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Brazil vs Turkey: Should Turkey Follow Suit?

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When Brazil decided last month not to request for fresh IMF support, analysts in international markets awaited word from Turkey since both countries sought and found relief in IMF arrangements when their economies were struck by severe crises. They both applied similar programs with similar outcomes. Ending the reliance on the IMF support has always been in the minds of Turkish politicians since IMF programs limit their flexibility and force them to take painful and unpopular actions. But the reality keeps them away from taking any such action.

By looking at macro economic indicators it can easily be concluded that Turkey's dependence on the IMF programs have substantially lessened. After years of political and economic instability, Turkey has undergone a major transformation process since 2000. Inflation came down to around 8 percent from a high 80 percent, and exports rose to over 65 billion dollars from below 40 billion. Economic activity rebounded strongly and the economy grew at an impressive pace of over five percent in the past three years despite high oil prices. The recovery, led by robust growth in private investment, saw a 40-year high of about 10 percent last year. Improved economic indicators encouraged foreign creditors and investors to invest in the Turkish economy.

Similar achievements were also observed in Brazil, which led to the loosening of ties with the IMF. It is a subject of another article whether the Brazilian administration made a mistake by leaving the IMF anchor. But two critical questions should be answered before reaching a conclusion on Turkey-IMF relations: "Are the improvements in the Turkish economy permanent or temporary, and what are the differences between Brazil and Turkey?"

In order to provide an answer to such a question, we should first look at the factors that brought the Turkish economy out of a crisis in 2001 in which the economy shrunk by 7.5 percent and the unemployment rate more than doubled to 12.3 percent.

Political stability

Turkey was governed by weak coalition governments for 11 years between 1991 and 2002. The major characteristic of this era was the lack of their ability to take tough and unpopular actions to correct economic imbalances. These short-lived governments could not find the required legislative support to pass crucial laws from the Parliament and failed to address the problems of public finance, such as widening budget and social security deficits. The picture changed in late 2002 when the early general elections yielded a two-thirds majority in parliament to Prime Minister Tayyip Erdogan's Justice and Development Party (AKP).

IMF support and stand-by programme

Before the 2001 crisis, Turkey had agreed on some 20 different arrangements with the IMF but failed to complete most of them. It agreed on the final one in mid-2001, shortly after its economy was devastated by a profound economic crisis.

The IMF played three major roles. First of all, it provided 17 billion dollars of fresh loans to Ankara, which Turkey used for budget financing and reserve strenghtening purposes. Secondly, it disciplined the government with regard to the fiscal policy and structural reforms. Thirdly, the IMF endorsement helped Turkey boost up its credibility and encouraged foreign creditors to lend Turkey at reasonable terms despite its sub-investment rating.

With the help of IMF's structural reforms and performance criteria, Turkey improved its fiscal imbalances over the last three years. January data showed that the fiscal performance remained strong and the government was on track to meet the fiscal target for the second consecutive year. Better-than-expected results show a very disciplined fiscal performance.

EU membership prospects

As observed in other candidate countries and recently joined EU members, both portfolio and foreign direct investment inflows tend to increase during the accession process. Turkey's bid for full EU membership and Brussels' decision to start accession talks with Ankara in October 2005 made Turkey a major destination for global funds and capital, looking for high yielding markets. The EU factor will bring improvement not only in the economy but also in other aspects of life. It will ensure continuation of the reform process which will boost productivity in the accession period as well as growth prospects.

Floating exchange rate regime

Turkey's 2000 program, which collapsed in 2001, was based on a crawling peg currency regime, agreed jointly by Ankara and the IMF. The crisis forced Turkey to abandon the fixed exchange regime for a free floating system, which helped Ankara smooth adjustment process and strengthen the economy’s resilience to external shocks. It has substantially reduced vulnerabilities. Because of the positive developments in the economy and improving macro-economic indicators in the post crisis era, a reverse currency substitution started in 2002. The lira has been on an appreciation trend for the last three years and the economic units are now talking in lira terms when they determine wages and prices in the economy. As a result, the central bank introduced a new currency this year, scrapping six zeros. Despite the adverse impact of the strong lira appreciation, Turkish exporters have been able to achieve an impressive growth rate over the last five years with the help of a considerable rise in productivity.

Favourable global environment

Thanks to a recovery in the global economies, Turkey has enjoyed an abundant liquidity and low interest rates in international markets in the past couple of years. It helped the crisis-ridden country to borrow at reasonable rates despite its sub-investment grade. The strengthening of the Euro against the dollar over the same period has also contributed to Turkey’s economic improvement since its export revenues are mostly in euro and imports in dollar.

Central Bank independence

For several decades, the central bank was used by Turkish governments as a major source of financing budget deficits and public expenditures. Thanks to a legislation in 2001, the central bank was freed from lending to the government. Its main task was defined by the new law as maintaining the price stability. The bank was given the right to use all the means to achieve this goal.

Differences between Brazil and Turkey

We can observe almost similar factors playing similar roles in the economic transformation of Brazil. Yet, we should focus on the differences between the two-countries rather than similarities, to make an accurate judgment about Turkey’s need for IMF support

- Brazil is producing a surplus in its foreign trade balance versus large Turkish trade deficits.
- Brazil is producing a surplus in its current account balance versus Turkey’s record high deficit of around five percent of its GNP.
- Brazilian debt to GNP ratio is lower than that of Turkey. Turkey’s debt structure is much fragile and sensitive to the fluctuations in interest and foreign exchange rates.
- Brazil’s foreign currency reserves are much stronger than Turkey.
- Brazil is in a stronger fiscal position.
- Brazil’s inflation is below Turkey’s level of inflation.

Turkey needs several more years

The comparison above suggests that it is not the right time for Turkey to end IMF support in its program. It is clear that Turkey is not in an urgent need of cash flows from the IMF. The Fund’s role is much lesser than it was three years ago. However, it is also obvious that Turkey is still in the middle of a dynamic and vital reform process. Despite all the achievements until now much remains to be done to ensure the sustainability of these structural changes. The IMF's presence is still important as a disciplining factor on the government.

For the IMF, Turkey's success in achieving permanent and sustainable economic stability will increase the Fund's reliability and improve its reputation, heavily eroded by the Asian crisis. Turkey needs to be successful to get rid of 30-year-old chronic inflation problem. The IMF needs to have a success story to get rid of its credibility problem. For this reason their mutual interests lie in the continuation of the present form of relationship for another three year period.

Turkey agreed a draft letter of intent in December of last year, but the IMF has yet to approve the arrangement since the Turkish government did not take the necessary prior actions. But the government has already unveiled its will to sign another IMF standby program. This would increase Turkey's ability to weather any fresh internal and external shock. Such shocks might stem from various controllable or uncontrollable factors. For example, large current account deficits might trigger a reversal in the capital flows and sharp depreciation of the lira. Any acceleration in the lira depreciation may create some other problems such as higher interest rates, debt sustainability, budget deficit and fall in growth rate.

On the EU front, which has recently driven Turkish markets to all-time high levels, there is still a long way to go until the full membership which, almost all analysts believe, will not be possible before 2014. If the Cyprus problem is not solved, the Greek Cypriots who represent the island in the EU will have the opportunity to stalemate the membership negotiations chapter by chapter since Turkey must get approval of each member states during the accession talks. Moreover, some other members of the EU might create fresh obstacles before Ankara. Although the December 2004 summit has given Turkey a clear green light, it will not be so easy for many Europeans to see a powerful Turkey which has a strong influence on the strategic decisions and key bodies of the Union. Turkey with a population of around 70 million is larger than almost all the EU members. Member states will have a very different level of power when Turkey becomes the part of the EU's voting system. In the European Parliament, Turkey will get 84 seats, the largest number of seats among all the member states. Despite such concerns among Europeans, it will be hard to refuse Turkey which completed all the requirements for full-membership. Moreover, the progress towards meeting the EU conditions will increase the Turkish economy's ability to survive and maintain its resilience against external and internal shocks.

On the global economic outlook, the conditions may not be as supportive as they were in the past couple of years. As mentioned above, Turkey benefited from low interest rates, excess liquidity and reasonable energy prices in the first half of this decade. However, interest rates in the US, the engine of the global growth, are gradually rising. The trend, seen to continue over the next year, appears as a threat on the attractiveness of emerging markets like Turkey. Oil prices were high last year but there was hope for a downward trend, then. This year, crude prices are still high but the hope for a meaningful decline is getting weaker every day. This will bring an additional burden on current account and public financing of Turkey, which imports almost 90 percent of its crude need.

In this context, Turkish officials are well aware of the fact that it is not the right time to relax their policies and lose the IMF anchor. Ongoing structural reforms in banking, taxation and social security, will lessen the burden on the central government in the medium term when they are completed. Foreign capital inflow and direct foreign investments will gain momentum in line with the progress in the EU process and reforms. In short, Turkey needs to stick to the IMF programs for couple of more years to make the recent accomplishments durable.