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Abstract

There can be little doubt that at the turn of the century the Turkish economy was in need of an urgent stabilization in order to halt a treacherous process of high and volatile inflation, unsustainable public debt accumulation, and increasing financial fragility, resulting from irresponsible policies and lack of fiscal discipline that had been endemic under various governments since the early 1980s. However, the stabilization 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 appears to have drawn no useful lessons from the recent bouts of crises in emerging markets.

I. INTRODUCTION

In December 1999 the Turkish Government launched an exchange-rate-based stabilization program with the support of the Bretton Woods Institutions in order to bring down inflation and check what looked like an unsustainable process of public debt accumulation. The program appeared to be on course in the subsequent nine months, enjoying wide public confidence and support as well as gaining praise from IMF officials. However, it started running into problems in Autumn 2000, necessitating a relatively large IMF bailout to keep it on course. After a few months of muddling through it became clear that the program was not viable, and in the face of massive attacks on the currency and rapid exit of capital, the currency peg had to be abandoned in February 2001 and replaced by a regime of free floating, again on advice from the IMF. As in most other episodes of financial crisis the currency overshot, interest rates rose sharply and the economy contracted at an unprecedented rate. After another bailout package from the IMF, financial and currency markets stabilized towards the end of the year, but employment and economic activity remained depressed. Just as the bust in the financial cycle came much earlier than in most other episodes of financial crisis, recovery also appeared to be delayed.

What went wrong? The Turkish crisis has a number of features common to crises in emerging markets that implemented exchange-rate-based stabilization programs. Such programs typically use the exchange rate as a credible anchor for inflationary expectations, often leading to currency appreciations and relying on capital inflows attracted by arbitrage opportunities to finance growing external deficits. The consequent build-up of external financial vulnerability eventually gives rise to expectations of sharp currency depreciations and a rapid exit of capital, resulting in overshooting of the exchange rate in the opposite direction and hikes in interest rates. Through such a boom-bust financial cycle, some countries (e.g. Mexico, Brazil and Russia) have succeeded in overcoming their chronic price instability and avoiding a return of rapid inflation, despite the collapse of their currencies and the external adjustment necessitated by the crisis. The Turkish program initially followed a similar path, but ran into difficulties at a much earlier stage of the disinflation process, forcing policy-makers to abandon the peg and setting of a sharp economic downturn in the context of a high inflation.

The difficulties arose largely because the program was launched in the face of structural problems and fragilities on many fronts, notably in public finances and the banking sector. In particular, the banking sector was heavily dependent for its earnings on high-yielding T-bills associated with rapid inflation, and was thus highly vulnerable to disinflation. Consequently, there emerged an inconsistency in policy since much of the fiscal adjustment was predicated on declines in the very nominal and real interest rates on which many banks depended for their viability. Furthermore, while the program incorporated a pre-announced exit from the crawling peg after 18 months, it failed to meet its inflation targets despite full implementation of its monetary and fiscal policy targets. Thus, what initially looked like a strength of the program backfired, as persistently high inflation, together with widening current-account deficits, fed into expectations of a sharp depreciation of the currency. These shortcomings in the design of the program, rather than a failure to implement it, are the main reason why the boom in capital inflows was much shorter in Turkey than in most other experiments with exchange-rate-based stabilization, and why the crisis broke out before inflation was brought under control.

It should also be recognized that recent bouts of liquidity crises in emerging markets have significantly eroded the confidence of international investors in the sustainability of such soft pegs, so that rapid exits tend to be triggered at the first signs of trouble. In this sense the Turkish experience also suggests that the chances of successful disinflation by means of an exchange-rate anchor may now be significantly lower. Indeed, the behaviour of private capital flows to emerging markets in the current global downturn shows that, unlike in the first half of the 1990s, international investors have become much more nervous in raising their exposure to emerging markets despite falling investment opportunities in the major industrial countries (UNCTAD 2001a).

That the Turkish crisis has proved much deeper than most crises in emerging markets is not only due to problems in the design of the stabilization program. Equally important is mismanagement in crisis intervention, which had been premised, as in most other emerging markets, on restoring confidence, maintaining capital-account convertibility, and meeting the demands of creditors through fiscal and monetary tightening. While the implementation of the program had created a trade-off between public and private finances, abandoning the peg and moving to free floating under full capital account convertibility and extensive dollarization aggravated the difficulties of both public and private sectors. The collapse of the currency hit hard those sectors with high exposure to exchange rate risks that the earlier peg had encouraged. Public finances were squeezed from rising external and domestic debt servicing obligations due to the collapse of the currency and the hike in interest rates. Fiscal austerity and monetary tightening have served to deepen recession, and even growth in exports has remained relatively modest despite the sharp depreciation of the currency because of disruptions in the credit and supply systems, in very much the same way as in the earlier phase of the crisis in East Asia. Various packages of legislation passed in order to initiate structural reforms in the public and private sectors failed to restore confidence, while their initial impact was to add to stagflationary pressures. Furthermore, the external economic environment deteriorated further with the downturn in the major industrial countries and the events of 11 September. However, these events have also helped Turkey in mobilizing unprecedented amounts of external support from the IMF due the strategic position that the country occupies in the United States' "war against terrorism". Despite four IMF bailout packages in two years, however, the economy shrunk at an unprecedented rate of some 9.5 per cent in 2001, and prospects for a strong recovery are highly uncertain.

II. THE BUILD UP OF IMBALANCES: INFLATION, DEBT AND CAPITAL FLOWS

Many of the imbalances and fragilities that characterized the Turkish economy at the turn of the century had their origin in the policies pursued in the previous two decades. Turkey started the 1980s with a stabilization-cum-liberalization experiment under a military rule in response to a deep debt and balance-of-payments crisis beginning in late 1970s. The program enjoyed some initial success and was widely praised as an example of successful transition from an inward to an outward development strategy and generously supported by multilateral institutions.[1] Inflation was brought down from three digit levels in 1980 to some 30 per cent in the subsequent two years, and the cost of disinflation in terms of foregone output was relatively small, with GDP contracting by some 2 per cent in 1980. This was followed by an export-led growth, with manufacturing exports growing at double-digit rates, supported by favourable exchange rates and massive incentives in the form of tax rebates. The average GDP growth rate stayed above 6 per cent per annum during 1983–1987.

Initially the program achieved a strong macroeconomic adjustment. The current-account deficit was halved during 1981–1982 from a level of 5 per cent of GDP at the beginning of the decade, while the public sector borrowing requirement (PSBR) fell from around 10 per cent of GNP to less than 4 per cent. However, macroeconomic imbalances reappeared after 1987. While the current account registered either a surplus or a small deficit, the PSBR reached almost 10 per cent of GNP at the end of the 1980s. Again, inflation accelerated rapidly from 1987 onwards, exceeding on average, 60 per cent during the last three years of the decade.