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Turkey: bankruptcy of neoliberal policies and the possibility of alternatives

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Abstract

The year 2001 in Turkey has been marked by a destructive economic crisis. This paper argues that the crisis can neither be explained solely by the coincidence of independent events nor by technical problems of economic policies. The increased fragility of the system after the implementation of an IMF-directed "disinflation and stabilization" program paved the way for the collapse of both the program itself and the economy. Insistence on these types of policies will only worsen the conditions, and results of the policies are both economically and socially undesirable. This paper proposes alternative policies and tools, which will provide improvements in growth, employment, and income distribution.
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Until November 2000, Turkey was winning praise from international financial analysts and the International Monetary Fund (IMF) for its stabilization policies. However, after a relatively small financial turmoil in November 2000, 2001 brought the country into the midst of a devastating crisis. The increased fragility of the system after the first year of an IMF-directed "disinflation and stabilization" program has paved the way for the collapse of the economy. The first section highlights the sources of macroeconomic instability in Turkey. The next section analyzes the road to the 2001 financial crisis. Finally, we show that alternative policies and tools are available.

1. Political economy of macroeconomic instability

After financial liberalization in 1989, Turkey's growth performance has been sluggish with a "boom-bust" growth performance with a relatively low average growth rate and high

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volatility. The mainstream analysis on the instability of the Turkish economy argues that the public sector deficits are the ultimate cause of the crisis environment. Indeed, at least on the surface, economic indicators (such as the losses of the State Economic Enterprises and public sector borrowing requirement) seem to verify this approach. However, this approach neglects distributional struggles and perverse effects of financial liberalization, which lie behind these indicators.

A close look at the developments in Turkey reveals that the public finance problems were initially the result of a new distribution policy.[1] One of the basic policies of post-1980 economic management was to cut the tax burden on capital. While this reduced the tax earnings of the state, spending could not be cut at the same rate. In addition, the state has been used as a direct tool of income transfer *via* state-owned banks' credits opened to various capitalists.

The public deficit went out of control when in 1988–89 labor, especially public sector employees, achieved higher real wages *via* widespread protests, and populist pressures of the 1989 elections resulted in a significant increase in social infrastructure spending. The state could have chosen to finance increased spending by increasing the tax burden on capital; however, neither the ideology of the ruling party who was committed to neoliberal policies, nor the capitalist circles supporting its existence, would permit such progressive fiscal measures. The solution was to be found in financial deregulation through which foreign short-term capital would be attracted to the country, and the conditions for fast public borrowing would be created.

After abolishing capital controls, short-term foreign capital flows financed the public deficit, and at the same time enlarged the import and consumption volume of the economy. This policy was in line with international financial institutions' financial liberalization policies, behind which lay the idea that capital originating from advanced capitalist countries and invested in developing country financial markets and government bonds should have the guarantee of not facing any barriers to exit.

A brief look at the capital account of the balance of payments reveals that the economy became dependent on short-term capital flows after 1989. The growth rate of GNP has been dependent on short-term capital movements. Total net movements showed great volatility, especially after 1993. More importantly, the annual totals of speculative capital in the economy exceed the value of total real output in the economy. This shows how the economy is exposed to the threats of speculative capital.[2] On the other hand, if we take the total of foreign direct investment in the last 15 years, it roughly is equal to only $7.7 billion, which is the total long-term borrowing by the private sector (excluding banks) in just one year, 1999.[3]

Meanwhile, banks changed their asset management from direct loan extensions to purchasing government securities to exploit the new profit opportunities by borrowing from the outside and lending to the state. The rate of total credits extended by the banking sector to GNP averaged above 15 percent before 1980, and it approached 20 percent only by 1996 and averaged approximately 20 percent in 1997–99. The average of post-1980 barely exceeded the

[1] For a documentation of the deterioration in the fiscal balances see, for example, Konukman, Aydin, and Oyan (2000), Turel (1999).

[2] For a similar analysis see, for example, Boratav, Yeldan, and Kose (2000).

[3] All figures come from the Central Bank of the Republic of Turkey Data Delivery System (www.tcmb.gov.tr) unless otherwise noted.

pre-liberalization average.[4] On the other hand, although high interest rates, low depreciation, together with an increasing PSBR thus rendered the banking sector vulnerable to speculative attacks, its interest revenues and profits sharply climbed after full liberalization. Both domestic private and foreign banks' before-tax profit/total assets ratios almost doubled together with their net interest margin/total assets ratios from 1988 to 1999.

2. 2000: A stabilization attempt and the collapse

At the end of 1999, the government announced an ambitious 3-year IMF-directed exchange rate-based stabilization program.[5] The main objectives of the stabilization program included reducing the CPI to 25 percent by the end of 2000, and to 12 and 7 percent in the following years, respectively. The program was built upon three main legs: increasing the primary surplus through tight fiscal policy and finalizing "structural reforms";[6] implementing an incomes policy consistent with the inflation targets to replace backward indexation in all contracts by forward-looking price adjustments; and foreign exchange and monetary policy focused on reducing the rate of inflation based on a pre-announced rate of currency depreciation and limited money creation. Capital inflows and outflows were not sterilized, so that interest rates would be fully determined by the market.

The program initially appeared to produce positive results. This was especially reflected in the slowdown in inflation and the decline in interest rates. After the recession in 1999, 2000 saw a resurgence of growth. Although domestic demand has also recovered, it was mainly met by imports of consumption goods and by stocks previously accumulated. Therefore, the recovery in demand was not fully reflected in industrial production. The relatively stable conditions of the economy in the first half of 2000 created an increase in consumer demand mostly because of the expectations of private agents that inflation and interest rates would return to their previous high levels; thus they brought forward consumption because of skepticism about the future.

2.1. The road to the crisis

Before 2000, Turkey had undertaken 16 IMF stabilization programs, and every one of these programs has failed to provide stability. Furthermore, half of them were called off before the end of the planned implementation period. This dismal history was significantly decreasing confidence with respect to the government and the stabilization program.

On the other hand, despite the arguments in favor of exchange rate-based stabilization, stylized facts were already indicating the possibility of a crisis due to the deterioration in the trade and current account balances, and an appreciation of the currency. Following the literature we can summarize some of the stylized facts about exchange rate-based stabilization programs as follows: (i) inflation rate (measured by the CPI) slowly converges to the rate of change in

[4] Banks Association of Turkey, www.tbb.org.tr.

[5] For the details of the program, see CBRT (2000).

[6] "Structural reforms" included privatization of many public enterprises, abolition of agricultural support policies, and limiting agricultural credits.

exchange rates; (ii) economic activity expands with the implementation of the stabilization program; (iii) domestic currency appreciates in real terms; (iv) trade balances and current account balances deteriorate; and (v) consumption and investment follow the expansion in output (Kiguel & Liviatan, 1992). Thus, the program itself might be taken as a crisis warning, if not an indicator of a possible crisis.

2.1.1. Short-term interest rate volatility

Throughout 2000, short-term interest rates were highly volatile. Because of the net domestic assets rule of the program, the interest rates were completely dependent on foreign inflows and shocks. The volatility of short-term interest rates was dependent on the volatility of foreign exchange inflows/outflows. If we take the standard deviation of the overnight interest rate as an indication of volatility, this measure increased from 0.04 at the end of 1999 to 11.67 in June, 16.90 in August, 14.05 in September, and 238.97 in December.

2.1.2. Short-term foreign debt/foreign exchange reserves

There was a significant increase in the ratio of short-term foreign debt to the foreign exchange reserves of the Central Bank in 2000. This ratio had reached to 1.1 by end of August, and 1.44 by the end of year, which was above the corresponding pre-crisis levels of Malaysia (0.61) and the Philippines (0.85), and almost equal to that of Thailand (1.45) before the Asian crisis. A similar deterioration was also observed in the ratio of short-term foreign debt to exports.

2.1.3. Current account deficit

Throughout 2000, there was a continuous increase in the ratio of the current account deficit to foreign exchange reserves and to GDP. The former ratio climbed from 5.9 percent at the end of 1999 to 27.7 percent in June 2000, and then 50 percent in December 2000. The ratio of the current account deficit to GDP began to climb up from 0.7 percent at the end of 1999 to around 3 percent in June 2000.

2.2. Crisis

On November 22, an explosive banking crisis emerged, accompanied by a massive capital outflow. The crisis was triggered by a criminal investigation launched into the collapse of 10 private banks. Foreign investors, amid fears of a wider banking crisis, exited out of Turkish treasury bills and stocks. That in turn created a liquidity squeeze, and as the fear spread even healthy banks stopped lending, sending interest rates soaring and the stock market plunging. The Central Bank had to suspend its net domestic asset target, and provided massive liquidity to the market. The outward-bound capital flow was halted and devaluation fears allayed only when the IMF announced a $10 billion bailout to be supplemented by $5 billion from the World Bank.

Three months after this, a dispute between the president and the prime minister triggered a new crisis. Jittery investors pulled $5 billion out of Turkey on February 19 alone. The Central Bank's foreign reserves of less than $20 billion were at risk of being depleted. Moreover, the government's own ability to raise money to finance the deficits was threatened by the absurdly high interest rates. In an attempt to maintain the managed exchange-rate regime, overnight

interest rates had soared to several thousand percent. The abandonment of the "crawling peg," under which the lira was allowed to slide down by about 15 percent in 2001 against a currency basket comprising the dollar and the Euro, caused an immediate and sharp devaluation of about 30 percent against the dollar.

The devastating effects of the collapse of the IMF-directed economic policies are accumulating with a growth rate around 8 percent and an annual inflation rate of over 80 percent. Only between January and September 14,540 firms, and almost 20 percent of the small shopkeepers, declared bankruptcy (*Cumhuriyet*, 10/22/2001). The total debt stock (foreign + domestic) rose from 75.8 percent of national income to 88.5 percent at the end of 2001. The average annual interest rate on domestic debt has increased from 38.1 percent at the end of 2000 to 65 percent in January 2001, and above 120 percent after the February crisis. Average maturity of the debt has fallen from 411 days, first to 155 and then to 30–60 days for the same period. This has caused a huge increase in domestic debt. According to our rough calculations, the cost of the crisis has been $45 billion for additional domestic debt, $22.4 billion for additional foreign debt, and $52 billion lost in national income. The estimated GNP is roughly $150 billion for 2001, which means that the cost of the IMF-directed program has almost reached 80 percent of GNP or $1800 per capita.

3. "There is no alternative." Is that so?

The failure of the 17th stand-by agreement with the IMF made it obvious that neoliberal IMF-type policies are unable to provide stability to the economy, and will rather bring even more devastation. Unfortunately, this did not prove to be enough to change the neoliberal minds of economic policy makers. After 2 months, the new minister of the economy Mr. Kemal Dervis (former vice-president of the World Bank) has announced the launching of a "new" stabilization program which has been approved by the IMF directors. The "new" program was nothing but a replication of the previous programs and a blend of IMF policies with some technical changes. The neoliberal rhetoric claims that its program is the only option. However, there are alternative policy options.

A healthy growth based upon industrialization and a real production increase can only be provided together with radical public finance reform. The holders of the government bonds who receive the interest payments on debt are usually not the same people who pay taxes. Interest payments in Turkey are taking away merely 80 percent of total tax revenues. Thus, the debt problem has also major distributional and political interests behind it. In this respect, to lessen the cost of domestic debt stock to the financial and the real economy, a "debt consolidation" option should seriously be taken into consideration. With debt consolidation, we mean an arrangement that lengthens the term of the debt and decreases the real interest burden.

To default or consolidate the domestic debt are two policy options for the short term. In the long term, we still need a method to finance the budget and cover the debts. Debt monetization is another possible way to finance the budget deficits. Here, monetization is simply defined as "money financing of the public debt," or in other words, the creation and supply of money by the Central Bank to the Treasury in order to solve the problems of the public debt and the budget deficit.

One of the advantages of monetizing government spending is that it minimizes distributional problems. However, it can create inflationary and exchange rate problems that will in turn have effects on distribution of income. There are two main ways in which monetization creates inflationary pressures. First, the idea that government spending is being financed through monetary expansion will raise inflationary expectations. Second, the inflationary pressure will occur when the monetary expansion exceeds the nominal growth rate of output. Sollenius (1996) suggests different methods to avoid this: (i) Extend fractional reserve banking to counterbalance monetization by increased reserve requirements. (ii) When direct monetization and direct government spending complete monetization, the result is that instead of high-powered money getting into the system and increasing the money supply by the money multiplier times its face value, now the new money increases the money supply by only its face value. (iii) Open market sales of government bonds will draw a significant amount of high-powered money to the Central Bank from the reserves of the banks. Thus, the sum of total high-powered money is decreased and hence the money supply shrinks. (iv) Selective credit controls can encourage the productive capacity in planned sectors of the economy while restraining general credit expansion. There can be administrative limits on banks lending to the private sector. Using credit controls will not only help to reduce the inflationary consequences of monetization of debt, but also can be helpful within a more general macroeconomic program of targeting growth in certain types of production.

To overcome the current recession and to provide long-run growth of industrial production and productivity, an active expansionary policy is also necessary. Given the large budget deficits and the composition of taxes in Turkey, targeting private consumption or investment *via* tax cuts should not be considered. Private consumption-led expansion in Turkey will not maximize the multiplier and accelerator effects, since there is a significant import content of private consumption; such an expansion runs the risk of increasing only demand but not supply, and hence contributing to the inflation problem. On the other hand, the policy tools to induce private investment-led expansion are weak and mostly indirect. The Central Bank could target the short-term interest rate, but this will not necessarily lead to a decline in the long-term interest rate. Also, recent econometric studies have shown that accelerator and profit/cash flow effects are more powerful than interest rate changes/other cost-of-capital effects (Berndt, 1991).

Public spending, on the other hand, has the advantage that the policy makers can minimize the import leakage of the expansion, and thus strengthen its multiplier and accelerator effects. A public investment-led expansionary program has the merit of establishing a strong link between short-term expansion and long-term productivity growth. An infrastructure program on the agricultural sector (irrigation systems, rural road building, improving production techniques) is a possible public investment area. Finally, a public investment program which lowers supply costs will also have a favorable effect on private sector expectations. Rent seeking and corruption could be avoided by creating broad-based forms of democratic accountability. For example, public investment might initially concentrate on small-scale and labor intensive projects (expanding education and health services, or small-scale construction) which create the means for substantial local control.

Meanwhile, the fact that after financial liberalization the economy has been subject to speculative capital movements which impeded growth, and that the major crises have always

been accompanied by massive capital flights, indicates the necessity of capital controls. Also, a possible debt monetization program has to be accompanied by certain controls on capital movements in order to prevent both financial instability and unwanted currency depreciation. Opponents would suggest that this would reduce the flows of capital to the country. However, the current system is already doing a poor job since the bulk of the capital movements are already in the form of short-term and portfolio investment which are subject to high volatility.

In implementing a sustainable expansionary policy in Turkey, another instrument that will act as a stabilizer can be a securities transaction tax. The first priority of a new tax system should be to tax unproductive activities, which can be defined as "directly unproductive profit seeking" activities that may be privately profitable but do not directly increase the flow of goods and services. A securities transaction tax would both raise revenue and discourage speculation by increasing the cost of trading financial assets.

4. Conclusion

The November 2000 and February 2001 crises resulted in a deep recession in Turkey. In this paper, we have argued that this recession and the current problems of the Turkish economy are the consequences of increased fragility of the system following the implementation of IMF-directed policies. We have also shown that there are alternative policies and tools to overcome these problems and to provide long-run growth. Of course, the question of who, by whose political support, will impose an alternative program needs to be answered by political practice.

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