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**Following the demise  
of the 1999 IMF program  
caused by two  
consecutive crises  
in three months,  
Turkey is still trying  
to come to  
a decision over  
its own fate.**

letter of intent was  
1 to the IMF after the  
isis in February 2001,  
is approved on May  
The "new" program  
received generous  
pport from the IMF  
amounting to a loan  
of \$300 for every  
person living in the  
country as noted  
in Horst Koehler's  
recent letter to  
Prime Minister  
Bülent Ecevit.  
Yet, three months  
later the question  
still lingers:  
"Whither Turkey?"  
The persistence of this  
estion is the single

most important, in fact determining,  
factor that blocks the necessary  
confidence gains expected from the  
announcement of a "new" program.  
This lack of confidence was also at the  
root of the visible disagreements  
between the government and the IMF  
in July 2001 that led to the drafting of  
Mr. Koehler's aforementioned letter to  
PM Ecevit.

The necessary confidence gains do  
not materialize because of two distinct  
sets of issues. They have to be  
identified clearly to understand the  
current situation in the country. Firstly,  
although the economic program was  
seemingly endorsed by the cabinet, the  
coalition government's determination  
and enthusiasm to pursue the designed  
policies looked questionable. Secondly,  
there are technical questions regarding  
the sustainability of the program. The  
objective of this article is to provide a  
framework to analyze the importance  
of both the political and the technical  
issues that need to be addressed in  
order to achieve a controlled  
transformation of the Turkish  
economy. The recent visit to Turkey by  
Mr. Stanley Fischer, the outgoing  
Deputy managing Director of the IMF,  
in July turned out to be a boon for  
those who believed in the attainability  
of a controlled transition process. Yet  
as the daily market indicators amply  
show, a lot remains to be done.

**Where do we come from?**

In order to understand the current

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situation and policy options, the recent past needs to be carefully analyzed. So let us begin with a quick review of the developments that caused the demise of the "old" program. The old letter of intent that shaped the basis of the IMF endorsed program was sent to the IMF in December 1999. That program's objective was to lower the rate of inflation to single digit figures in three years. Technically, it was the result of a serious intellectual effort to solve the mounting problems of the Turkish economy. It was built on three premises: An up-front fiscal adjustment; a fixed exchange rate regime together with a compatible monetary policy; and structural measures to contain further fiscal irresponsibility which stems from the "clientelist" nature of party politics in Turkey. However, the difficulty of Turkish authorities in coming to terms with the true causes of economic disequilibria in the Turkish economy has delayed structural reforms. The reluctance to undertake a reform of the banking industry proved to be especially costly as the banking crisis of November 2000 has painfully demonstrated. Mismanagement of that earlier crisis particularly by the newly established banking authority has arguably paved the way for the February 2001 crisis. The second of the "twin crises" has totally destroyed the "old" program as it led to the decision to adopt a floating exchange rate regime.

Four issues have to be noted in discussing the end of the "old" program. First of all, the decision to float the exchange rate was dictated by circumstances. With a confidence crisis looming, it was not possible to continue to fix the exchange rate in any

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credible way. Secondly, the twin crises would have been avoided if the banking sector reform had started earlier and carried out with the meticulousness commensurate with its importance. This would have definitely required a full appreciation of the severity of the banking sector troubles at an earlier stage. On this score, given its responsibility in the design of the "old" program the IMF deserves criticism. Thirdly, with a troubled banking system, it was not possible for the Central Bank to maintain stability and follow a consistent policy rule as visualized by the November experience in Turkey. In discussing the transition process to a floating exchange rate regime this particular point needs to be taken into consideration.

The last factor needed to understand the premises of the "new" program concerns the vulnerabilities of the banking industry. The banking crisis in Turkey is the mirror image of the crisis in the government's debt management. This amounts to saying that the risks accumulated in the balance sheets of commercial banks were a direct result of the incentives provided by authorities that enabled the banking industry to invest in government debt instruments (GDIs). Both the currency and maturity mismatches accumulated in bank balance sheets culminated from the Treasury-friendly policies of the banking authorities and the Central Bank in earlier periods. The banking crisis of November 2000 itself has instigated a process that culminated in the realization of accumulated risks in bank balance sheets. The costs of the banking crisis have further deteriorated the prospects of rolling over the outstanding GDI today. Thus, the process that brought Turkey from the November 2000 banking crisis to the February 2001 crisis could be analyzed by the developments in the GDI market.

The November crisis and the flight of foreign portfolio investments have adversely affected the behavior of the banking sector towards GDI investments. The resultant problems regarding debt management have led to a massive domestic portfolio shift towards foreign exchange following a political crisis in February 2001. The

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fallout from that incident, in turn, has forced the authorities to float the exchange rate.

#### **What is "new" in the new program?**

The decision to float has further weakened the banks' balance sheets, highlighting both exchange rate and interest rate risks. The "new" program announced and officially approved by the IMF in mid-May signalled a shift in the priorities that was dictated by the circumstances. Firstly, while the anti-inflationary objectives were more visible in the "old" one, the "new" program rightly placed government debt management at its core. Rolling over the outstanding GDI, that now reflected the newly visible costs of the banking sector reform, was identified as the single most important objective. Both monetary and fiscal policies were designed to achieve this overriding goal. Secondly, although the structural reform agenda of the "old" program has remained intact, this time around the reform of the banking industry was designed more comprehensively.

Because of the generous support it received from the IMF, the "new" program rested upon the assumption of a massive credibility gain that was to ensue right after its announcement. This credibility gain was expected to lower interest rates and secure the stability of the exchange rate. Lower interest rates and the accompanying demand for GDIs were then expected to facilitate the sustainability of debt management. To achieve this goal, the plan of the Treasury was to borrow only about 75 percent of its redemptions and make up the difference with the help of fiscal tightening and the funds from the IMF. Since the Central Bank was expected to support the banking sector operation, the plan looked feasible on paper.




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**Both the 1999 and 2001  
SBAs could be considered  
as direct consequences of  
the failed public sector reform  
agenda during Turkey's  
liberalization experiment**

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However, recent developments have clearly shown that these were rather optimistic assumptions.

#### **What happened?**

The banking sector operation was initiated rather swiftly in May. Both the public sector banks and the private banks recently taken under the Savings Deposit Insurance Fund (SDIF) have been financing themselves with rather high overnight liabilities that put pressure on interest rates and threatened the stability of financial markets. The Treasury started to provide newly issued GDIs to these banks to replace their "bad" assets. Then the Central Bank began to fund these banks either by purchasing their GDI portfolios or through repos. Because of the liquidity provision of the Central Bank, public sector and SDIF banks started to redeem their overnight exposures to private banks and households. This operation has also led the public sector and SDIF banks to reduce the size of their balance sheets. The liquidity thus created by the Central Bank was then

collected in the hands of private banks or households. The plan was to channel this liquidity into the GDI market. This would then have the effect of sterilizing the liquidity created by the Central Bank for the banking sector operation, solve the sustainability problem and lower the interest rate as envisaged in the program.

In brief, the plan was expecting a change in the maturity structure of the portfolios of private banks and households. The government anticipated that the overnight assets of private banks and households would be replaced by longer term GDIs. Market developments however betrayed these optimistic expectations. At least, three reasons could be cited to explain this outcome: the increased political risk, the state of bank balance sheets after two consecutive financial crises and the floating exchange rate regime.

Declarations to the contrary notwithstanding, there was doubt in the sincerity of the coalition partners to pursue the structural reform objectives of the "new" program. The prescribed structural reforms were designed to change the government's mode of intervention in the economy and to prevent "state capture" which was prevalent in Turkey. Such a change, if taken to its logical end, would ultimately mean a transformation of the patronage-based party politics in the country that reigned supreme for the last few decades. In addition to this quandary, the historically high primary surplus objectives of the program increased the political costs to be incurred by the coalition partners. These two factors generated considerable uncertainty regarding the determination of the government to imple-

ment this program to the bitter end.

The questions relating to political sustainability were the first reason that prevented the restoration of calm in financial markets so essential for achieving declining domestic interest rates and foreign exchange stability. The other two factors are more structural/technical. Sustainability of the outstanding GDI is both the objective and the main pillar of the "new" program. As suggested earlier, according to the financing program for 2001, the Treasury has planned to borrow only around 75 percent of its own redemptions. The objective was to leave liquidity in the market and thus force interest rates to decline. Borrowing around 75 percent of its own redemptions was a policy first implemented right after the 1994 crisis and it was indeed helpful in dampening interest rates then. This financing policy assumed, however, that the strength of the banking sector remained the same after the twin crises. In reality, the losses incurred during the crises severely damaged the "risk carrying capacity" of the banking sector and increased their risk perception. This heightened risk perception became a factor in preventing the success of GDI auctions after the inception of the "new" program. Because of the low level of demand, the expected sharp decline in interest rates did not occur.

The third factor that completes this picture is the new exchange rate regime. For a banking system that was accustomed to predictable exchange and interest rates, the floating exchange rate regime looked like an additional factor that increased risk perception. As noted above, the shift to a floating exchange rate regime was dictated by the circumstances of the twin crises. Moreover two additional

factors complicated the situation even further. One was the vagueness of the policy rule of the Central Bank in the minds of market professionals. The second was the exchange rate instability created by political uncertainty. The upward movement of exchange rates after every political crisis since the inception of the "new" program attests to the importance of this factor. Yet, there is also the dire need of the markets to have more information regarding the Central Bank policy rule.

#### What could be done?

Having noted the importance of the sustainability of outstanding GDI and the factors hindering the success of the program on that score, we can now turn to the future. If political uncertainty persists and prevents a decline in the risk perception of market participants, the continuation of portfolio shifts towards foreign exchange is a distinct possibility. To avoid this, interest rates may be increased. However, increasing interest rates creates its own problems regarding the sustainability of the government debt management and therefore further contributes to the portfolio shift towards foreign exchange. In order to sustain debt management, the primary surplus of the government budget could be further increased since such a move would contain the damage of rising interest rates. However, the projected primary surplus already signifies a historically high belt tightening effort for the nation. Going beyond this point would necessitate more reductions in actual defense expenditures. Otherwise the option of an even higher primary surplus does not look either politically or socially feasible. In an environment of political uncertainty, there does not

exist a myriad of options to achieve success. Or, more correctly, in an environment of political uncertainty, the set of market based policy options is rather limited. Under such circumstances, measures are required that could enhance the cooperation among economic agents to achieve success. In order to build this cooperation among economic agents, tighter coordination between economic agents is needed. This, in turn takes us back to the imperative of reliable political leadership.

If, on the other hand, political uncertainty could be contained at the current level, two sets of "technical" measures could be implemented to deal with the sustainability issue. First of all, the policy rule of the Central Bank has



to be clarified. The priority objective of the Central Bank is to provide price stability according to the new amendments to the Central Bank law. However, that is the policy objective. What the markets need now is the policy rule, i.e., the instruments that the Central Bank is to use to attain that objective. In defining the policy rule or instrument rule, the Central Bank will

also need to declare its position regarding exchange rate stability, for example. This is not because the "Central Bank cares about the exchange rate in and of itself but because it cares about inflation". In order to contribute to stability, the instrument rule of the current "implicit" inflation targeting policy must be disclosed. As recently as the second week of July, the Central Bank still came up with vague announcements regarding its policy rule. However, Stanley Fischer's statement during his press conference at the end of his visit and consultations, regarding Central Bank interventions, disclosed the policy rule of the Central Bank more forcefully. Mr. Fischer stated that "Turkey is still in a period of transition following the abandonment of the peg in February... Under these circumstances, intervention can be used, sparingly, from time to time, to deal with major market instabilities, but not to target a particular rate." This is good news for stability in the near future.

Secondly, in order to contribute to stability in an environment of relative political uncertainty, the Treasury must disclose its financing program more transparently. The increase in the outstanding GDI is due to banking sector restructuring. However, not all the GDIs that have been issued are to be financed by the markets. Hence the burden to be carried by financial markets is less than it is assumed at the moment. Nearly 60 percent of the current outstanding GDI are composed of securities held by public sector banks, SDIF banks and the Central Bank. Note that it is easier to restructure this component of the debt stock and get lower interest payment requirements. However, the situation has to be explained properly to market

participants and it must be proven to them that through the partial restructuring of outstanding GDI, the sustainability problem could be solved at least for the moment. This could open the way for increased bidding in Treasury auctions. Minister of the economy Kemal Derviş made the expected announcement regarding this issue on July 26. This was the second piece of good news for domestic debt sustainability.

#### **The need for a controlled transformation process**

Provided that relative political stability can be achieved, there is a feasible way out of the current trap, however hard and painstaking this might prove to be. Yet, there is one more issue that needs to be tackled in order to completely answer the "Whither Turkey?" question. Is all this merely to establish stability and avert crisis conditions in the Turkish economy? The answer is definitely a "No". As noted in the latest Country Economic Memorandum on Turkey by the World Bank, the entire effort is meant to pave the way for sustainable growth in the Turkish economy. Throughout the 1990s, growth in the Turkish economy has been highly volatile. This was due to the structural imbalances in the Turkish economy that resulted from the clientelist mode of government intervention. The mechanisms of state capture in the Turkish economy are to be dismantled with the implementation of the structural reform agenda.

Turkey has launched its economic liberalization process in 1980 with an IMF stand by agreement (SBA). After twenty years of policy experience, a new SBA was signed with the IMF in 2001, in the wake of the collapse of an earlier one signed in 1999. Although

this journey from 1980 to 2001 gives the impression of a futile experiment in economic liberalization at first glance, there is an important difference between the two dates. During these two decades the Turkish policy experiment has led to a rapid structural change in the country. However, such changes as the outward orientation of the economy, liberalization of the financial sector have been limited to the private sector up until now. Between 1980 and 2000, the scope of change has been very limited and very shallow in the public sector. In fact, both the 1999 and 2001 SBAs could be considered as direct consequences of the failed public sector reform agenda during the liberalization experiment. For the first time in twenty years, the country is about to implement the public sector reform agenda and change the mode of intervention by the government in the economy. This should be considered as a historically significant, albeit painful step.

This is exactly the point where the fate of the country is to be determined, this is why this program has to succeed and this is the reason for the importance of the "Whither Turkey?" question. The political elite of the country has to answer the question correctly this time. Important steps in the right direction have already been taken. Any hesitation beyond this point would only increase the pain of the transformation that is going to happen anyway. The failure of the 1999 SBA has already led to the loss of a less painful transformation alternative. Let this "new" program for a controlled transformation process succeed and save the country from more painful alternatives! Let the positive steps continue!

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