Smoked Turkey:
Recovering From Crisis; Seeking Stability

by

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16 April 2001
SPP 556: Macroeconomics
Winter Term 2001
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Introduction

Since 1983, Turkey’s GNP has grown at an average annual rate of 5%, higher than any other OECD country. The energy and telecommunications sectors are thriving. Turkey also established a Ministry of Environment in the 1990s. These are signs of a country that is successfully managing an economic transition that will eventually lead it into the Euro Zone. However, terrible inflation, political turmoil and great uncertainty describe Turkey’s current situation as it tries to manage an economic comeback following a currency crisis in February of 2001. This case study analyzes Turkey’s current macroeconomic situation, with an on emphasis the adjustments necessary to eventually join the Euro Zone.

The Financial Crisis

Turkey’s economy is market oriented, but with a huge state sector. Its efforts to trim the public sector have been met with objection by a large and organized public workforce that has political representation. In fact, the February crisis was touched off by a public disagreement between Turkey’s President and Prime Minister over whether or not to adhere to the IMF’s recommended privatization plan. This incident created great uncertainty and sent a signal of panic to investors, who promptly withdrew their holdings of Turkish lira in search of a more stable currency. That brings us to Turkey’s most serious problem: inflation.

There have been few benefits to the eroding value of the Turkish lira, but great costs. Cheap textile and agricultural exports, along with a customs union trade agreement with Euro Zone countries have created a market for Turkish goods abroad. However, inflation has been between 91% and 55% annually in recent years. This instability has eroded investor confidence, as evidenced by a peak of $12 billion annual foreign direct investment across the last two decades, and only $817 million in 2000.

As part of Turkey’s economic reform efforts, aimed at earning it a spot in the Euro Zone, Turkey had pre-announced an exchange rate depreciation path, with no band through the first half of 2001, then with a progressively widening band aimed at reaching 22 ½ percent by the end of 2002. Turkish banks were exposed to net foreign exchange
deficits, and the CBT (Turkey’s central bank) responded with direct liquidity injections into certain banks, and takeover of others⁴, despite the IMF’s recommendation to let the exchange rate go. The apparent instability of this system further fueled doubts about the sustainability of the exchange rate regime, leading to a decrease in confidence and more foreign exchange outflows. At this point, having lost a substantial amount in foreign reserves⁵, and with speculators challenging the strength of the lira, the exchange rate control was abandoned, and the liquidity injections halted.

Naturally, interest rates skyrocketed following the float, and Turkey’s economy deteriorated into crisis. Until this point, Turkey had been relatively successful at building up currency reserves to support the lira, and also at maintaining an even depreciation rate to keep pace with inflation.⁶ During the crisis it became apparent that Turkey could not maintain the rate of depreciation, and the real net appreciation created pressure on the CBT to expand the monetary base and affect lower interest rates. However, fears of further exacerbating inflation tied their hands. Our recommendations for Turkey’s recovery and long term growth including freeing the exchange rate permanently so that monetary policy can be an effective way to control inflation and interest rates.⁷

**Assessment of Turkey’s Major Problems**

Inflation is clearly the most damaging problem facing Turkey. As high as 91% annually in the 1990s, and currently rising again following the crisis, inflation is eroding many aspects of the economy. Since February 22, the day the government abandoned the exchange rate policy and allowed the lira to float, the lira has dropped 44%.⁸ Turkey’s working classes feel the worst effects of such rapid inflation. Civil servants, who comprise a substantial portion of the workforce, have seen their real wages fall 35% since the crisis.⁹

Turkey has responded with a piecemeal policy to control inflation. They have kept price controls relatively steady, allowing slight increases in gasoline prices and wholesale prices. Mainly, they have announced very small increases in nominal wages, leading to a rash of protests. In one nationally publicized incident, a florist form Ankara threw an empty cash register at Turkey’s Prime Minister to voice his disgust over the lack of a policy to deal with the crisis.¹⁰
Reducing inflation

We believe that Turkey must affect policies that signal its willingness and determination to dramatically lower inflation. The first step is to continue policies aimed at keeping nominal wages from rising too quickly, and forcing a slower rate of growth on key prices, such as for wholesale goods and gasoline. These measures are crucial in reducing expectations of high inflation.

Second, Turkey should end its policy of propping up failing banks. Infusing new liquidity into the whole banking system fuels inflation in two ways: 1) It bails out the failing banks, and allows them to continue to make loans that cannot be repaid. 2) It also allows the stronger banks to shift these new funds into foreign exchange, meaning a loss in reserves, which also weakens the lira. Clearly Turkey must take on sweeping reforms in the banking sector. It should eventually privatize its three large state run banks. A good start, however, is to force banks to be more responsible with the funds they have, or risk going under.

A third way to decrease inflation is to simply cut public expenditure, specifically on its huge social security, unemployment and pension systems, and especially on the military. This may be the most politically difficult step, but in the view of Turkey’s chief economic advisor, former World Bank vice president Kemal Dervis, it is a crucial part of an effective economic policy. Prime Minister Ecevit, however, declared this impossible, crushing investor and market confidence yet again.

Long Term Growth

The difficult part of reducing public sector spending is that it requires trimming the safety net and firing civil servants. A large reduction in government spending may reduce output slightly in the short term, as it is tantamount to a contraction in the goods market. However, we view Turkey’s shrinking public sector as a priority in establishing a more sustainable long-term growth policy. As government spending shrinks, this may create new opportunities for private investment in certain markets. Certain industries that Turkey has privatized, or semi-privatized, including telecommunications, energy, and media, have grown quickly. Should Turkey apply a privatization scheme to the other
aspects of its economy, it may realize more widespread private investment, thus boosting output.

The silver lining in the crisis is that because Turkey was forced to let its exchange rate float, its goods should become more competitive on the world market after a period of real appreciation. As net exports grow, Turkey’s output will grow too.

As of now, Turkey’s output is largely a function of its public sector expenditures. The overblown public sector, combined with fixed exchange rates rendered Turkey’s central bank powerless to control inflation and interest rates. In order to realize long-term and stable growth, Turkey must create a political and economic environment more conducive to effective monetary policymaking. Shrinking government expenditure and allowing a floating exchange rate are the keys to such a transformation.

A monetary framework with fully flexible exchange rates can be a more effective way to bring about stability than an increase in government funds to the banking industry and military. If Turkey can effectively control prices and lower interest rates, then these rates become more meaningful. Thus, the right monetary policy could create a savings-friendly environment. An increase in national savings could produce a one-time increase in output by advancing Turkey to a higher steady state of growth.

**Conclusion: The Big Picture**

Turkey is certainly not the only county to have experienced a currency crisis. It may stand to learn what policy priorities other countries pursued in reviving their economies. Many successful countries have emphasized an export promotion strategy with floating exchange rates rather than emphasizing microeconomic policies like price controls, and import regulations. Currently, Turkey seems to be on the export promotion path, but it certainly has a long way to go. According to Dani Rodrik, the key variables that many successful countries focused on include:

1) Fiscal discipline and low levels of external debt.
2) A redirection of public expenditure away from military and subsidies and toward health, education and infrastructure.
3) Tax reform, especially a broadening of the tax base.
4) A unified and competitive exchange rate.
Turkey seems to be moving in these directions, especially with regards to broadening its tax base and freeing its exchange rate. In fact, tax reform has created a primary surplus (the public sector balance excluding interest payments) in recent years. Also, by allowing the exchange rate to float, Turkey may be moving toward a unified exchange rate, diminishing the importance of its fairly large and well established black market. Many of these under-the-table traders may even begin to enter the official sector. The difficult parts of this package include redirecting public spending away from agriculture subsidies, public employment, and the military. Such reforms may spell the death of the political party who pushes them through. As of now, Turkey seems to be unwilling to implement the serious cuts in government spending. It also seems unwilling to reform the banking system, which is rot with corruption and drains so much of government revenue. This was the source of contention between the Prime Minister and President in February, and there is still no policy for affecting these reforms.

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ii State Department Background Notes: Turkey, p. 9 of 16.
http://www.state.gov/www/background_notes/turkey_9910.bgn.htm
iii “Fingers Crossed; the latest economic reform programme just may deliver the goods,” an opinion piece found at Economist.com. June 8, 2000.
vii The Mundell-Fleming Balance of Payments model illustrates Turkey’s monetary policy weakness. A small country with a horizontal Balance of Payments line has ineffective monetary policy options. When it does expand or contract, it will only be in response to changes in the goods market with the intent of solidifying the exchange rate at any cost. The most damaging cost in Turkey's case is clearly exacerbated inflation. This representation shows an expansion in the goods market, due quite possible to an increase in government spending. In order to remain in Balance of Payments equilibrium at the fixed exchange rate, it must expand its monetary base. The initial IS expansion creates inflation. And, the necessary LM expansion further increases inflation. Clearly, according to this model, Turkey’s monetary policy options were hampered by the fixed exchange rate.
Currently Turkey has a very poor inflation to unemployment tradeoff because expectations of inflation are so high. In fact, Turkey is both highly inflationary and experiencing growing unemployment, now estimated at over 18% (Ibid), up from single digits in past years. By implementing and sticking to policies aimed at lowering expectations, such as keeping real wages low and prices increasing slowly, Turkey can obtain a better tradeoff between inflation and unemployment. This is easily seen on the Phillips Curve:
equation: \text{Inflation} = \text{Expected Inflation} - B(U-U_f) + v
By lowering expectations, the curve shifts in. in the process Turkey may move out along the curve, but will achieve a much more desirable tradeoff.


xiv Ibid.


xvi This is the Solow Growth model argument. With more controlled interest rates and stable, lower inflation rates, people will be more confident in leaving money in the bank. This increase in the savings rate shifts the sf(k) function up slightly, creating a higher steady state of growth. Graphically:

State Department, page 10.
