TALKING TURKEY: A Macroeconomic Analysis

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The Recent Economic Indicators in Turkey: An Overview  

Chronic high inflation has plagued Turkey for more than two decades. Government programs designed to reduce inflation have never been completely successful. As a consequence, there is a constant threat of instability that has discouraged long-term saving and lending and led to high interest rates and weakened the currency. With a backdrop of frequently changing governments and loose fiscal policy, Turkey’s economic growth experienced a boom and bust pattern throughout the 1980s and into the early 1990s. Investor confidence weakened sharply at the beginning of 1994 and a rapid depreciation in the value of the lira began as Turkey’s credit rating on sovereign debt was reduced to sub-investment grade. In response to this currency crisis, the government responded with emergency stabilization measures that included price increases, freezing of public sector wages, privatization plans, and structural reforms. The government followed up its emergency package with a letter of intent to the IMF stating it would work to reduce the inflation rate, then around 107%, to balance the current account in 1994 and 1995. The IMF granted Turkey access to IMF funding, beginning a consistent pattern of borrowing throughout the 1990s. As a result many of its fiscal and monetary decisions were made for the country by the stipulated targets given by the IMF in return for financial aid.

Turkey’s IMF Backed Stabilization Program  

In December 1999, Turkey designed a new program that included early action to grant the disinflation effort credibility. This program was instrumental in the Turkish government reaching a USD 4 billion three-year stand-by agreement with the IMF in December 1999. This agreement set goals to reduce inflation from almost 70% at the end of 1999 to 25% by end-2000 and to single-digit figures by end-2002. The three main tenets of the program were tighter fiscal policy, structural reform, and a pegged exchange rate. The main goal of tightening the fiscal policy was to decrease expenditures by such means as tying raises for civil servants and minimum wages to the targeted inflation. In addition, structural reforms such as privatization, changing the agricultural financial support system, and reforming the banking sector would combine with the stricter fiscal policy in an attempt to stabilize the public debt. In stabilizing the public debt the government hoped to cause a sustainable reduction in government borrowing. This has been a main cause of the high inflation rate that has been troubling Turkey for decades. Although these fiscal reforms were necessary to stabilize the economy and future growth they had to be accompanied by monetary policy fine-tuning.

How the Mundell-Fleming Model Factored into Policy Design  

According to the Mundell-Fleming model, Turkey, with a small open economy, does not necessarily have an interest rate equal to the world interest rate due to its risk premium. Turkey has a high-risk premium that implies there is concern that the volatile political situation could lead to loan defaults or there is an expectation of a fall in currency. A high-risk premium causes domestic interest rates to increase leading to reduced investment and a downward shift in the IS curve. The increase in domestic interest rates also leads to a decreased
demand for money and shifts the LM curve downward. In turn, output rises and the currency depreciates. However, this model does not hold in practice because output does not rise, it falls. This discrepancy between theory and practice can be caused by one of three things: the Central Bank wants to avoid depreciation so they decrease money supply, the depreciation causes import prices to increase leading to an increase in price levels, or the increase in risk premium leads to an increase in domestic demand for money. All three options would shift the LM curve upward, mitigating the fall in the exchange rate but also depressing output. Thus, increased risk premiums depreciate currency and cause aggregate output to fall in the short run, and in the long run the higher interest rates cause a decrease in investment that reduce capital accumulation and lower economic growth. Therefore, one goal of the IMF backed stabilization program is to reduce the risk premium.

**Fiscal Policy: The Intent of the Stabilization Program**

The key fiscal objective of the IMF backed stabilization program was to tighten fiscal policy primarily through improving the external current account balance. Turkey’s large budget deficit has been at the heart of much of its problems. The consistently high public-sector borrowing has contributed to high yields on government securities, increased the cost of servicing the public debt stock and crowded out lending to productive sectors of the real economy. The past decade has seen the central government debt increase substantially from year to year. Turkey's 2000 current account deficit jumped up 55 times that of its 1999 first half level, USD 103 million to USD 5.588 billion. The foreign trade deficit also climbed sharply, rising by 139.2% during the first six months of 2000 to reach $9.791 billion, primarily due to the rising cost of imports.

Turkey has attempted to meet its fiscal objective by reining in government spending and decreasing private- and public-sector borrowing, which have led to a decrease in the growth rate of debt stock. When Turkey implemented the crawling exchange rate in early 2000 it provided a way to anchor interest rates. The drastic drop of interest rates was a result of the substantial decline in inflationary expectations and the risk premium. The government was able to begin to pay off domestic debt through a series of tax increases, accelerating privatization, and anti-inflationary monetary policies. As a result, Turkey began to see a decreased growth rate of its budget deficit.
**Mundell-Fleming Analysis** The decrease in government expenditure along with raising taxes shifts the IS curve inward representing the contractionary nature of fiscal policy. However, because of the fixed interest rate, monetary policy must also shift upward to adjust the economy back toward the set exchange rate. According to the model, this will result in decreased output. Prior to the recent crises, addressed below, this model held as can be seen by projected percent change in GDP from 2000 to 2001. To confirm this analysis, economists have predicted that Turkey’s GDP will contract sharply for the remainder of 2001. In addition, Turkey’s high propensity for imports and the higher costs of imports due to the devaluation of the lira will negatively affect both private consumption and investment (shifting the IS curve inward) leading to a deterioration of the current account. On a brighter note, the foreign balance is expected to turn positive by end of year 2001, as expensive imports create competitiveness among exports. If the government can create stability and credibility, the GDP should experience growth in 2002.

**Monetary Policy** The new exchange rate policy, which took effect at the beginning of 2000, is intended to act as a brake on inflation as well as lowering the expectation of inflation. The rate of depreciation of the lira is set against a basket of US goods and is limited to 20% for 2000. Therefore, the Central Bank has announced that it will gradually decelerate monthly rates of depreciation from 2.1% in the first quarter of 2000 to 0.85% in the second quarter of 2001. However, due to the fixed aspect of the exchange rate monetary policy has no effect, instead it must work as an automatic stabilizer to balance out any fiscal policies or endogenous changes.
**Targeting Inflation** Fixing the exchange rate is a method used to stabilize output when the monetary market, or more succinctly inflation, has been causing the shocks to the economic system. A large problem the Turkish economy faces is the lack of confidence caused by its instability. By controlling the exchange rate the government is giving the value of the lira stability, decreasing interest rates, and therefore giving confidence to investors. The main difference between this and prior programs is that instead of attempting to lower inflation it is aiming to also lower inflationary expectation. By lowering the expected inflation, through announcing a devaluation schedule, they are putting the economy on a lower Phillips curve. The benefit of being on a lower Phillips curve is that lowering inflation will not cause as severe an increase in unemployment.

**Obstacles to Success** The disinflation program with the IMF and Turkey’s candidacy for joining the European Union brought consumer confidence to a high. GDP levels were growing at 7%, the crawling peg was working at 20% to the US dollar, interest rates were down, and inflation was miraculously down to 44% year-to-year October 2000. A new mood displayed itself as the main market index rose by 650% during this time period. Money flowed into the country as investors’ confidence grew. However, this would come crashing down in the crises during the last quarter of 2000 and the first quarter of 2001.

**First Crisis** The November 2000 crisis was triggered by a forex liquidity squeeze. The uneasiness of the markets, which had been observed since the middle of the month, turned into turmoil on November 22. Demand for foreign currency rose sharply, and initiated a squeeze in the lira market. The overnight rates hiked to 250%. The Central Bank then injected TRL liquidity, while the authorities bought back bonds before maturity and eased minimum reserve requirements (from 4% to 2%) to further the movement. The support of the IMF and the World Bank also relieved the tension. Finally, the overnight rates rose as far as 1,700%. The concerted actions of the central bank, the IMF and the government were able to temper a significant crisis. The Turkish lira continued to crawl with the US dollar, the foreign reserves were cut into, but not depleted. This crisis could be considered a mild stroke.

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\pi = \pi_{-1} - \beta (u - u^n) + \nu
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Second Crisis  The chief economist of the Ottoman Bank, in a report dated February 23, 2001, referred to the November crisis as “the first heart attack of the anti-inflation program.” The second heart attack was provoked by a mere political dispute between the Prime Minister and the President. On Monday, February 19, 2001, interrogated on the spot after a meeting, Prime Minister Ecevit declared the coalition government in jeopardy, and within one hour, the central bank forex reserves plummeted by USD 3.3 billion. The storm drained USD 7.6 billion by the end of the day, more than a quarter than the original level\(^1\). Contrary to the November 2000 crisis, the CBT stopped injecting liquidity in the market, in order to prevent further depletion of forex stock. The crisis deepened, and over-night rates skyrocketed to 7,500% levels, while the currency was left floating (although, in the absence of buyers, an exchange market was virtually non-existent after the withdrawal of the central bank). The banks, already on the verge of insolvency after the November crisis, were hit even more deeply, with an estimated USD 10-15 billion open forex position. In the meantime, on Tuesday, the Treasury was due to auction a critical TRL 3 quadrillion, 12 months maturity bill. It was finally auctioned for TRL 2 trillion, 7 months maturity, yielding 144%. The benchmark bond (11/07/01) yield ended the week at 154%, from prior week closing of 59%. The month-to-month inflation for March jumped to 10.1%\(^2\), from a February 2000-2001 average of 2.0%.

Analysis of the Crises  Most analysts attribute the recent crisis to the differential between the crawling peg, maintained by the central bank against USD, and actual inflation. We do not entirely subscribe to this conclusion. Although this is a factor, we believe other important elements must be considered. As the following graph suggests, the long-term gap is very low. The crises caused expected inflation to skyrocket. This coupled with the rising risk premium significantly decreased the confidence in the lira, both internally and externally. As a result, the capital inflow, which had compensated the trade balance deficit for the last several years, suddenly reversed, draining the central bank and the entire Turkish economy.

\[^{1}\text{The reserves had reached USD 27.9 billion as of February 16, the highest level ever.}\]

\[^{2}\text{Wholesale Price Index}\]
Recommendations for Turkey’s Future  Turkey is in dire straits at the current time. Dropped to the lowest sovereign rating, investors are staying clear of Turkey. Turkey must boost consumer and investor confidence if it is to successfully attract capital and external investment. They must first begin with reforms to structural and financial institutions. In addition, the government must continue to contract fiscal policy and impede the devaluation of the lira.

First Things First  As a first priority, Turkey must continue the difficult task of fundamental structural reform. Public sector debts continue to contribute to the chronic inflation problems. Several of the past IMF reform programs have cited this, and attempts to rein in public expenditures have continued to fail, often for political reasons. The banking sector must be reformed. To have a credible currency the banking system must be sound. An increase in transparency and supervisory regulations will help to control many of the past abuses, including use of the banking system for political patronage. Both of these credibility issues speak to the question of whether Turkey will be able to achieve some sort of painless disinflation, or whether inflation will have a momentum of its own. The devaluation of the currency and the ensuing rise in inflation has already begun to exact a political price.

Fixed, Floating, Crawling, Currency Board, and Capital Controls  There is no shortage of opinions on what is the appropriate exchange rate regime for a developing country. Turkey has experienced some success at disinflation through the crawling peg approach. These successes have been quickly undone by political instability and a lack of fundamental reforms. For a while, Turkey may have no other choice than to allow the currency to float. This is an unattractive option, since it means a return to the high inflation levels prior to the IMF program. In time (unless the political unrest becomes severe) the markets should force the exchange rate to adjust to a market-determined rate. Turkey may wish to return to the crawling peg approach that the IMF has attempted to implement. It is hard to say that the approach was imprudent, since the banking sector problems and fiscal irresponsibility were the true culprits in the crises. The question that remains is whether there will be any true guarantees that this cycle will not repeat itself. There is no guarantee that future fiscal irresponsibility will not undermine whatever exchange rate method is selected.

This may be the time to consider the creation of a currency board. This would be similar to a hard peg fixed exchange rate. Turkey may want to select the Euro instead of the USD as the basis for exchange. This could put Turkey on the road to eventual monetary union with the EU. While this approach would be an abandonment of the tools of monetary policy, it might prove more successful at restoring credibility to the country. A return of investor and consumer confidence could go a long way to restoring the health of the Turkish economy.
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