resources heavily. This caused money supply to increase in the economy, which led to decrease in interest rate. By this action the government thought the excess money in economy would go to stock market. But it has gone to foreign exchange market and led to increase in the demand for foreign currency, which in turn resulted in depletion of the central bank’s
foreign currency reserves. This depletion of reserves increased the expectations further that the exchange rate regime would not survive. This anticipation triggered a sudden speculative attack to get rid of TL to prevent excessive losses and to benefit from the significant depreciation. The huge demand for foreign currency was followed by a large capital outflow from the country (see Graph 7). As a result, in 1994 the TL depreciated severely against the dollar. In May 1994 the Turkish authorities signed a stand-by agreement by the IMF. The financial crisis ended only after the Treasury was able to re-borrow from the domestic debt market with very high interest rates. Because of the high devaluation, the firms couldn’t afford their foreign currency denominated loans, there were lots of bankruptcies and then the output decreased severely. Meanwhile, due to devaluation the trade balance improved and current account balance turned to surplus in 1994.

After the stabilization program, except the big earthquake year of 1999, the economy has strongly bounced back, and the output has grown significantly since 1995. Both the budget deficit and public sector borrowing requirement (PSBR) decreased in 1994 and 1995 have risen considerably since 1996. To finance the budget deficit, the government was again forced to offer very high interest rates on short-term domestic bonds, further exacerbating the deficit. As a result, Turkey’s domestic debt stock has increased significantly and interest payments have become a large burden on budget (see graph 6).

After 1994 crises, the main problems of the economy have remained the same including the high inflation rate. In order to stabilize the economy, Turkey launched a comprehensive and consistent disinflation program at the beginning of 2000. The success of a disinflation program was dependent on the consistency of the overall package of the measures and perceived ability of the authorities to pursue these policies successfully. Besides the structural reforms and privatization target, the disinflation program is based on a predetermined nominal exchange rate anchor supported by restrictive fiscal policies. Since the large budget deficits financed by money creation were the primary reasons of high inflation, the tight fiscal and monetary policies were the major elements of the program and they were also prerequisites for stopping chronic high inflation in Turkey.

The first goal of the structural reforms was to lower the agricultural subsidies to reduce the high burden on the budget and to abolish their effects on domestic prices, which has been distorting resource allocation by altering market price signals. The second one is the privatization of the public enterprises that would provide financial resources to decrease the budget deficit. Also, the abolishment of the losses of the social security institutions, the improvement of the inefficient banking system and the tax administration were the other goals of the government. These reforms constitute the structural part of the stabilization program. Within the new framework of the disinflation program, the exchange rate regime was also shifted from managed floating to a pre-announced crawling peg system.

The government could not achieve the structural reforms as it was expected at the beginning of the stabilization program. In this period, due to the crawling peg system the trade deficit significantly increased and made the sustainability of the exchange rate regime more difficult. At the end of February 2001, the political dispute between president and prime minister worsened the situation further. Finally, Standard and Poor’s decreased Turkey’s rate from B+ to C-. At the same time, the expectations increased that stock exchange market would collapse and government would not survive any more. Then these expectations brought about huge outflow from stock market and increased demand for foreign currency, which in turn decreased the central bank’s reserves (see Graph 7). At the same time, there were some other problems in the banking system. Turkish private banks had borrowed huge amounts of loans from abroad and bought TL-denominated government bills with these funds, believing in that the peg would be sustained. Since the banks have been left with unhedged borrowings; when the currency started to depreciate, their demand for foreign currency to cover their shortage contributed in depreciation of TL further. Then, the government gave up crawling peg system and adopted the floating exchange rate regime in order not to run out of reserves. As a result, TL has depreciated more than 70% since February 2001.
V. POLICY RECOMMENDATIONS

Due to the unsuccessful stabilization programs, the main problem in Turkish economy is lack of credibility for the economic policies being executed. Therefore, in Turkey, any economic policy should aim to provide credibility on the tools that are used in the program. In order to achieve this credibility, we would like to suggest currency board application supported by the IMF program in Turkey, which will provide reliance on TL. Fixing TL irrevocably to Euro will force inflation down to European Union’s level. So, Euro-anchored currency board might be offered as a useful policy for Turkey to bring its monetary stability standards in line with those of the European Union. The currency board application will create trade deficit at the beginning. However, if this policy is applied precisely, then its mechanisms will solve this problem automatically. These mechanisms work as follows; firstly, the increase in trade deficit leads to deterioration of the current account balance; then this causes the demand for foreign reserves to increase, which brings about simultaneous decrease in both central bank’s reserves and money supply; after that domestic interest rate rises in the economy that leads to fall in investment which results in decline in total output. Finally, the reduction in output causes import demand to decrease, which improves trade deficit. According to this mechanism, there will probably be no problem in balance of payment in medium/long run. But in the short run there can be some temporary shortage of foreign reserves, which can be compensated by the loans from the IMF.

The currency board system should also be supported by some structural reforms including improvement of tax system, restructuring of government expenditures, privatization of the state-owned enterprises, rehabilitation of the social security institutions and restructuring of the agricultural support policies. These reforms will help Turkish government to decrease public sector borrowing requirement. Moreover, the supervision on banking system should be stricter to prevent their actions, which creates big fluctuations in foreign exchange market in Turkey. Accordingly, the privatization of the state-owned banks prevents politicians from misusing of government resources.

In order to keep the mechanisms of the currency board working properly, we also suggest the capital controls to avoid significant fluctuations of foreign reserves in Turkey. In the previous IMF stabilization programs, huge amounts of foreign borrowing of private sector including banks led to increase in foreign currency in domestic market, which increased vulnerability of the crawling-peg regime. Since, in the case of trade deficit, the increased demand for foreign currency can be satisfied from the resources of private sector not from the central bank’s reserves, which do not lead decrease in money supply and increase in interest rates and so on. Unless there are capital controls, this situation disrupts the mechanisms of the currency board. Therefore, we offer capital controls via two channels, taxing the foreign borrowings directly or forcing the private agents to keep some portion of their foreign borrowings at the central bank with no interest for a certain period. Furthermore, the taxation of luxury goods’ imports is another policy tool to improve the trade balance in the short term.

The implication of the currency board and the structural reforms, on the other hand, bring about recession and unemployment in the economy. Despite these negative effects, government should continue to implement the stabilization policies consistently. In addition, under the currency board the exchange rate regime can no longer be used as a policy to improve the competitiveness of Turkish products. For this reason, Turkish firms should increase their productivity in order to be able to export to the world market. Furthermore, the successful implication of the economic policies will stabilize the economy in the medium and long run, which will attract the foreign direct investment into Turkey. These developments will firstly compensate the negative effects of the currency board on output and employment and eventually improve both of them.
VI. APPENDIX

Graph 1: GNP Growth (%)

Table 1: Balance of Payment (US $ Millions)

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<tr>
<td>Current Account Balance</td>
<td>961</td>
<td>-2625</td>
<td>250</td>
<td>-974</td>
<td>-6433</td>
<td>2631</td>
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<td>Trade Balance</td>
<td>-4219</td>
<td>-9555</td>
<td>-7340</td>
<td>-8190</td>
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<td>-4216</td>
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<td>-2339</td>
<td>-2437</td>
<td>-2638</td>
<td>1984</td>
<td>-1364</td>
<td>-9765</td>
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<td>-10582</td>
<td>-15358</td>
<td>-14220</td>
<td>-10447</td>
<td>-22341</td>
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Table 2: Revenues, Expenditures and Public Sector Borrowing Reqr. of Turkey (% of GNP)

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<tbody>
<tr>
<td>PSBR/GNP</td>
<td>5.3</td>
<td>7.4</td>
<td>10.2</td>
<td>10.6</td>
<td>12.0</td>
<td>7.9</td>
<td>5.2</td>
<td>9.0</td>
<td>9.5</td>
<td>9.0</td>
<td>15.3</td>
<td>10.9</td>
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<tr>
<td>Revenues/GNP</td>
<td>21.0</td>
<td>19.9</td>
<td>18.3</td>
<td>18.6</td>
<td>19.8</td>
<td>22.1</td>
<td>22.0</td>
<td>23.4</td>
<td>23.4</td>
<td>25.2</td>
<td>24.8</td>
<td>31.1</td>
</tr>
<tr>
<td>Expenditures/GNP</td>
<td>26.3</td>
<td>27.3</td>
<td>28.5</td>
<td>29.2</td>
<td>31.8</td>
<td>30.0</td>
<td>27.2</td>
<td>32.4</td>
<td>33.0</td>
<td>34.2</td>
<td>40.1</td>
<td>42.0</td>
</tr>
</tbody>
</table>

Graph 2: Consumer Price Index Growth and Money Supply Growth (%)
Graph 3: Consumer Price Index Growth and Exchange Rate Growth (%)

Graph 4: Consumer Price Index Growth and Avg. Compounded Interest Rate (%)

Graph 5: Real Exchange Rate Growth (%)

Graph 6: Turkey’s Outstanding Debt Position (% of GNP)

Graph 7: Foreign Exchange Reserves of Central Bank (US $ Millions)

1994 Crisis
2001 Crisis
VII. REFERENCES

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