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NAVAL POSTGRADUATE SCHOOL Monterey, California



THESIS

THE 1994 ECONOMIC CRISIS IN TURKEY

by

Ahmet Durgut

June 2002

Thesis Advisor:
Second Reader:

Robert M. McNab
Bill Gates

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THE 1994 ECONOMIC CRISIS IN TURKEY

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First Lieutenant, Turkish Army
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Submitted in partial fulfillment of the
requirements for the degree of

**MASTER OF SCIENCE
IN INTERNATIONAL RESOURCE PLANNING AND MANAGEMENT**

from the

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ABSTRACT

The Turkish economy remained an inward-oriented closed economy until the government launched an economic reform and stabilization program on January 24, 1980, to liberalize the Turkish economy. The stabilization program had a favorable impact on the Turkish economy, transforming it into an export-oriented, private-sector-driven economy. As the economy flourished, however, increasing political competition forced the government to compromise the stabilization program and pursue fiscally damaging populist economic policies, which resulted in an economic crisis in the beginning of 1994. The government responded to the economic crisis by launching an IMF backed economic stabilization program on April 5, 1994. As the economy recovered and economic stability improved, the government delayed continued implementation of the structural measures of the April 5th stabilization program, which resulted in the further deterioration of the Turkish economy. The worsening fiscal situation eventually culminated in another major economic crisis in 2001. The purpose of this thesis is to examine the causes of the 1994 Turkish economic crisis and the role of the government's economic policies in the emergence of the crisis. In addition, this thesis tries to demonstrate correlation between the economic crises of 1994 and 2001.

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I. INTRODUCTION

A. BACKGROUND

The Turkish economy achieved high rates of gross domestic product (GDP) growth after the government launched a series of market-oriented reforms in the 1980s. While the government's expansionary public sector policies significantly contributed to economic growth, they began, however, to distort macroeconomic balances in the Turkish economy. The current account deficit and inflation rate increased, particularly after 1988, due to an increase in domestic demand (Celasun 1998). In 1989, the government liberalized the capital account, which took place against a background of macro-populism and mounting fiscal imbalances. During the period following capital account liberalization, fiscal performance deteriorated significantly. This deterioration in the fiscal performance reached its highest level when the public sector borrowing requirements (PSBR)¹ ratio increased from 11.2% of gross national product (GNP) in 1992 to 15.2% of GNP in 1993 (Demirkol 2000). Meanwhile, an increase in the trade deficit raised expectations that the government would not be able to maintain the exchange rate, resulting in even more depreciation expectations, causing a gradual rise in interest rates.

The government initially refrained from monetizing the public sector deficits by issuing short-term debt at high interest rates. As domestic interest payments rose in 1993, the importance of short-term advances from the Central Bank in financing the deficit increased (Celasun 1998). In this economic environment the Central Bank relaxed its monetary policy by raising the upper limit on the Central Bank's budget deficit financing. This policy change led to an expansion in the domestic demand and worsened the current account² deficit. Excessive liquidity expansion through short-term advances from the Central Bank to the Treasury created a suitable environment for a financial crisis. This

¹ The amount of borrowing required (whether through issuance of bonds, increasing money supply, or offshore borrowing) to supplement revenue so as to finance a government's activities. In other words, the amount of a government's spending that exceeds government's revenues (Money manager 2002).

² A country's international transactions arising from current flows, as opposed to changes in stocks which are part of the capital account. Current account includes trade in goods and services (including payments of interest and dividends on capital), plus inflows and outflows of transfers (Deardorff 2001).

excess money increased the demand for foreign currency, which in turn resulted in depletion of the Central Bank's foreign currency reserves (Ozatay 2000). On the other hand, the overvaluation of the Turkish Lira between 1989 and 1993 also contributed to the perception that the exchange regime would not survive. Between 1989 and 1993, the government was unable to successfully implement tight monetary and fiscal policies. As a result, both the money supply and the government's expenditures increased during this period. The impact of the government's expansionary fiscal policy on the exchange rate, however, outweighed the impact of increasing the real money supply, resulting in a downward pressure on the exchange rate (Taskin, Ozgun, and Al-Shewey 2001). During this time, the Central Bank maintained the exchange rate below the inflation rate. As a result, the exchange rate depreciated less than the inflation rate, which made the Turkish Lira overvalued against foreign currencies.

The government's expansionary fiscal policy and the overvaluation of the Turkish Lira after the capital account liberalization in 1989 led to a severe financial crisis in the Turkish economy in 1994. During the first quarter of 1994, the Turkish Lira depreciated by almost 70% against the United States Dollar. Consequently, annual economic growth contracted by about 6% and the annual inflation rate soared to three-digit levels (Celasun 1998). In the next section, we highlight the scope of this thesis and briefly review the 1994 Turkish economic crisis. Additionally, we discuss the relationship between the 1994 and 2001 economic crises.

B. RESEARCH SCOPE

In this thesis we focus on the Turkish economic crisis of 1994, examining the government's economic policies and its efforts to overcome and resolve the economic crisis. We attempt to establish a substantial link between the government's economic policies preceding the crisis and the emergence of the 1994 economic crisis. In order to demonstrate this point, we will follow Taskin, Ozgun, and Al Shewey's (2001) argument that the government's economic policies closely contributed to the emergence of the 1994 economic crisis through the creation of a lopsided economic structure of heavy dependence on short-term and volatile capital flows. This economic situation created a

fragile balance of payments structure in which large current account deficits were disguised by inflows of short-term capital.

While examining the government's economic policies, we also discuss why the government was unsuccessful in implementing necessary structural economic reforms before the 1994 economic crisis. Moreover, the discussion addresses why after 1994, the government continued to pursue economic policies similar to those of the pre-crisis period. Consequently, we argue, these economic policies led to another economic crisis in 2001. Reviewing the goals of Turkey's IMF-backed stabilization program of 1999, we observe that the stabilization program aims at similar problems, like improving the fiscal balance, which were prevalent in the Turkish economy before the 1994 economic crisis. We additionally attempt to demonstrate whether the economic crisis of 1994 signaled the economic crisis of 2001.

In order to demonstrate the linkages between the government's economic policies and the emergence of the 1994 and 2001 economic crises in the Turkish economy, we initially examine the Turkish economic situation before 1994. This is followed by a discussion of the government's economic policies during this pre-crisis period. We then assess the crisis event and its immediate impact on the Turkish economy. Finally, we describe the causes of the economic crisis of 2001 and present a link between the economic crises of 1994 and 2001.

This thesis can contribute to the understanding of the causes of the 1994 Turkish economic crisis and the appropriateness of the economic measures the government took in tackling the crisis. This thesis can also contribute to understanding the correlation between the causes of the 1994 and 2001 economic crises in Turkey.

In conclusion, our objectives in this thesis are:

1. Examine the government's economic policies before the 1994 economic crisis and demonstrate that the government's economic policies significantly contributed to the 1994 economic crisis.
2. Discuss the government's efforts to overcome and resolve the 1994 economic crisis.
3. Examine the similarities between the causes of the 1994 and 2001 economic crises.

4. Demonstrate the linkage between the government's economic policies and the emergence of the 1994 and 2001 economic crises.

C. ORGANIZATION OF THE STUDY

This thesis is organized into six chapters. Chapter II briefly reviews the studies on the Turkish economic development during the 1980s and 1990s. This section also provides a brief historical background of the Turkish economic development efforts before 1994. Chapter III focuses on the government's economic policies before the 1994 economic crisis. First, we examine the Turkish political environment in the 1980s and 1990s, and its relationship between the emergence of the 1994 economic crisis. Second, we examine the government's economic policies before 1994 attempting to demonstrate that these economic policies primarily affected the emergence of the 1994 economic crisis. Chapter IV describes the crisis event of 1994 and its immediate impact on the Turkish economy. We will also examine the government's efforts to overcome the crisis in this chapter. Chapter V discusses the causes of the economic crisis of 2001 by comparing the causes of both economic crises while demonstrating a link between them. Finally, Chapter VI concludes our examination of the 1994 economic crisis.

II. REVIEW OF LITERATURE

The Turkish government entered the 1980s with a comprehensive and unprecedented structural change and economic transformation program. The program aimed at decreasing the government's intervention in the Turkish economy while giving a major role to private enterprise in economic development. In this respect, the 1980 stabilization program succeeded in transforming the inward-oriented Turkish economy into an export-oriented, private-sector-driven economy. However, between 1989 and 1994, we observed a deterioration in the stability of the Turkish economy. We argue that wayward economic policies, populist cycles, and the lack of a continuation of structural reforms each played an important role in the deterioration of the Turkish economy and that these factors led to the 1994 economic crisis.

The objective of this chapter is to review the Turkish economic development literature with specific focus on the decades of the 1980s and 1990s. In the beginning, we present a brief historical background of Turkish economic development efforts before 1994 and we highlight the causes of the 1994 economic crisis. Subsequently, we review the literature on the government's economic policies during the pre-crisis period and discuss whether these economic policies had a role in the evolution of the 1994 economic crisis. After that we will discuss the impact of the 1994 economic crisis on the Turkish economy and the government's response to overcome the crisis. In the last section, we will survey the evidence on whether there is a relationship between the causes of the economic crises of 1994 and 2001.

A. DEVELOPMENTS IN THE TURKISH ECONOMY PRIOR TO THE CRISIS

The Turkish government has pursued several different development strategies since the foundation of the new Turkish Republic in 1923. The central elements of the economic development efforts between the establishment of the Turkish Republic in 1923 and the economic reform package of January 24, 1980, were state-directed and protectionist development plans. Following Hale (1981), we divide the period since the foundation of the Turkish Republic into four main categories:

1. Recovery and liberalism (1923 – 1930)
2. The etatist era (1930 – 1950)
3. The democratic decade (1950 – 1960)
4. Import substitution period and economic growth (1960 – 1980)

The government initially followed a liberal economic policy which gave private enterprise a major role in economic development and limited government intervention. The government, however, failed to achieve its economic development goals, particularly in the area of industrial development, in the first decade of its liberal economic development plan. Industrial development lagged behind the other sectors of the economy, especially agriculture. This failure was mainly due to the lack of capital and qualified labor (Sahin 2000). In 1930, the government's economic focus changed from market-oriented development to state control and direction of industrial activity in the interest of national development and security. The objective of etatism was to lay the foundations for developing private enterprise and stimulating growth in those sectors of the economy neglected by private capital. Etatism remained the guiding principle of the government's economic development efforts until 1950.

Beginning in 1950 there was a shift from etatism towards a new economic policy which placed equal weight on the role of the state and private sectors in industrial development. The government emphasized the importance of the private sector in economic development and liberalized some parts of the economy (Sahin 2000). These steps, however, were implemented on an ad hoc basis and were not part of a comprehensive economic plan. These uncoordinated attempts at economic development had an adverse impact on the economy. During the second half of the 1950s, the economic environment deteriorated significantly. In order to stop the deterioration in the economy and coordinate economic development plans, the government adopted "economic planning" (Krueger and Aktan 1992). The government established the State Planning Organization (SPO) to design economic development policy. The SPO began designing five-year-plans to organize economic development in 1963. At the same time, the government adopted an import substitution policy as a major tool to protect and develop the private sector.

The first two five-year-plans formalized an inward oriented economic development approach between 1963 and 1972 (Kopitz 1987). These plans set ambitious targets for industrial growth through increased capital formation and import substitution. The State Economic Enterprises (SEEs), which accounted for a large share of productive capacity, were primarily responsible for realizing the targets of the SPO and had access to significant public resources and protection from foreign competition.

By the late 1970s, economic growth had lagged and the Turkish economy entered an economic contraction. Inflation increased throughout the 1970s and reached an annual rate of over 100% in 1979. Foreign exchange shortages and an increasingly overvalued exchange rate also resulted in major difficulties and dislocations resulting in negative net foreign exchange reserves by late 1979 (Kocaliogullari 1996).

On January 24, 1980, the government launched a new stabilization program to overcome the economic contraction of the late 1970s. The new stabilization program was significantly different from the previous attempts at economic stabilization. It marked the beginning of an attempt to shift the economy away from the course set at the founding of the Turkish Republic in 1923. The program included profound stabilization measures and market-oriented reforms. The main objectives of the stabilization program were (Onis and Riedel 1993):

1. To improve the balance of payments and raise international competitiveness.
2. To contain inflation.
3. To raise the efficiency of the SEEs.
4. To shift the economy's center of gravity from the public to the private sector, giving greater freedom to the market in determining resource allocation.

The program was designed to shift Turkey's growth strategy away from import substitution towards greater integration with international markets. Moreover, the government explicitly stated that its role in the economy would be significantly reduced and the private sector would be the primary factor in economic growth.

The measures of the 1980 stabilization program facilitated liberalizing foreign trade, the financial sector, and the capital account in Turkey. The inward-oriented

economy was transformed into an export-oriented, private-sector-driven economy. Yildirim (2001) describes the economic reform package introduced on January 24, 1980 as a landmark in the history of the Turkish economy. He argues that it was a revolution to change the basic concepts governing the country's economic management.

On one hand, the program addressed the internal and external balances of payment to overcome the external payment bottlenecks and to stabilize the economy. By liberalizing trade and capital flows, the program aimed to transform a closed economy into an export driven economy (Sahin 2000). Atiyas (1995) argued that the speed with which macroeconomic stability was achieved and the rapid response of the private sector to the new economic regime made Turkey a success story among the adjusting countries. Yildirim (2001) argues that the main developments achieved between the initiation of the reform package in 1980 and the crisis event in 1994 were the following aspects:

1. Quantitative restrictions on imports and exports were eliminated.
2. Foreign currency regulations were progressively eliminated. Residents and non-residents were allowed to open foreign currency accounts which could be transferred abroad freely. Meanwhile, banks were allowed to deal in foreign currencies and to maintain foreign currency positions under the guidelines of the Central Bank. Exporters and importers were also allowed to buy and sell foreign currencies freely.
3. In 1981, the Central Bank started daily quotations of the exchange rate based upon a simple basket of the United States Dollar (USD) and the German Mark (DM).
4. The treasury started auctioning bills and bonds on the financial markets. The main objective was to phase out the treasury's interest-free borrowing from the Central Bank.
5. An interbank money market in TL was introduced through the intermediation of the Central Bank in 1988.
6. Interest rates were freed gradually. Since 1988, banks have been authorized to set their own interest rates for deposits and loans.
7. Convertibility of the Turkish Lira was announced and confirmed by the IMF in 1990.

These developments in the Turkish economy indicated the positive side effects of the economic reform package of 1980.

On the other hand, this transformation process created some problems. The government's expansionary public sector policies, particularly after 1988, caused the macroeconomic balances in the Turkish economy to deteriorate. Until the first quarter of 1994, the public fiscal and external imbalances continued to increase. On the other hand, the government's policy mistakes on the monetary front also significantly contributed to the increase in the fiscal and external imbalances, especially following the capital account liberalization in 1989, fiscal and external imbalances steadily increased until 1994. Finally these problems culminated into an economic crisis in 1994.

B. CAUSES OF THE CRISIS

We need to examine the economic situation preceding the crisis to understand the causes of the 1994 crisis. According to Atiyas (1995), a major element of stabilization in the early 1980s was a significant retrenchment in the public sector. Public sector borrowing requirements (PSBR) were reduced from almost 9% of GNP to 4% between 1980 and 1981. The government achieved this steep reduction by cutting both the deficit of the central government budget and the SEE losses. Personnel expenditures, transfers to the SEEs, and agricultural subsidies were reduced. The government managed to maintain a low PSBR ratio until the mid-1980s, where the average PSBR/GNP ratio was approximately 4%. In 1987, a significant jump occurred in the PSBR ratio when it reached 6.1% (Atiyas 1995). This jump in the PSBR ratio can be attributed to the fiscal expansion associated with the election year. A mini economic crisis and a stabilization program followed the increase in PSBR ratio in 1988. Subsequently, between 1988 and 1993, the PSBR ratio increased on a sustained basis until it hit a record of 15.2% in 1993 leading to a continuous deterioration of macroeconomic fundamentals in the Turkish economy during the pre-crisis period.

Celasun (1998) explains that the continuous increase in public expenditures mainly stemmed from increases in the government's total wage bill, generous agricultural support policies, the worsening economic performance of the SEEs, and the increased cost of military operations in the southeastern part of Turkey. Increasing public sector

expenditures created additional problems in the financial markets. As public sector deficits increased, private savings to finance these increasing and high deficits became insufficient. Consequently, the increased burden on financial markets led to high and downwardly rigid interest rates (Sak 1996). These high interest rates enabled Turkey to attract capital inflows after the capital account liberalization in 1989. This situation increased the dependency of the public sector on foreign savings (Karluk 1999).

The Central Bank was another reform area during this period. The Central Bank launched a monetary program to restructure its balance sheet in 1989. The Central Bank restricted credit to commercial banks so that liquidity could be created basically against foreign assets (Celasun 1998). The financing of public sector deficits was shifted to domestic borrowing with the objective of reducing external borrowing. Simultaneously, it was agreed that the Central Bank's financing of the treasury would not exceed 15% of total budget appropriations. External borrowing was delegated to private financial institutions, particularly to commercial banks, which were the main source of demand for domestic debt instruments. Celasun (1998) notes that as the foreign exchange purchases of the Central Bank became the main source of money creation, the ultimate source of public debt financing became short-term capital inflows. Financing of the public debt through short-term capital inflows, however, raises another problem. Ozatay (2000) argues that domestic debt financing is not sustainable when real interest rates surpass the real economic growth rate. He notes that under this condition, certain actions of both sides of the domestic debt market may trigger a currency crisis. First, holders of domestic debt instruments may refuse to hold these assets in their portfolios and instead shift to foreign-currency denominated assets. Second, despite the demand for domestic debt instruments continues, the supplier of domestic public debt may choose to monetize all or a certain portion of the debt stock. This will create an excess supply of base money which, in turn, would deplete the Central Bank's foreign exchange reserves.

In accordance with Ozatay's argument, in 1992, the government increased the share of money financing in the face of high domestic debt service payments. The government used almost all of its short-term advances from the Central Bank up to its legal limit during the first half of 1992. Consequently, the government shifted towards longer maturities in its domestic financing and abandoned its policy of keeping external

borrowing at about the level of principal repayments (Celasun 1998). In November 1993 the Treasury cancelled the treasury-bill auctions due to high interest rates. In January 1994, the treasury resumed its auctions; however, this time the demand for these bills was very low. Meanwhile, the treasury had used up half of the 1994 legal limit on short term cash advances from the Central Bank (Karluk 1999).

The government's efforts to suppress interest rates simultaneously put downward pressure on the exchange rate. The pressure on the exchange rate and the interest rates increased the demand for the United States Dollar. An outflow of capital from the Turkish Lira to the United States Dollar occurred; banks rushed to foreign exchange markets to close their foreign exchange positions. The Central Bank intervened in the foreign exchange market to defend the exchange rate and lost more than half of its foreign exchange reserves by the time the crisis ended on April 5, 1994.

C. THE ROLE OF GOVERNMENT POLICIES IN THE CRISIS

A currency crisis may be expected when a speculative attack on a specific currency results in devaluation, a sharp depreciation, or forces the authorities to defend the exchange rate by either depleting large volumes of international reserves or sharply raising interest rates. Currency crises in several regions during the 1980s and 1990s aroused interest in developing techniques for assessing currency vulnerability and predicting crashes (Kumar, Moorthy and Perraudin 2002). This increased interest in predicting currency crashes may be attributed to the fact that few emerging market economies are immune to the destabilizing fluctuations that have affected countries like Indonesia, Korea, Thailand, and Russia. Kumar, Moorthy and Perraudin (2002) note that statistical measures of risk and empirically examining a currency crisis depend on whose viewpoint one takes on the crisis: the view of a macro policymaker, an investor, or a manager of foreign reserve position.

From a common perspective, financial crises may be attributed to the need for sudden and sharp changes in prices and quantities in financial markets for bonds, equities, and foreign exchanges. Delays in the adjustment process increase the sharpness of the change, hence the degree of the crisis (Kibritcioglu, Kose and Ugur 1999).

Berument (2001) examines the empirical research on the effect of monetary policies in open economies. He argues that most of these empirical studies performed their analysis for developed countries. However, central bankers of developing countries face additional challenges beyond those of developed countries. He emphasizes two closely related challenges: the problem of currency substitution and the central bank's incentive to monitor its foreign reserves closely. Therefore, construction of a model for developing countries may differ from those of developed countries (Berument 2001). In his article, the author uses a new measure to monitor monetary policy when the interest rate and exchange rate are used simultaneously. He argues that the extent to which the interbank interest rate exceeds the depreciation rate of the local currency spread can be used as an indicator of the stance of a central bank's monetary policy.

In this respect, the Turkish economy offers a unique environment for assessing the stance of monetary policy. The Central Bank of the Republic of Turkey (CBRT) is actively involved in monetary policy setting either by influencing interbank interest rates or by setting the exchange rate. The CBRT hosts an interbank market where commercial banks can trade the Turkish Lira with overnight and over-week options. The CBRT can also engage in open market operations. The daily depreciation of the exchange rate for the whole month does not change much within any given month; whereas, the interbank interest rates may fluctuate widely. In this context, if the public perceives that the interbank interest rate exceeds the return of foreign currency, then they have incentive to hold the Turkish Lira. On the other hand, if the public perceives that the return of the Turkish Lira decreases relative to the depreciation of the foreign currency, then, this time, they have an incentive to hold foreign currency. In the 1990s, the Central Bank showed no major weakness with regard to the foreign exchange reserves it used. Therefore, the Central Bank could use its foreign exchange reserves as a tool to determine its monetary policy (Berument 2001).

In regards to the 1994 currency crisis in Turkey, finding an answer for the predictability of this crisis is needed. As discussed earlier, there was a continuous deterioration of macroeconomic fundamentals during the period preceding the crisis. Starting from this fact, the question is whether the 1994 currency crisis in Turkey was inevitable. Ozatay (2000) argues that neither foreign exchange reserves nor interest rates

moved in accordance with the predictions of early balance of payments crises which give a central role to weak fundamentals. He notes that the premium between the parallel market exchange rate and the official rate was steady just before the crisis. Moreover, despite a continuous deterioration in fiscal fundamentals during the past five years preceding the crisis, the inflation rate remained high but stable. Ozatay (2000) attributes this apparent lack of correlation between fiscal fundamentals and inflation to the domestic financing of the budget deficit. He argues that domestic debt financing not only blurs the correlation between inflation and public deficits, but also masks loss of reserves which has a central role in early models of currency crisis. Hence, we surmise that the main reason behind the 1994 Turkish currency crisis was government policy.

Atiyas (1995) supports the arguments of Ozatay (2000). After examining the political structure during the economic reform period, he argues that the failure in fiscal policy originates in a failure of governance capacity. He notes that in the context of competition to acquire or maintain political power, political actors behave in a predatory manner while distributing the resources of the state to political constituencies, causing inflation and macroeconomic instability. Atiyas attributes governance failure to the absence of the norms and mechanisms that would support cooperative outcomes. Consequently, the lack of cooperation in governance creates important complications for conducting macroeconomic policy.

When comparing the 1994 Turkish currency crisis with those in the European countries, Mexico, and Southeast Asian countries, we notice that the Turkish currency crisis is different from the others due to the exchange rate in Turkey being a managed float rather than being fixed (Kumar, Moorthy and Perraudin 2002). Ozatay (2000) argues that the currency crisis of 1994 in Turkey started due to public debt mismanagement. He notes that since the late 1980s, the main financing mechanism for public debt has been domestic debt. Consequently, the domestic debt to GDP ratio followed an upward trend until 1994. He notes that at the end of 1993 policymakers gave clear signals to the market that they were strongly in favor of changing the deficit financing mechanism. The Treasury cancelled short maturity domestic debt auctions and started to rely heavily upon Central Bank resources (Ozatay 2000). Ozatay highlights

these developments as significant policy mistakes. He claims that in the absence of these policy mistakes the currency crisis of 1994 in Turkey could have been avoided.

There is another factor that contributes to the policy mistakes of the government in Turkey. This factor is the populist cycle, which is well known in the Turkish economy. A typical populist cycle is initiated by a period of fiscal expansionism designed to generate political support to the political actors (Alper and Onis 2001).

During expansion, the emphasis is placed generally on current expenditures, which have immediate positive repercussions on the current generation of voters. Alper and Onis note that the Turkish economy experienced its third populist cycle during the period of 1987 – 1993, which contributed to the crisis of 1994. They argue that the third wave of fiscal expansionism occurred in an environment of capital account openness and managed or controlled flexibility of exchange rates. Consequently, a highly fragile and unstable pattern emerged whereby the pace of fiscal expansionism became heavily dependent on highly volatile and reversible short-term capital inflows. With the outbreak of the 1994 currency crisis, the inability of policymakers to adjust themselves to the new environment became clear. The policymakers still continued to operate within the parameters of a closed economy model and tended to neglect the current account as an important source of disequilibrium on the assumption that capital flows would be irreversible and sustained on a steady course.

At the same time, Sak (1996) criticizes the Turkish financial liberalization policy. He argues that the Turkish financial liberalization experience raises three points for consideration. First, there was no blue print for forming financial liberalization policies and their sequencing. Second, policies for financial change disrupted the initial status quo and started a dynamic process. As a result, control of behavioral responses to implementing the policies became problematic. Third, the very objective of the dynamic process was to strengthen the role of economic agents in the fund allocation process (Sak 1996). Sak concludes that these factors limited the options available for policymaking. He also argues that the 1994 currency crisis was the result of policies formulated to deal with the problem's effects while ignoring the problem's causes.

D. THE CRISIS EVENT AND THE GOVERNMENT'S RESPONSE TO THE CRISIS

The impact of the crisis on the Turkish economy was devastating. The Turkish Lira depreciated by 70% against the United States Dollar in the first quarter of 1994. Ozatay (2000) notes that as a result of the intervention of the Central Bank in the foreign exchange market, the Central Bank lost half of its international reserves. Overnight interest rates meanwhile increased to unprecedented levels, to almost 700% from stable pre-crisis levels of approximately 70%.

In the aftermath of the crisis, the Turkish economy recorded the highest level of annual output loss in the history of the Turkish Republic, of approximately 6%. The main reason behind this contraction in the economy was the high devaluation of the Turkish Lira. Firms which had foreign-currency denominated loans could not afford to pay these loans; as a result, there were many bankruptcies which caused a drastic decrease in output (Taskin, Ozgun, and Al-Shewey 2001). Another factor contributing to the contraction in the economy was the increase in the prices of imported inputs to production. As the prices of these inputs increased, the industrial production declined sharply.

The government launched a stabilization program and structural reforms on April 5, 1994 to overcome the crisis. This stabilization program was later supported by an International Monetary Fund (IMF) stand-by agreement. The economic crisis ended only after the stability in the financial markets was restored by this stabilization program and the treasury was able to re-borrow from the domestic debt market. According to Voyvoda and Yeldan (1999), these measures depended crucially on wage suppression coupled with reinvigoration of short-term foreign capital inflows. These inflows enabled the financing of the fiscal gap and the consequent current account deficit as real wages continued to decline. Sak (1996) notes that the program restored stability in the financial markets, reversed currency substitution, increased international reserves and temporarily reduced the consolidated budget deficit.

Despite all these improvements in the economy, the stabilization program was short-lived and macroeconomic balances began to worsen towards the end of 1995. The reasons that contributed to the collapse of the 1994 stabilization program and other stabilization programs in the 1980s and 1990s will be discussed in detail in the following

section. The stabilization program also had some imperfections. Sak (1996) argues that despite the confidence they established in the economy, these measures only included expensive cuts and one-off taxes. The program did not include any structural remedies to the economic problems. There were also other adverse affects associated with the stabilization program. Interest rates were increased following the crisis in order to reestablish the government debt market; the external debt was internalized; and the maturity on the government debt was shortened (Sahin 2000). As a result, the burden on financial markets increased after the 1994 crisis.

E. DID THE CRISIS OF 1994 SIGNAL THE CRISIS OF 2001?

As discussed in the previous sections, macroeconomic instability has been a fundamental problem of Turkish economic performance since the 1970s. High and persistent inflation rates were a major indicator of the macroeconomic instability during this period. Yildirim (2000) notes that the main reason behind the high inflation rate was high budget deficits.

One of the government's primary objectives was controlling the high rate of inflation through a series of economic stabilization programs. The disinflation programs of the 1990s, however, failed to achieve their objective of decreasing high inflation rates. The World Bank and the IMF identified the lack of structural reform as contributing to the continued fiscal pressures which, in turn, undermined attempts to achieve and maintain macroeconomic stability (World Bank 2001). The World Bank and the IMF particularly emphasized the fiscal commitments to the SEEs, agricultural subsidies, social security obligations, and financial sector bailouts as the major causes of fiscal expansion which undermined attempts to stabilize prices.

The Turkish economy suffered two major balance of payments crises in 1994 and 2001. We examined the causes and economic policies that created the crisis of 1994 in the previous sections. When examining the underlying causes of the economic crisis of 2001, we encountered familiar problems. The goal of Turkey's 1999 IMF backed stabilization program is to resolve these problems. This stabilization program aimed at improving Turkey's fiscal balance and reducing the long-lasting price inflation (Yeldan

2001). The three main tenets of the program were tighter fiscal policy, structural reform, and a pegged exchange rate (Colmant, Hackworth and Li 2001).

Since the causes are basically the same, did the crisis of 1994 signal the crisis of 2001? The articles, books, and working papers on the Turkish economy and its crises, read for this literature review, suggest that the answer is yes. Despite all of the stabilization programs, the main problems of the Turkish economy remained the same. The success of a stabilization program depends on the consistency of the overall package of the measures and perceived ability of the authorities to pursue these policies successfully (Taskin, Ozgun, and Al Shewey 2001). During the period between 1994 and 2001, the Turkish government failed to follow this consistency principle, mostly due to political factors. As the political competition in the Turkish political environment increased after the 1994 economic crisis, the government began to compromise with the April 5, 1994 stabilization program and pursued expansionist economic policies to increase its voter support and prevail in the political competition. This situation, however, significantly affected the government's ability to implement essential fiscal measures to stabilize the Turkish economy. Consequently, although tight monetary and fiscal measures were supposed to be implemented after the 1994 economic crisis, the government failed to achieve neither of these successfully. The main problems of the Turkish economy, such as the increasing public deficit and high inflation rate, remained unresolved and these problems finally led to another economic crisis in 2001.

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III. THE GOVERNMENT'S ECONOMIC POLICIES

The government's economic policies significantly contributed to the emergence of the 1994 Turkish economic crisis. Initially, the government's economic policies transformed the Turkish economy into an export-oriented, private-sector-driven economy. On the other hand, as the political competition began to increase after the 1987 referendum on the political rights of pre-coup political leaders, the government strayed from implementing the original reform program and pursued fiscally-damaging populist economic policies. Consequently, when the government completed the Turkish economic liberalization process with the capital account³ liberalization, the Turkish economy was in an unfavorable condition with a high public deficit and inflation rate. Following the capital account liberalization, the government's expansionist fiscal policies further deteriorated the stability of the Turkish economy and created a volatile economic environment highly vulnerable to an economic crisis. In this economic context, the government made significant policy changes regarding its debt financing methods during the second half of 1993, which, in return, triggered an outflow of capital into foreign exchanges and started an economic crisis.

This chapter discusses the government's economic policies and their contribution to the 1994 economic crisis in 3 sections. The first section covers the period before the capital account liberalization with a brief overview of the Turkish political environment during the 1970s and a discussion of the developments that led to a military intervention in 1980. We conclude this section with a discussion of the Turkish political environment after the military coup and its impact on the government's economic policies. The second section of the chapter examines the government's major economic policies and their impact on the Turkish economy. This section begins with a discussion of the trade policy, including the government's export, import, and monetary policies and their impact on the Turkish trade. We then examine the government's regular public revenue (tax) policy along with a discussion of the government's financial liberalization policies. The third section examines the period between the capital account liberalization and the crisis

³ A country's international transactions arising from changes in holdings of real and financial capital assets (but not income on them). The capital account includes foreign direct investment, plus changes in private and official holdings of stocks, bonds, loans, bank accounts, and currencies (Deardorff 2001).

event. This section begins with a discussion of the capital account liberalization and its immediate impact on the Turkish economy. Subsequently, we discuss the economic and political developments after the capital account liberalization and the government's response to these events. Finally, we conclude the third section with an attempt to demonstrate the correlation between the government's inappropriate economic policies and the emergence of the 1994 economic crisis.

A. TURKISH POLITICAL ENVIRONMENT BEFORE 1980

In the early 1970s, the stability of the Turkish political environment significantly decreased due to consecutive coalition governments. After each general election, the major political parties formed coalition governments even though this situation contributed to political instability in Turkey. The question is why these political parties formed coalition governments during the 1970s? Rodrik (1990) argues that coalition governments during the 1970s were an outcome of a substantial reduction in the popular vote gap between the leading political party and the major opposition party. As a result, following the 1970 general election, it became increasingly difficult for any political party to obtain a ruling majority. Furthermore, after political parties managed to form a coalition government, the coalition government's duration in office was generally short due to political strife and conflicting interests among the coalition parties. Consequently, throughout the 1970s, coalition governments lasted on average two years (Rodrik 1990).

The volatility in the political environment adversely affected the government's ability to implement stable economic policies. The government could not implement the necessary fiscal measures to decrease the public deficit and improve its fiscal situation. Moreover, the government's inability to implement disciplinary economic measures further aggravated the impacts of the 1973 world oil price increases and the 1974 Cyprus War. The government responded to these events by depleting foreign exchange reserves and by borrowing abroad instead of restraining expenditures and increasing revenues. These wayward economic policies started an economic contraction towards the end of 1970s. Although the government signed two stand-by agreements with the IMF in 1978 and 1979, the government failed to implement either of the agreements due to its inability to curb public expenditures (Sahin 2000).

Towards the end of 1979, the Central Bank's foreign exchange reserves significantly decreased and the manufacturing sector was unable to secure enough foreign exchange to import intermediary goods. This drop in intermediate imports resulted in a decline in industrial production, exacerbating the recession. Following these developments in the economy, in January 1980, the government designed a comprehensive economic stabilization and reform program under the leadership of Mr. Turgut Ozal, a technocrat serving as Undersecretary of the Prime Ministry. The government also aimed at getting the confidence of international creditors, such as the World Bank and the IMF, in its determination to implement structural reforms to overcome its major economic problems with the stabilization program. The government succeeded in this goal and signed a three-year stand-by agreement with the IMF in June 1980 (Kocaaliogullari 1996). Political factors, however, again obstructed the implementation of the economic stabilization program and IMF stand-by agreement measures. First, the government was a minority government; therefore, it did not have enough political power to implement all economic measures. Second, Turgut Ozal could not effectively communicate the scope of the economic reforms to the cabinet and high-level bureaucrats. As a result, this situation caused delays in implementing reform measures (Krueger and Aktan 1992). Meanwhile, political instability continued to increase finally culminating in a military coup in September 1980.

B. POLITICAL DEVELOPMENTS BETWEEN 1980 – 1989 AND THEIR IMPACT ON THE ECONOMY

The military coup started a new period in the Turkish political arena. Following the coup, the military closed political parties, suspended union activity, and formed a civilian government under its control. Nevertheless, the military did not interfere with the economic policy and allowed Mr. Ozal to continue to implement the January 1980 reform measures by keeping him in charge of the economy.

Suspension of political and union activities enabled the military-backed government to overcome the distributional stalemate which complicated previous economic recovery attempts during the 1970s. The government imposed a new income policy in 1981 and redistributed income away from wage earners (Yilmaz 2000). At the

same time, the government managed to reschedule its foreign debt and find new foreign credits to finance the economic reforms, thanks to its determination in implementing economic measures and the June 1980 IMF stand-by agreement. Inflows of foreign credits, decreasing real wages, and a fiscal austerity program helped the government to stabilize the economy within 18 months after the military coup. The PSBR decreased from 8.8% in 1980 to 4% in 1981, the inflation rate decreased from 107.2% in 1980 to 36.6% in 1981 and to a record low 25.2% in 1982, the lowest inflation rate in Turkey since 1980 (Rodrik 1990).

Table 1. Main Economic Indicators (% of GNP) Between 1978 - 1983

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|-------------------------|-------|-------|-------|-------|-------|-------|
| GNP Growth | 1.2 | -0.5 | -2.8 | 4.8 | 3.1 | 4.2 |
| Current Account | -2.6 | -2.1 | -5.5 | -3.5 | -2.1 | -3.5 |
| PSBR | 3.2 | 7.2 | 8.8 | 4.0 | 3.5 | 4.9 |
| Inflation Rate | 52.6 | 63.9 | 107.2 | 36.6 | 25.2 | 30.6 |
| Expenditures | 20.35 | 20.75 | 20.33 | 18.89 | 15.09 | 18.75 |
| -Personnel Expenditures | 7.18 | 7.41 | 6.44 | 4.96 | 4.17 | 4.81 |
| Revenues | 18.82 | 17.60 | 17.20 | 17.35 | 13.61 | 16.51 |
| Budget Balance | -1.53 | -3.15 | -3.13 | -1.54 | -1.48 | -2.24 |

Source: Turkish State Planning Institute (2001), Rodrik (1990)

As economic performance improved, the Turkish citizens' demand for a return to democracy grew stronger. In 1982, a vast majority of voters approved the new constitution in a referendum and scheduled the first general election in the spring of 1983 (Kocaaliogullari 1996). However, because of existing political restrictions on pre-coup political parties and political leaders, only a small group of recently formed political parties could compete in the election. In this respect, the 1983 general election started a limited-democracy period in Turkey. Mr. Ozal won the election and became the prime

minister of Turkey. Mr. Ozal was committed to an open-market economy and after assuming office his government began to design new economic measures to further liberalize the Turkish economy. The government's agenda was comprised of reducing agricultural subsidies, actively managing the exchange rate, improving exports, removing restrictions on imports, and reforming the tariff policy (Onis and Webb 1994).

The 1983 elections, however, created new difficulties for the government. The government needed to maintain a broad-national coalition to implement its economic agenda. In the absence of union activity between 1980 and 1983, the adjustment and reform process significantly affected the wages of certain socio-economic groups, such as labor and agricultural workers. During this period, the wages of these socio-economic groups continuously decreased in real terms. Hence, maintaining political support from these groups and simultaneously implementing economic reforms became increasingly difficult for the government. In order to tackle this problem and prevail in political competition, the government began to stray from the original reform program of January 1980 and began to pursue populist economic policies. The government sought to find new ways to build public support, therefore, started to shift its investments from manufacturing to infrastructure. There were ample investment opportunities in infrastructure because previous governments neglected infrastructure investments during the 1960s and 1970s. This situation, as a result, gave the government maneuverability in designing new investment projects in infrastructure (Sahin 2000). On the other hand, with these populist economic policies, the government compromised fiscal discipline and failed to implement necessary economic measures to control and cut the fiscal deficit on a permanent basis.

In the mean time, a referendum on the political rights of pre-coup political leaders started a new period in the Turkish political arena in 1987. The electorate voted in favor of abolishing the political bans imposed after the military coup. Two months after the referendum, the second general election since the military coup took place. Both the referendum and general election were turning points for the Turkish democracy and economic development efforts. The referendum ended the limited-democracy period and reinstated full-democracy in Turkey. Almost all pre-coup leaders returned to the political arena after the referendum. In addition the referendum relaxed restrictions on founding

political parties and labor unions. New political parties and labor unions began to reemerge increasing competition in the Turkish political arena. All these developments significantly changed the environment for macroeconomic policy. The government became more concerned with getting voter support than attending to the major problems of the Turkish economy (Atiyas 1995).

Mr. Ozal's Motherland Party lost significant voter support in the 1987 general election; however, the Motherland Party managed to win the election with a small difference between its major competitor, the True Path Party. Moreover, thanks to the new election law, the Motherland Party won 60% of the seats in the Parliament despite receiving only 36% of the popular vote (Atiyas 1995). Since the election results clearly demonstrated decreasing support for Mr. Ozal's government and its economic policies, this situation substantially increased the government's concern of regaining public support for the local elections in 1989 and general election in 1991. The government began to use more government resources to gather support, particularly from workers and government employees. In order to achieve this goal, the government further compromised its structural reform measures and pursued fiscally-damaging populist policies; such as restraining public goods' prices, spending more on popular local projects, and giving large increases in public sector wages (Onis and Webb 1994). The increased power of labor in collective bargaining through union activities also significantly contributed to large wage increases in the public sector.

The Turkish economy achieved a 9.8% GNP growth in 1987 as a result of the government's election-oriented economic policies. The government, however, could not maintain this high GNP growth in the following years, so the GNP growth rate decreased to 1.5% and 1.6%, respectively, in 1988 and 1989. The slowdown in the GNP growth necessitated additional resources to finance the fiscal deficit and enable high GNP growth. The government perceived capital account liberalization as a solution to financing the fiscal deficit and started the capital account liberalization process in 1988. By the end of 1989, the government completely liberalized the capital account in Turkey (Karluk 1999).

To sum up, developments in the Turkish political arena during the 1980s created the foundation for an economic crisis. The government designed and implemented

economic policies mainly according to the level of political competition in the political environment, not according to the requirements of the Turkish economy. Additionally, political actors used state resources to increase their chances of getting into power. The ultimate outcome of this behavior, however, was fiscal deterioration. Atiyas (1995) argues that the Turkish political system lacks the norms and mechanisms that could support compromise and cooperation among political actors. This situation motivates political actors in using state resources to claim public office. The absence of legal or procedural rules in the Turkish political system limiting fiscal expansion, such as limits on the accumulation of public debt, aggravated the impact of political competition among political actors while creating an unstable economic environment prone to an economic crisis.

C. THE GOVERNMENT'S MAJOR ECONOMIC POLICIES BETWEEN 1980 AND 1989

1. Trade Policy

This section covers the government's trade policies between 1980 and the capital account liberalization in 1989. During this period, the government mainly designed its monetary, export, and import policies to improve Turkey's foreign trade, particularly exports. As a result, this section also discusses the government's monetary, export, and import policies and their impact on the development of the Turkish trade between 1980 and 1989. This section begins with an overview of the government's trade policies during the military regime between 1980 and 1983. Then it concludes with a discussion of the developments in the government's trade policies between 1983 and 1989.

Trade reform was a major component of the January 1980 stabilization and reform program. The government initially aimed at increasing foreign exchange reserves by improving the profitability of the tradable goods sector, and hence implemented trade policies accordingly. The government launched export promotion measures, such as export subsidies and exchange rate measures to promote exports and eliminate foreign exchange constraints on the tradable goods sector. Under the exchange rate policy, the government initially devaluated the Turkish Lira by 33% in 1980 and continued to devalue the Turkish Lira occasionally until May 1981, when daily adjustments on the

exchange rate began (Rodrik 1990). Simultaneously, the government relaxed restrictions on accessing foreign exchange, especially for economic groups and conglomerates that engaged in export business. However, the government's export stimulation measures included direct subsidies, low-cost export credits, and tax rebates. The government concentrated its export support efforts on economic sectors that developed somewhat during the protectionist import-substitution period between 1960 and 1980; therefore, machinery, mining, and metal sectors received a significant portion of the export subsidies. In contrast, the agriculture sector, a traditional beneficiary of government subsidies before 1980, lost most of the subsidies it received before 1980.

On the import side, the government implemented modest measures in the initial stage of the economic reform period compared to its foreign exchange and export policies. The Turkish import system consisted of two lists, liberalized and quota lists, until 1980. The liberalized list contained goods that the government considered essential to meet the objectives of its economic plan; whereas, the quota list contained both goods that were less essential for achieving the economic goals and goods that competed with imports. In 1980, the government reduced the number of categories in the quota list and finally eliminated them in 1981. In addition, the government lowered deposit requirements for imports and abolished import taxes on raw materials and intermediary goods that the tradable goods sector used in manufacturing export goods. The government, however, placed most of these quota list items on the liberalized list, which still had various quantitative restrictions, and maintained a restrictive import licensing system (Onis and Webb 1994).

After the general elections in 1983, the government revised its import policy and started a substantial import liberalization program. The old system prohibited importing goods that were not on the liberalized list. The new import system contained three quantitative restriction lists instead; all items outside of these three lists did not have any quantitative import restrictions. Furthermore, the new import system relaxed restrictions on import licensing and the number of goods categories requiring import licenses; which decreased from 821 in 1983 to 33 in 1989 (Onis and Webb 1994).

In addition, the government tried to reduce unfavorable impacts of import liberalization on the Turkish economy by simultaneously adjusting tariff rates. The

government reduced tariff protection less in economic sectors that lost most of their licensing protection than in economic sectors that did not lose much licensing protection. In other words, although the government reduced quantitative restrictions on most consumer goods, it simultaneously tried to offset the negative impacts that this policy could cause on the economy by increasing tariffs on those goods, particularly through USD-denominated levies imposed by extra-budgetary funds. Nevertheless, despite some increases, the overall impact of the government's import policies on import licensing and tariffs was to relax import restrictions (Onis and Webb 1994).

In 1984, the government introduced a new incentive measure to increase exports by issuing incentive certificates to trading companies that had \$30 million or more in export revenues and whose exports consisted of 75% or more industrial and mining products. The government would increase the annual export requirement by 10% each year. Incentive certificates significantly stimulated exports; however, they also had an unfavorable impact on domestic economic competition. Onis and Webb (1994) argue that although the incentive certificates encouraged exports, they also created special interest groups favoring an outward economic orientation, but not necessarily free trade.

In 1985, the government introduced a mini-stabilization program after the inflation rate significantly increased from 31% to 48%. The government reduced export subsidies and low-cost export credits as part of the stabilization package. However, the government aborted the mini-stabilization program and increased export subsidies and credits after export growth slowed in 1986. Furthermore, the government resumed an aggressive devaluation policy and linked the adjustment to recent inflation to reduce real exchange and increase exports. The new devaluation policy and increased export subsidies stimulated export growth, but they also contributed to the deterioration of the government's fiscal situation. In 1988, the government's economic priority shifted from trade to inflation. The government eased its devaluation policy and adopted a floating exchange regime to decrease the inflation rate. The new exchange rate regime significantly affected Turkish trade and trade growth started to decrease after 1988 (Onis and Webb 1994).

Table 2. Foreign Trade Volume, Total Exports, and Imports (millions of USD) Between 1980 - 1989

| | Foreign Trade Volume | Total Exports | Total Exports / GNP | Total Imports | Total Imports / GNP |
|------|----------------------|---------------|---------------------|---------------|---------------------|
| 1980 | 10,819.5 | 2,910.1 | 4.2 | 7,909.4 | 11.3 |
| 1983 | 14,962.8 | 5,727.8 | 9.2 | 9,235.0 | 14.8 |
| 1984 | 17,890.5 | 7,133.6 | 11.7 | 10,756.9 | 17.7 |
| 1985 | 19,301.4 | 7,958.0 | 11.7 | 11,343.4 | 16.6 |
| 1986 | 18,561.5 | 7,456.7 | 9.8 | 11,104.8 | 14.5 |
| 1987 | 24,347.8 | 10,190.0 | 11.6 | 14,157.8 | 16.1 |
| 1988 | 25,997.4 | 11,662.0 | 12.8 | 14,335.4 | 15.8 |
| 1989 | 27,416.8 | 11,624.7 | 10.7 | 15,792.1 | 14.5 |

Source: Turkish State Planning Institute (2001)

2. Regular Public Revenue (Tax) Policy

In the early 1980s, the government's tax policies were generally aimed at decreasing the tax burden on capital to improve the financial sector and getting capital owners' support to finance economic policies. Despite the military coup, capital owners had substantial influence on the military-backed government. While the military prohibited labor union activities, it did not put any restrictions on the activities of businessmen and craftsmen organizations. Consequently, these organized groups managed to establish close ties with the government and bureaucracy over time. In this context, political conjuncture significantly affected the feasibility of the government's tax policies. When a new tax regulation loaded a new tax burden on a certain socio-economic group, depending on the extent of the reaction from this group, the government usually

amended the tax law or somewhat alleviated the tax burden through exemptions, exceptions, and postponement of the tax payments (Candemir 1994).

After 1983, the government further expanded the scope of tax reductions on capital and provided several tax exemptions to stimulate economic growth and increase employment in economically-backward regions of Turkey, particularly in Eastern Turkey. In 1985, the government introduced the Value Added Tax (VAT) as a part of the mini- stabilization program. The government also adopted a reward system for consumers to ensure maximum collection of the VAT. The reward system encouraged consumers to demand sale receipts from sellers for the goods or services they received by paying back a portion of the receipts they collected.

The VAT regulation was the only considerable tax reform in the 1980s to increase the government's tax revenues. Nonetheless, the government's tax revenues declined in real terms between 1980 and 1989 due to the government's inappropriate tax policies, particularly on the income tax. The personal income tax constituted a major portion of the total tax revenues of the government's consolidated budget (see Table 3). It included the payroll tax, taxes on the income of artisans, taxes on rental revenues, and corporate taxes. The government collected the income tax according to the rates it determined for each income bracket; however, the government did not increase the nominal income bracket limit at the same rate as the inflation rate. As a result, lower income groups, particularly the government employees who paid payroll taxes, sustained high tax rates. The payroll tax payers had no means of avoiding their tax rate because the government deducted their income tax directly from their payrolls (Candemir 1994).

The government, however, could not implement strict tax policies to collect the personal income tax more effectively from income tax payers other than the payroll tax payers. For example, artisans in Turkey paid a lump-sum tax and the government levied the tax on their earnings based on the individual's declared income. Since the artisans were paying a lump-sum tax, the government did not require them to sign bills after they sold a good or performed a service. In the absence of effective government supervision on their income declarations, the artisans had flexibility in declaring lower incomes and avoiding taxes.

Table 3. Tax Revenues (% of GNP) Between 1980 - 1989

| | Taxes on Income | Taxes on Wealth | Taxes on Goods and Services | Taxes on Foreign Trade | Total Tax Revenue |
|------|--------------------|--------------------|-----------------------------------|------------------------------|----------------------|
| 1980 | 8.75 | 0.13 | 3.88 | 1.38 | 14.14 |
| 1981 | 9.30 | 0.27 | 3.85 | 1.42 | 14.84 |
| 1982 | 7.58 | 0.20 | 3.14 | 1.37 | 12.30 |
| 1983 | 7.97 | 0.28 | 3.81 | 1.83 | 13.88 |
| 1984 | 6.05 | 0.19 | 2.76 | 1.70 | 10.70 |
| 1985 | 5.01 | 0.15 | 3.56 | 2.11 | 10.83 |
| 1986 | 5.96 | 0.10 | 3.66 | 1.94 | 11.67 |
| 1987 | 5.90 | 0.09 | 3.71 | 2.34 | 12.06 |
| 1988 | 5.36 | 0.11 | 3.48 | 2.07 | 11.02 |
| 1989 | 5.85 | 0.08 | 3.32 | 1.84 | 11.09 |

Source: Turkish State Planning Institute (2001)

Likewise, the government's tax policies granted similar flexibilities to the corporate sector. The government granted extensive tax reductions to the corporate sector by redefining expenditures that could be deducted from taxable income, tax exemptions for undistributed profits, tax exemptions on income from mutual funds and securities, and tax delays for the portion of revenue defined for investment (Candemir 1994). As a result, although the corporate tax rate was around 46%, corporations paid only 8% to 15% due to the government's tax exemptions and reductions.

In conclusion, the government's tax policies between 1980 and 1989 could not establish an effective tax collection system nor increase the public revenue. The government gave up some of its tax revenues either to improve the financial sector or to support a certain economic activity. On the other hand, occasional remittances of the

interests on tax debts and lack of supervision of the income earner's accounts, excluding the payroll taxpayers, degraded tax morality and obstructed the government's attempts to broaden the tax base (Candemir 1994).

3. Financial Liberalization

The Turkish financial system before 1980 was a repressive financial system with negative real interest rates, a high tax burden on financial earnings, and high liquidity and reserve requirement ratios. The capital and stock exchange markets were underdeveloped and highly fragmented. In this financial environment, corporations had to over rely on bank credits, rather than issuing stocks to finance their working capital balances. The government mostly financed fiscal deficits by direct monetization through the Central Bank (Balkan 2001).

After 1980, the government began to implement financial liberalization reforms in order to develop a competitive and efficient financial system that would support trade liberalization and export promotion policies. The government initially aimed at diversifying financial institutions and developed a capital market outside the banking sector. Under this policy, the government eliminated interest rate limitations and relaxed restrictions on new entry into the financial market. Subsequently, new banks and non-bank financial institutions began to flourish in the financial market. These developments increased competition among the agents in the financial market for deposits leading to an increase in interest rates (see Table 4). The government, however, failed to simultaneously implement necessary regulations with the liberalization measures. In the absence of effective regulation, six banks and several other brokerage houses collapsed as a result of high interest rates in 1982 (Denizer 1997). This incident caused a partial reversal from financial liberalization reforms and the Central Bank began to re-regulate deposit interest rates.

In 1984, the government liberalized the foreign exchange regime and allowed banks to deal in foreign currencies under the Central Bank's supervision. Simultaneously, the government revised the liquidity and reserve requirement system to simplify the Central Bank's supervision. In 1985, the government adopted the Banks Act to improve the structural weakness of the banking system. Under the Banks Act of 1985, the government took some legislative measures to supervise banks and other non-bank

financial institutions, using independent external auditing institutions that examine an institution's legal compliance and financial standing (Ersel 2001).

Table 4. Interest Rates (%) Between 1980 - 1989

| | Saving Deposit Interest Rates | Interest Rates on Central Bank Discount | Interbank Overnight Interest Rates |
|------|----------------------------------|--|---------------------------------------|
| 1980 | 33.0 | 26.0 | - |
| 1981 | 35.0 | 31.5 | - |
| 1982 | 50.0 | 31.5 | - |
| 1983 | 45.0 | 48.5 | - |
| 1984 | 45.0 | 52.0 | - |
| 1985 | 55.0 | 52.0 | - |
| 1986 | 48.0 | 48.0 | 39.09 |
| 1987 | 58.0 | 45.0 | 42.36 |
| 1988 | 89.9 | 54.0 | 46.77 |
| 1989 | 58.8 | 54.0 | 26.87 |

Source: Turkish State Planning Institute (2001)

In 1985 the government established a market for its securities and began selling government bonds and bills. Banks and other authorized non-bank financial institutions were the buyers in this market. Although the government was the sole seller in the market, it did not have monopoly power in determining interest rates because of increasing public sector liquidity needs. The government initially auctioned securities with one-year maturity and began auctioning short-term debt instruments towards the end of 1986. As the government securities developed, the government established an interbank money market where commercial banks traded on their free balances through the Central Bank. In addition, in 1986 the government established the Istanbul Stock

Exchange and formed the Capital Market Board to regulate and supervise the capital market (Candemir 1994).

In 1988, the government opened an official exchange market under the Central Bank's control and abolished regulations on deposit interest rates. Banks and non-bank financial institutions began to trade in this market, and this determined the exchange rate according to demand and supply in the exchange market. This enabled the banking sector to manage their foreign exchange reserves more efficiently (Civcir 2000). Furthermore, establishing the foreign exchange market completed the framework for the Central Bank to implement exchange rate, monetary, and interest rate policies through the market mechanism. Following these developments, the government fully liberalized the capital account in 1989.

D. FROM THE CAPITAL ACCOUNT LIBERALIZATION TO THE 1994 CRISIS

1. Capital Account Liberalization and its Immediate Impact

As discussed in the previous sections, the government's election-oriented public policies created pressure on the fiscal expenditures. The fiscal deficit became more acute after 1986, when the government gave greater financial autonomy to the SEEs and local administrations. In the absence of automatic budgetary transfers to these organizations, the SEEs and local governments borrowed from the domestic market. This situation, however, increased interest rates and contributed to the crowding out of private investment (Alper and Onis 2001). This created a need for additional funds to accelerate the growth of private investment and the government perceived capital account liberalization to be a solution in achieving this goal. In 1989, the government liberalized the capital account in Turkey.

The capital account liberalization package included significant measures. Civcir (2000) argues that these measures included:

1. Substantial liberalization of regulations governing transactions in securities.
2. Permission of Turkish citizens to purchase foreign exchange from banks or other authorized financial agencies.

3. Liberalization of the rules regarding repatriation of cash proceeds from sales of property to non-citizens.
4. Allowance for Turkish citizens to invest abroad in cash up to \$5 million or its equivalent in other currencies through banks and financial institutions.
5. Allowing Turkish citizens to secure foreign credits abroad in cash or by other means provided that they used banks or financial institutions as intermediaries.

These measures initially created a rapid capital inflow into the Turkish economy through both banking sector borrowing from the international markets and increasing portfolio investments in the Istanbul stock exchange (see Table 5). Meanwhile, the Central Bank announced a monetary program to control its own balances and restore confidence in the financial markets against the continuing deterioration in public finances. This program, however, resulted in higher interest rates, appreciation of real exchange rates due to the government's loose fiscal policy, and further increased short-term capital inflows (Civcir 2000). In addition, currency appreciations, coupled with tariff reductions, caused a major increase in imports and the trade balance began to deteriorate (see Table 6).

Table 5. Foreign Direct Investment (millions of USD) Between 1983 - 1994

| | Foreign Direct Investment Permits | Foreign Direct Investment Realizations (Net) |
|------|-----------------------------------|--|
| 1983 | 103 | 46 |
| 1984 | 271 | 113 |
| 1985 | 235 | 99 |
| 1986 | 364 | 125 |
| 1987 | 655 | 106 |

| | | |
|------|-------|-----|
| 1988 | 821 | 354 |
| 1989 | 1,512 | 663 |
| 1990 | 1,861 | 700 |
| 1991 | 1,967 | 783 |
| 1992 | 1,820 | 779 |
| 1993 | 2,063 | 622 |
| 1994 | 1,478 | 559 |

Source: Turkish State Planning Institute (2001)

Table 6. Import Coverage of Exports

| | Total Exports (millions of USD) | Total Imports (millions of USD) | Import Coverage of Exports (%) |
|------|------------------------------------|------------------------------------|-----------------------------------|
| | | | |
| 1989 | 11,624.7 | 15,792.1 | 73.6 |
| 1990 | 12,959.3 | 22,302.1 | 58.1 |
| 1991 | 13,593.5 | 21,047.0 | 64.6 |
| 1992 | 14,714.7 | 22,870.9 | 64.3 |
| 1993 | 15,345.1 | 29,428.4 | 52.1 |
| 1994 | 18,106.1 | 23,270.0 | 77.8 |

Source: Turkish State Planning Institute (2001)

On the other hand, short-term capital inflows significantly affected the government's independence in designing monetary policies. Between 1991 and 1994, gross short-term capital inflows increased from \$50 billion to \$120 billion, substantially increasing international lenders' influence on the Turkish financial markets. Because of this, international lenders began to influence the interest rates and foreign exchange rates

more than the Central Bank. These developments, as a result, forced the Central Bank into a passive role in foreign exchange management and more of an active role in holding significant amounts of foreign exchange. This situation contradicted the government's expectations of the capital account liberalization expanding investment funds to the private sector (Balkan and Yeldan 2001).

2. Growing Economic Imbalances and the Government's Response

The government launched the capital account liberalization amid growing fiscal imbalances and populist cycles. Hence, the government could not achieve its expected goals through capital account liberalization. Moreover, the government's fiscal situation continued to deteriorate after the capital account liberalization.

On the political side, the capital account liberalization coincided with a period of intense political competition for the 1989 local elections and upcoming 1991 general election. This situation forced the government to embark on more populist policies to increase its chances of winning the elections. The 1991 general election caused a new period regarding the formation of the government. The one-party-government rule that prevailed since 1983 ended because no single political party managed to obtain a majority of the popular vote in the 1991 general election. Moreover, two political parties with opposite political agendas, the right-of-center True Path Party (DYP) and the left-of-center Social Democratic Populist Party (SHP), formed the government. The Social Democratic Populist Party predominantly represented the wage earners and agricultural workers. As discussed earlier, these two socio-economic groups suffered most from the economic liberalization and became the main target of populist policies after 1986. Suleyman Demirel became the prime minister of the coalition government. Mr. Demirel was prime minister before the military takeover in 1980 and was famous for pursuing populist economic policies. Therefore, the composition of the government significantly changed the extent of the populist policies after 1991, and the new government increased the dimensions of the populist economic policies that the previous government had already started (Alper and Onis 2001).

On the fiscal side, the Gulf War created uncertainties and minor panics in the financial markets, which increased interest rates, shortened debt maturity, and put constraints on foreign financing. These developments and the new government's

expansionist economic policies worsened the fiscal deficit towards the end of 1991. In return, the government announced an economic program aimed at reducing the inflation rate by reducing the public deficit; however, the program did not include structural reform measures to achieve this goal. The government did not compromise with its populist policies; instead it perceived high levels of interest payments as a potential area for savings and increased the share of money financing (Celasun 1998). The government used almost all of the short-term cash advances from the Central Bank, up to its legal limit during the first half of 1992, and shifted towards longer maturities in its domestic financing. Furthermore, the government abandoned its policy of keeping external borrowing at the level of principal payments and borrowed about \$1 billion in international markets. On the other hand, the government's reliance on short-term cash advances from the Central Bank to prevent interest rate increases created pressure on the exchange rate. The Central Bank began to have difficulty in controlling its foreign exchange position; hence, the Treasury increased interest rates on three-month bills and borrowed an additional \$1.5 billion to solve this problem (Celasun 1998). Simultaneously, the Central Bank adopted a new exchange rate policy, stricter than its present exchange rate policy. Under the new policy, the Central Bank did not allow exchange rates to appreciate according to the market principles, and depreciated exchange rates less than the inflation rate.

In the absence of structural measures, the government's economic program failed to achieve its projected goals and the fiscal deficit continued to increase in 1992. In the first half of 1993, government interest payments significantly increased, particularly due to the interest payments for short-term domestic and foreign financing acquired during 1992 (see Table 7). The government designed a new budgetary program to decrease the burden of interest payments. The underlying Program objective was to lengthen maturity in financing the public deficit. The government decreased interest rates on three-month and six-month bills and increased interest rates on longer maturity bills. Meanwhile, a significant event occurred in the Turkish political environment: President Ozal passed away in March 1993 and the parliament elected Prime Minister Suleyman Demirel as the new president. Mrs. Tansu Ciller, a True Path Party Member of Parliament, became the new prime minister (Ozatay 2000).

Table 7. Consolidated Budget Balance (% of GNP)

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---------------------------|-------|-------|-------|-------|-------|-------|
| | | | | | | |
| Expenditures | 16.52 | 16.92 | 20.53 | 20.08 | 24.29 | 23.08 |
| -Current | 7.73 | 8.93 | 10.38 | 11.28 | 11.09 | 9.49 |
| -Personnel | 5.96 | 7.19 | 8.63 | 9.45 | 9.32 | 7.60 |
| -Other Current | 1.77 | 1.74 | 1.75 | 1.83 | 1.77 | 1.89 |
| -Investment | 1.68 | 1.72 | 1.85 | 1.72 | 1.83 | 1.30 |
| -Transfers | 7.11 | 6.27 | 8.31 | 7.09 | 11.36 | 12.30 |
| -Interest Payments | 3.59 | 3.52 | 3.79 | 3.65 | 5.83 | 7.67 |
| -Transfers to SEEs | 0.53 | 0.32 | 1.92 | 0.74 | 1.29 | 0.54 |
| -Tax Rebates | 1.25 | 0.90 | 1.02 | 0.98 | 1.06 | 0.80 |
| -Social Security | 0.61 | 0.31 | 0.25 | 0.36 | 0.69 | 1.01 |
| -Other Transfers | 1.14 | 1.23 | 1.32 | 1.36 | 2.50 | 2.27 |
| | | | | | | |
| Revenues | 13.19 | 13.91 | 15.25 | 15.79 | 17.59 | 19.16 |
| -General Budget Revenues | 13.06 | 13.74 | 15.10 | 15.66 | 17.43 | 19.03 |
| -Tax Revenues | 11.09 | 11.43 | 12.40 | 12.83 | 13.23 | 15.12 |
| -Non-Tax Revenues | 1.06 | 1.07 | 0.62 | 0.69 | 0.88 | 1.24 |
| -Special Revenues & Funds | 0.85 | 1.24 | 2.09 | 2.14 | 3.31 | 2.67 |
| -Annexed Budget Revenues | 0.19 | 0.17 | 0.15 | 0.13 | 0.17 | 0.13 |
| | | | | | | |
| Budget Balance | -3.33 | -3.01 | -5.28 | -4.30 | -6.70 | -3.91 |

Source: Turkish State Planning Institute (2001)

Table 8. Consolidated Budget Financing (% of GNP)

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|--------------------------|------|-------|------|-------|-------|-------|
| Foreign Borrowing (Net) | 0.24 | -0.09 | 0.01 | 0.30 | 0.37 | 1.05 |
| -Receipts | 2.06 | 1.56 | 1.38 | 1.72 | 1.79 | 2.31 |
| -Payments | 1.82 | 1.65 | 1.37 | 1.41 | 1.42 | 1.26 |
| Domestic Borrowing (Net) | 3.70 | 3.10 | 4.97 | 5.02 | 5.26 | 5.64 |
| Gov. Bonds (Net) | 2.60 | 2.00 | 0.36 | 1.40 | 1.51 | -1.81 |
| -Receipts | 3.90 | 3.15 | 1.81 | 3.23 | 3.25 | 0.64 |
| -Payments | 1.30 | 1.15 | 1.46 | 1.83 | 1.74 | 2.45 |
| Treasury Bills (Net) | 0.43 | 0.49 | 2.02 | 2.17 | 1.11 | 6.28 |
| -Receipts | 3.31 | 2.13 | 5.40 | 6.88 | 8.57 | 16.05 |
| -Payments | 2.88 | 1.64 | 3.39 | 4.71 | 7.46 | 9.77 |
| Central Bank (Net) | 0.20 | 0.08 | 1.69 | 1.58 | 2.65 | 1.33 |
| Other | 0.47 | 0.53 | 0.90 | -0.12 | -0.02 | -0.17 |

Source: Turkish State Planning Institute (2001)

The second half of 1993 was a turning point for the government's economic policies. Mrs. Ciller stated that the most important short-term economic goal of the government was to lower the interest rates. Subsequently, the government designed an annexed budget law and a consolidation law that would permit the Parliament to cancel the Treasury's accumulated debt to the Central Bank by the parliament. In August 1993, the government passed these two laws in the Parliament and relaxed the 15% limit on the Central Bank's budget deficit financing. Moreover, the annexed budget enabled the Treasury to borrow almost twice the amount it borrowed prior to these two laws (see Table 8). Consequently, the Central Bank's cash advances increased and reached \$2 billion during the last three months of 1993 and first three weeks of January 1994 (Celasun 1998).

Meanwhile, the government began to cancel securities auctions because of high interest rates. In November, the government cancelled four auctions for three, six, and nine-month bills; in December the government did not auction bills with maturities less than one year. In December, the government announced that it would impose a 5% income tax on government securities; up until then the government securities were not subject to taxes. Consequently, demand for government securities began to decrease (see table 8). On the other hand, the government's 1994 budget did not contain any fiscal measures to overcome the fiscal deterioration. Upcoming local elections in April were the main reason for the government's reluctance to take corrective measures to improve its fiscal situation. Moreover, the government delayed public good price increases in the first quarter of 1994, thus increasing the inflationary expectations that the price increases would take place shortly after the elections in April (Ozatay 2000). These developments increased instability in the financial markets while major international agencies downgraded Turkey's credit rating.

As the government's ability to borrow from the domestic market decreased, the government began to rely more on cash advances from the Central Bank. During the first three weeks of 1994, the Treasury used almost 53% of its legal limit for 1994. Increasing liquidity in the economy affected the exchange rate and the margin between the official and parallel market exchange rates began to increase. Between January 1st and the 17th, the margin increased from 1% to 22.9%. Despite this increase, the Central Bank did not increase interest rates until January 20th. Subsequently, overnight interest rates increased sharply, from 70% on January 20 to 700% on March 11 (Ozatay 2000). High interest rates collapsed the government securities market and the government was no longer able to borrow from the securities market. This situation triggered a rush to foreign currencies. Commercial banks that engaged in offshore borrowing and that mainly held Turkish Lira denominated assets rushed to acquire foreign currency to close their foreign currency positions and triggered the economic crisis. The Central Bank attempted to intervene in the foreign exchange market and sold foreign currency below market prices to defend the parity and contain the capital outflow. This policy, however, reduced the Central Bank's foreign exchange reserves; by April, it lost more than half of its foreign exchange reserves (Celasun 1998). After the April 1994 local elections, the government announced

a stabilization program and the economic crisis ended only after the stabilization program restored durability in the financial markets and the government was able to re-borrow from the domestic debt market.

Table 9. Exchange Rates Between 1989 - 1994

| | End of Year USD Rate | Average USD Rate | End of Year DM Rate | Average DM Rate |
|------|-------------------------|---------------------|------------------------|--------------------|
| 1989 | 2,311.37 | 2,120.78 | 1,364.45 | 1,129.98 |
| 1990 | 2,927.13 | 2,607.62 | 1,947.53 | 1,620.64 |
| 1991 | 5,074.83 | 4,169.85 | 3,339.81 | 2,511.49 |
| 1992 | 8,555.85 | 6,887.51 | 5,302.66 | 4,419.82 |
| 1993 | 14,450.03 | 10,985.96 | 8,347.59 | 6,635.80 |
| 1994 | 38,687.00 | 29,704.33 | 24,924.00 | 18,498.82 |

Source: Turkish State Planning Institute (2001)

3. The Effects of the Government's Economic Policies on the 1994 Economic Crisis?

This section evaluates the relationship of the government's economic policies on the 1994 economic crisis. Following Ozatay's (2000) argument, we try to demonstrate that the changes in the government's economic policy during the second half of 1993 mainly triggered the 1994 economic crisis. As discussed in the previous sections, both the developments in the Turkish political arena and the government's wayward expansionist economic policies created a suitable environment for an economic crisis. On the other hand, although the economic situation during this period was not substantially better than in 1993 or 1994, neither the political factors nor the unfavorable economic situation caused an economic crisis. The events that ultimately started the crisis began with the government change in 1993, after Mr. Ozal's death. During the second half of 1993, the

government gave explicit indications that it would change the financing mechanisms for the fiscal deficit, which in return caused a rush to foreign currencies and started the crisis.

Ozatay (2000) notes that early models of balance of payment crises identify gradual deterioration of macroeconomic fundamentals as the main source of currency collapses; which, in return depletes central bank's foreign exchange reserves. At some point, however, economic agents, anticipating the gradual depletion in foreign exchange reserves, know that the government will not be able to continue its prevailing exchange rate regime. This anticipation triggers a rush to foreign exchanges in order to prevent excessive capital losses, which starts a currency crisis. In the 1994 Turkish economic crisis, what triggered the rush to foreign exchanges is important in determining the immediate cause of the crisis. Was it the government's inappropriate economic policies or deteriorating macroeconomic fundamentals that started the capital outflow to foreign exchanges? We argue that it was the government's inappropriate economic policies.

During the pre-crisis period, macroeconomic fundamentals in the Turkish economy did not move according to the predictions of the early models of balance of payments crises. For example, depletion of the Central Bank's foreign exchange reserves was sudden rather than gradual, and the margin between the official exchange rate and the parallel market exchange rate remained almost stagnant until January 1994 (Ozatay 2000). On the other hand, despite the government's fiscal laxity and increasing fiscal deficits, the inflation rate remained stable, around 65%, for almost five years before the crisis event (see Table 10). Moreover, the government was able to borrow from the domestic market to finance its fiscal deficits until November 1993. All these factors suggest that, until late 1993, economic agents had confidence in the government's ability to maintain the exchange regime despite its unfavorable fiscal situation.

The government, however, made a significant policy change regarding its deficit financing during the second half of 1993. Initially, the government reduced short maturity auctions and then cancelled them in November and December, regardless of the demand for those short-maturity government bonds. This action created uncertainties in the financial markets. Additionally, following the government's announcement that it would tax income earned in the government securities market, the economic agents' demand for the government securities began to decline. The government responded to this situation

by increasing the amount of cash advances from the Central Bank to finance the public deficit (see Table 8). Consequently, deficit financing through domestic borrowing as a ratio to the GNP continued to decline and became negative in the beginning of 1994. This was an inappropriate policy change when considering that the government financed its fiscal deficit and managed to prevent inflation rate increases and foreign exchange reserve depletions through domestic borrowing since the late 1980s.

Table 10. Main Fiscal Indicators (% of GNP), Inflation, and Growth Rate

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|--------------------|------|------|------|------|------|-------|
| Total PSBR | 5.3 | 7.4 | 10.2 | 10.6 | 12.0 | 7.9 |
| Public Debt | 41.8 | 34.5 | 38.5 | 41.8 | 44.3 | 62.3 |
| -Domestic | 6.3 | 6.1 | 6.8 | 10.5 | 12.8 | 13.9 |
| -Foreign | 35.5 | 28.4 | 31.7 | 31.3 | 31.5 | 48.4 |
| Real Interest Rate | -2.8 | -4.6 | 8.1 | 9.6 | 13.0 | 28.2 |
| Inflation Rate | 63.3 | 60.3 | 66.0 | 70.1 | 66.0 | 106.3 |
| GNP Growth | 1.6 | 9.4 | 0.3 | 6.4 | 8.1 | -6.1 |

Source: Ozatay (2000)

As the government relied more on the Central Bank's resources, economic agents began to anticipate that the government would not be able to keep the exchange rate at its prevailing level and rushed to foreign exchanges in the beginning of 1994 (Ozatay 2000). Even though the margin between the official and parallel market exchange rates began to increase, the government did not respond immediately by increasing the interest rates to prevent further appreciation of foreign exchanges. The Central Bank tried to defend the exchange rates by using its foreign exchange reserves; however, this coincided with the commercial banks' efforts to close their foreign exchange positions and the Central Bank lost more than half of its foreign exchange reserves between January and April 1994.

In conclusion, the government's economic policies during the second half of 1993 significantly contributed to the 1994 economic crisis. This does not mean that deterioration in macroeconomic fundamentals did not contribute to the crisis. On the contrary, the deteriorating fiscal situation created a volatile economic environment prone to speculations. As a matter of fact, the government's economic policies in the second half of 1993, canceling domestic debt auctions and relying on the Central Bank's resources, were some of the main factors that started the crisis. In the absence of substantial stabilization measures, the government should have continued domestic debt financing despite its high cost, rather than relying on the Central Bank's resources. This would allow the government to maintain foreign exchange reserves, contain the inflation rate, and gain valuable time to design and implement radical stabilization measures to improve its fiscal situation.

IV. THE CRISIS EVENT AND THE GOVERNMENT'S RESPONSE

Chapter IV focuses on the government's efforts to overcome the 1994 economic crisis. This chapter begins with a brief account of the immediate impact of the 1994 economic crisis on the Turkish economy. We then continue the chapter with a discussion on the government's April 5, 1994, economic stabilization program. Finally, we conclude this chapter with an assessment of the April 5th stabilization program's effectiveness in alleviating and resolving the impacts of the 1994 economic crisis.

A. THE IMMEDIATE IMPACT OF THE 1994 ECONOMIC CRISIS

The 1994 economic crisis significantly affected the Turkish economy; in the aftermath of the crisis, the Turkish economy recorded the highest decrease in output in the history of the Turkish Republic. The economy contracted by approximately 6% (see Table 10). The Turkish Lira substantially depreciated against major foreign currencies between January and April 1994; for example, the Turkish Lira depreciated by almost 70% against the United States Dollar. In response, the Central Bank attempted to curb depreciation in the Turkish Lira by injecting foreign exchange into the foreign exchange market losing around \$3 billion of its reserves, which accounted for almost half of the Central Bank's total reserves at the beginning of 1994 (Sahin 2000).

The high depreciation ratio of the Turkish Lira significantly contributed to the output loss in the Turkish economy by causing bankruptcies among businesses. Businesses that had foreign-currency denominated loans could not afford their payments and went bankrupt, causing a drastic decrease in national output and increasing unemployment. The unemployment rate increased from 11.2% in the first half of 1993 to 12.6% during the same period in 1994. The exchange rate depreciation also affected the Istanbul Stock Exchange; the composite index (IMKB 100) decreased by 10.3% in the first quarter of 1994. Meanwhile, the exchange depreciation created upward pressure on consumer prices. The inflation rate spiked between January and April and reached almost 150% in the beginning of April 1994. Rising consumer prices resulted in a sharp decrease in both real wages and household income. Banks did not want to extend their lending in

such an uncertain environment and increased their lending rates by approximately 400% between January and April 1994. The volatile economic situation, coupled with rising lending rates, significantly affected private consumption and investment, both of which declined during the crisis period (Karluk 1999).

On the other hand, the 1994 economic crisis substantially affected the trade balance by increasing the competitiveness of Turkish exports. In 1994, due primarily to the devaluated Turkish Lira, exports increased significantly while a sharp contraction in imports replaced the import boom of 1993. Turkey's exports increased from around \$15,345 million in 1993 to \$18,106 million in 1994; whereas, imports decreased from around \$29,428 million to \$23,270 million in the same period (see Table 6). In other words, import coverage of exports increased from 52.1% in 1993 to 77.8% in 1994 (State Planning Institute 2001).

Following these events in the Turkish economy, the government responded to the 1994 economic crisis by announcing a stabilization program on April 5, 1994. The government's response, however, came quite late when considering that the crisis event began to unfold in mid-January 1994. Political considerations about the upcoming local elections in April 1994 prevented the government from taking substantial measures to resolve the economic crisis. As a result, the delays in the government's reaction to the crisis further aggravated the impact of the 1994 economic crisis on the Turkish economy.

B. THE GOVERNMENT'S RESPONSE TO THE 1994 ECONOMIC CRISIS

In this section we discuss the government's efforts to overcome the 1994 economic crisis. This section begins with a brief overview on the definition and the methods of stabilization programs. Then it discusses the government's April 5, 1994 stabilization program.

Economic stabilization programs are usually implemented in developing countries facing high inflation, high external debt, unsustainable public-sector budget deficits, and balance of payments crisis. The fundamental objective of a stabilization program is to balance aggregate supply⁴ and demand⁵ in the economy. Bahceci (1997) argues that

⁴ Total supply of goods and services in an economy in which firms produce for given price levels (Money Manager 2002).

⁵ Total demand for a country's output, including demands for consumption, investment, government

stabilization programs can be split into two groups according to their scope and methods: orthodox and heterodox stabilization programs. Orthodox stabilization programs rely on tight fiscal and monetary policies to discipline the economy and reduce inflation. On the other hand, heterodox stabilization programs temporarily use price and wage controls to reduce the inflation rate. Timing is a crucial factor for achieving the projected goals of a stabilization program, regardless of which type of program is implemented. In the case of an economic crisis, the sooner the government launches a stabilization program, the more successful the stabilization program will be to alleviate the impacts of the economic crisis (Bahceci 1997).

When examining the 1994 economic crisis, we observe that the Turkish government was late in responding to the crisis with a stabilization program. Despite the fact that the crisis event started in mid-January 1994, the government postponed any major stabilization effort until after local elections in the beginning of April 1994. Any stabilization effort before the local elections would endanger voter support for the coalition parties that formed the government. Only a week after the local elections, on April 5th, the government announced a stabilization package that included both orthodox and heterodox stabilization measures. With these mixed stabilization measures, the government aimed at decreasing the high inflation rate, stabilizing the Turkish Lira, and reinforcing the economic structure for future economic growth. In other words, the government would restore economic stability in the short-run and implement structural reforms to maintain economic stability in the long-run. The main measures of the April 5 stabilization program are (Karluk 1999)

1. Devaluation of the Turkish Lira by 39%. The exchange rate of the United States Dollar increased from TL 23,000 to TL 32,000 on April 5th.
2. Abolition of the 5% tax on the revenues earned in the government securities market.
3. A one-time tax surcharge on private enterprises.
4. Liberalization of the exchange rate determination. With the new system, the exchange rates would be determined according to the data provided by 10 major commercial banks along with the Central Bank.

purchases, and net exports (Deardorff 2001).

5. An increase in the amount of the government's insurance coverage on bank deposits. The insurance limit increased from TL 50 million to full coverage.
6. Increases in public sector prices. Before the economic crisis, the government artificially kept the prices of public goods low by subsidizing them. Following the announcement of the stabilization program, public sector prices increased sharply: the government increased the prices of sugar by 50-62%, tobacco and liquor by 70-100%, tea by 64-72%, and fuel by 46-90%.
7. Reduction in public expenditures. With this measure, the government would cut its current non-defense expenditures by 30%.
8. Increases in interest rates to curb the downward pressure on the exchange rate. The average real interest rate on the government securities increased to 24.9%.
9. Privatization of the state economic enterprises. Under this measure, the government would privatize certain SEEs and restructure the others to increase their efficiency.

The IMF and the World Bank welcomed the stabilization program and urged the government to turn the stabilization program into a major economic reform (Yilmaz 2001). In May 1994, the government signed a stand-by agreement with the IMF and received a \$720 million loan for the implementation of the stabilization program.

C. THE IMPACT OF THE APRIL 5TH STABILIZATION PROGRAM ON THE TURKISH ECONOMY

The April 5th stabilization program partially succeeded in achieving its projected goals. The program managed to achieve its short-term goals, such as stabilizing the financial markets and the Turkish Lira; however, it failed to achieve its long-term goals of reducing the public deficit and high inflation on a permanent basis.

The IMF's close monitoring of the government during the initial phase of the stabilization process, significantly contributed to the achievement of the program's short-term goals. Under the 1994 IMF stand-by agreement, the IMF set quarterly performance

criteria and supervised the realization of these criteria. As seen in Table 11, the government met most of the criteria set for the first 9 months of the stabilization period. In addition, the government's initial determination to implement the stabilization measures, the additional revenues raised through one-time tax surcharge and the public sector price increases during this period also substantially contributed to the program's success in the short-run.

Table 11. 1994 IMF Stand-by Agreement's Performance Criteria and Their Realization (Trillion TL)

| | 30 June 1994 | | 30 September 1994 | | 31 December 1994 | |
|---|--------------|----------|-------------------|----------|------------------|----------|
| | Planned | Realized | Planned | Realized | Planned | Realized |
| Consolidated Budget Deficit | 73.5 | 61.1 | 96.3 | 99.2 | 109.6 | 152.2 |
| USD Exchange Rate (TL/\$) | 35,000 | 31,725 | 35,700 | 33,895 | 38,000 | 37,407 |
| CB Foreign Exchange Reserves (million USD)* | -350 | 812 | 300 | 2,906 | 1,000 | 3,066 |
| CB Net Domestic Assets | 305.5 | 271.2 | 294.5 | 259.9 | 293.0 | 271.9 |
| Currency Issued | 76.9 | 91.7 | 81.4 | 118.1 | 90.0 | 120.2 |
| Reserve Money | 139.4 | 148.1 | 147.8 | 184.1 | 164.2 | 185.7 |
| Money Supply (M1) | 150.0 | 147.3 | 159.7 | 205.5 | 187.3 | 239.0 |

Source: Turkish State Planning Institute

* Cumulative changes to the Central Bank's \$4,613 million net reserves on March 31, 1994.

In 1994, the government's nominal consolidated budget revenues increased by 110.3%, while nominal expenditures increased by only 84%. This situation enabled the government to decrease the consolidated budget deficit from 6.7% of nominal GNP in 1993 to 3.9% of nominal GNP in 1994. Likewise, the PSBR ratio decreased from around 12% of nominal GNP in 1993 to 7.9% of nominal GNP in 1994. In the meantime, foreign exchange reserves of the Central Bank recovered rapidly (see Table 11). Moreover, as the United States Dollar denominated wages declined, export earnings increased. Between January and July of 1994, exports increased by 10.8% and imports declined by 23% compared to the same period in 1993. As a result, the current account deficit of \$1.1 billion in the first quarter of 1994 transformed into a surplus of \$2.2 billion in the second quarter of 1994 (Ozatay 2000).

On the other hand, the government did not successfully achieve the long-term goals of the April 5th stabilization program. The government's failure to implement the orthodox measures of the stabilization program, such as privatization, social security, and SEE reforms, contributed to this failure. The government, for example, did not raise the revenue it expected to raise from SEE privatization. In general, following Karluk's (1999) argument, we observe these reasons for the shortcomings of the April 5th stabilization program:

1. The government did not maintain the tight fiscal policy it adopted in the initial stage of the stabilization program and relaxed its fiscal policy over time. As a result, despite the initial increase in the consolidated budget revenues and the decrease in the current expenditures, the government failed to keep the consolidated budget deficit within the IMF performance criteria with the deficit substantially increasing towards the end of 1994 (see Table 11). Meanwhile, increasing interest payments on both domestic and foreign debt, rising costs of military operations in Southeastern Turkey, and low SEE privatization revenues deteriorated the government's fiscal position.
2. Like its fiscal policy, the government failed to pursue the tight monetary policy except during the initial phase of the stabilization period. The

government did not sterilize⁶ the monetary expansion caused by the rapid increase in the Central Bank's foreign exchange reserves. Although the government met the IMF's three-monthly performance criteria on the net domestic assets of the Central Bank, the Central Bank's net domestic assets fluctuated widely between the months of these three-month intervals.

3. The government experienced delays in implementing the structural reforms it managed to launch during the stabilization process. These delays mainly occurred as a result of administrative and legal problems which, in turn, substantially reduced the prospected success from the reform measures.
4. During the stabilization period, the government reduced net foreign debt by 2.7%. This policy, however, aggravated the impact of insufficient foreign credits available to fund the stabilization program and significantly affected the realization of the goals regarding public finance.
5. The government did not decrease inflation on a permanent basis. Delays in the stabilization program and the government's deviation from the original stabilization program, as it faced resistance from certain socio-economic groups, obstructed the long-term success of the anti-inflationary measures. The inflationist expectations and the lack of public confidence in the government's stabilization efforts also contributed to the failure of the government's anti-inflationist measures.

By late 1994, after decreasing the inflation rate to two-digit numbers, the government began to relax its tight fiscal policy by either postponing or canceling any further cuts in government spending. This was an inappropriate policy change because without significant fiscal adjustments, the labor unions' passive reaction to the government's economic policies mainly facilitated the reduction in the inflation rate. Yilmaz (2001) argues that despite substantial decreases in real wages, labor unions did not organize general strikes during the post-crises period. The labor unions' passive

⁶ To use offsetting open market operations to prevent an act of exchange market intervention from changing the monetary base. With sterilization, any purchase of foreign exchange is accompanied by an equal-value sale of domestic bonds, and vice versa (Deardorff 2001).

standing helped the government prevent inflation from getting out of control through wage suppression. The government, however, failed to take advantage of this situation to bring down inflation permanently as it abandoned the stabilization program.

On the other hand, the 1994 economic crisis and the government's inability to fix its fiscal situation weakened the government and led to an early general election in December 1995. Once again, political concerns gained priority over fiscal concerns and the government embarked on a series of expansionary public policies. Following the election in 1995, the IMF withdrew its support from the government and did not disburse the last portion of the 1994 stand-by agreement credit. In 1996, the stability of the Turkish political environment significantly decreased and the coalition government changed twice which, in turn, further increased public expenditures. Meanwhile, Turkey joined the European Union Customs Union (EUCU) in 1996 and the trade balance started to deteriorate once again (Celasun 1998).

In August 1998, the Asian financial crisis hit the Turkish economy and aggravated the already adverse macroeconomic conditions in the Turkish economy. In the aftermath of the Asian financial crisis, fiscal and current account deficits, the inflation rate, and unemployment rates significantly increased. These developments forced the government to sign a new stand-by agreement with the IMF in 1999. The government, however, could not effectively implement the measures of the 1999 IMF stand-by agreement and the Turkish economy experienced another economic crisis in 2001.

V. THE RELATIONSHIP BETWEEN THE 1994 AND 2001 ECONOMIC CRISES

Chapter V focuses on the 2001 economic crisis. This chapter first examines the evolution of the 2001 economic crisis and then attempts to demonstrate the correlation between the 1994 and 2001 economic crises. In order to do this, Chapter V begins with an overview of the 1999 economic stabilization program and its immediate impact on the Turkish economy. We then examine the evolution of the 2001 economic crisis. In the last section, we try to demonstrate that the 2001 economic crisis occurred for the same reasons that created the 1994 economic crisis.

A. 1999 IMF-BACKED STABILIZATION PROGRAM

After the general election on April 18, 1999, three political parties formed a coalition government⁷. Following their inauguration, the deteriorating public fiscal situation and high inflation forced the new coalition government to launch a new economic stabilization program in December 1999. In general, the stabilization program was a set of disinflation measures that supported a predetermined nominal exchange rate anchor by restrictive fiscal measures. Shortly after the announcement of the 1999 economic stabilization program, the government signed another stand-by agreement with the IMF. The new IMF stand-by agreement included a \$4 billion credit to be disbursed over a three year period and set goals to reduce the inflation rate from around 70% in December 1999 to single-digit figures by the end of year 2002 (Hackworth, Li, and Ryan 2001).

In order to achieve the objectives of the IMF backed stabilization program, the government sought to employ a variety of policy instruments, to include tighter fiscal policy, structural reform, and a pegged exchange rate regime⁸. With tighter fiscal policy, the government sought to decrease public expenditures through disciplinary means, such

⁷ Nationalist Movement Party (MHP), Motherland Party (ANAP), and Democratic Socialist Party (DSP).

⁸ A regime in which a government or central bank announces an official par value of its currency and then maintains the actual market rate within a narrow band above and below that by means of exchange market intervention (Deardorff 2001).

as tying the minimum wage and public wage increases to the targeted inflation. In addition, the government included some structural reform measures in the stabilization package to reinforce the impact of tight fiscal policy on stabilizing the public deficit. These structural measures included the privatization of the SEEs, modifying the agricultural financial support system, and reform of the banking and social security systems. Under the pegged exchange rate regime, the Central Bank would announce an exchange rate basket and depreciate the exchange rate in line with the targeted inflation, which was 25% for year 2000 (Hackworth, Li, and Ryan 2001).

The 1999 economic stabilization program had a favorable impact on the Turkish economy during the first ten months of its implementation. During this period, the stabilization program significantly reduced Turkey's exchange rate risk and sovereign risk⁹, starting a capital inflow. The stabilization program did not require any sterilization for capital inflows; hence, money market liquidity increased as the capital inflows increased. This created a downward pressure on the interest rates and lowered the future burden of interest payments on the debt stock, further accelerating the capital inflows due to the reduced default risk. Interest rates decreased from around 100% in December 1999 to around 35% in September 2000 (Yeldan 2001).

Falling interest rates reinforced the expectations that the government would be able to sustain the 1999 economic stabilization program and achieve the pre-announced stabilization goals, such as the single-digit inflation target. Increasing confidence in the government's economic policies encouraged some mid-size banks to borrow large amounts of loans from abroad and make long-term investments on government securities. These banks also offered large volumes of consumer credits which, in turn, increased consumption and investment, stimulating the economic growth.

On the other hand, the mid-size banks, which engaged in excessive foreign borrowing and long term investment, risked themselves by ignoring the fact that the government might not be able to sustain the stabilization program and keep the interest rates down. These banks depended almost exclusively on repo¹⁰ funding and interbank

⁹ The risk that a country or a sovereign power will default on its payment obligations (Deardorff 2001).

¹⁰ Agreement in which one party sells a security to another party and agrees to repurchase it on a specified date for a specified price (Forbes Magazine 2001).

loans for short-term financing. Alper and Onis (2001) argue that the financing methods of their long-term loans through short-term loans expose these banks to maturity mismatch risk. Because, the majority of transactions in the repo market have one-day maturity, while average maturity on government securities is approximately 15 months. Therefore, the maturity mismatch risk renders these banks substantially vulnerable to unexpected interest rate increases.

B. CAUSES OF THE 2001 ECONOMIC CRISIS

In mid-September, 2000, the favorable impact of the 1999 economic stabilization package began to reverse. Two factors significantly contributed to this downturn: political strife among the members of the coalition government and the widening current account deficit.

The composition of the coalition government was the major source of competing interests within the coalition government. All three members of the coalition government had differing political ideologies; MHP, DSP, and ANAP embraced nationalist, left of center, and right of center political ideologies, respectively. The sharp political split between the coalition members significantly reduced their ability to reach a consensus on implementing some structural reform measures. For example, the resistance of some cabinet members prevented a block sale of Turk Telekom¹¹ and caused around \$2 billion shortfall in the government's projected privatization revenues for year 2000. Likewise, some of the cabinet members' resistance to the energy sector privatizations delayed foreign direct investment into the energy sector. Moreover, the government's failure to pass the state banking privatization delayed the approval of a \$780 million World Bank loan (OECD Policy Brief 2001).

On the other hand, the current account deficit continued to deteriorate during the first 10 months of the stabilization period and reached 4.9% of GDP in October 2000. The widening current account deficit was a signal of a fiscal problem with the 1999 economic stabilization program. Hristov (2001) argues that the pegged exchange rate regime significantly contributed to the widening current account deficit. Under the pegged exchange rate regime, the Central Bank depreciated the Turkish Lira 25% as

¹¹ State telecommunications company

opposed to an average real inflation rate of 50% in year 2000. This policy led to significant increases in production costs of Turkish export items and reduced their competitiveness in international markets, causing a reduction in export revenues. On the export side, the pegged exchange rate regime led to a sharp increase in imports, which further deteriorated the trade balance and widened the current account deficit.

Following these events, the downward trend in the interest rates began to reverse towards the end of September 2000. Soaring interest rates raised suspicions in the financial markets about the government's ability to maintain the stabilization program. Beginning in October 2000, the initial capital inflow of around 11 billion until September 2000 turned into a capital outflow mainly due to the loss of international creditors' confidence in the government's ability to continue the 1999 stabilization program. The capital outflow and rising interest rates eventually culminated into the 2001 economic crisis. The 2001 economic crisis unfolded in two steps: the first step started with a small banking crisis in November 2000 and eventually culminated into an economic crisis with the second step, which broke out after a political dispute between the president and the prime minister in February 2001.

The November 2000 banking crisis started with liquidity¹² problems of some mid-size banks. As we discussed in the previous section, these banks positioned themselves against the downward trend of the interest rates by long term investments in government securities. As the interest rates increased after September 2000, these banks began to sell their government securities holdings at a loss to maintain their liquidity (Elekdag 2001). The Central Bank, consistent with its monetary policy, did not intervene in the banking system by injecting liquidity, which further aggravated the liquidity problems of these mid-size banks. As rumors about the illiquid banks spread, first-tier banks cut their credit lines to the interbank money market and international creditors exited the overnight money market to avoid the Turkish banking risks. This situation further exacerbated the portfolio losses of the exposed mid-size banks and resulted in an increasing liquidity squeeze and rising overnight interest rates. As the banking system came under severe pressure, the Central Bank suspended its net domestic assets policy and injected liquidity

¹² a. The maintenance of cash and reserves by a financial institution to fund withdrawals by depositors, unit holders, or clients. b. The availability of an investment to be early converted into cash with little or no loss of capital and minimum delay (Deardorff 2001).

into the banking system between November 22nd and 30th, 2000, in order to protect the banking system and curb the increase in the interest rates (OECD Policy Brief 2001). The Central Bank's intervention, however, increased fears about the sustainability of the 1999 economic stabilization program which, in turn, further increased overnight interest rates to three-digit figures and accelerated the capital outflow. Following these events, the Central Bank returned to its original monetary policy and ceased injecting liquidity into the banking system on November 30, 2000, in order to prevent further decrease in its foreign exchange reserves.

The volatility in the financial markets stabilized temporarily after the IMF announced the availability \$10 billion financial assistance to the government. The IMF conditioned the financial assistance on the government's commitment to strengthen the financial sector, accelerate privatization, and to strengthen the budget to accommodate the fiscal costs of bank recapitalization¹³ (Beris and Gurkan 2001). In line with the IMF's financial assistance conditions, the government announced a measures package to overcome the fluctuations in the financial sector on December 6, 2000. Beris and Gurkan (2001) argue that this stabilization program included:

1. The announcement of a tender¹⁴ for 33.5% of Turk Telekom by December 14, 2000.
2. The announcement of a tender for the privatization of a 51% stake of the Turkish Airlines by December 14, 2000.
3. Drafting of a new electricity law to liberalize the electricity market by December 14, 2000.
4. Realizing the requirements for the 2001 inflation target and expected improvement in the balance of payments.
5. Continuation of the pegged exchange rate regime.
6. Continuation of wage increases at the targeted inflation rate.
7. Maintaining guarantees on deposits.

¹³ The financial restructuring of a bank so as to improve its operations and enhance performance. It may involve new debts or change in ownership of recapitalized banks (Forbes Magazine 2001).

¹⁴ To offer shares for sale at a specified price, usually in response to a specific request from a potential purchaser (Deardorff 2001).

8. Introduction of guarantees on loans extended to the banking system.

Under this policy, the Treasury would provide full guarantee for the deposits and credits of the Turkish banks.

Following the IMF financial assistance announcement and the government's measures package, overnight interest rates declined and dropped to two-digit figures at the end of November 2000. The stability in the financial markets, however, lasted only until February 19, 2001, when the second step of the 2001 economic crisis unfolded after a dispute between President Ahmet Nejdet Sezer and Prime Minister Bulent Ecevit.

At the National Security Council meeting, the president and the prime minister argued about the government's handling of the November 2000 banking crisis. After the dispute, Prime Minister Bulent Ecevit left the National Security Council meeting early and announced that the coalition government was in jeopardy. Within hours after the prime minister's announcement, the financial markets plunged and the banks rushed to buy foreign exchange, particularly the United States Dollar. Despite the increasing demand for foreign exchange, the Central Bank did not inject liquidity into the banking system in order to comply with the tight monetary policy of the 1999 stabilization program. The resulting liquidity shortage affected the banking system and overnight repo interest rates soared to around 3000% on February 20. Meanwhile, the average yield in the government securities market rose to 154% (Beris and Gurkan 2001). The financial turmoil deepened and culminated in currency devaluation. On February 22, 2000, the government announced that it would let the free market determine the exchange rates by adopting a floating exchange rate regime as opposed to the pegged exchange rate regime. The Turkish Lira devaluated by around 27% against the United States Dollar in the first trade after the government adopted floating exchange rate regime. The 2001 economic crisis ended after the government announced another IMF-backed stabilization program on April 14, 2001.

C. WERE THE 1994 AND 2001 ECONOMIC CRISES A RESULT OF THE SAME PROBLEMS IN THE TURKISH ECONOMY?

When we examine the causes of both the 1994 and 2001 economic crises, we observe that the underlying causes of both crises are similar. Prior to each crisis,

economic mismanagement and structural problems of the Turkish economy, such as high public deficit and PSBR ratio, created a lopsided economic structure highly vulnerable to an economic crisis. In this economic environment, the government's inappropriate economic policies distorted the financial markets' confidence in the government's ability to maintain a pegged exchange rate regime and necessitated devaluation of the Turkish Lira. The similarities between the underlying causes of both crises suggest that the causes that created the 1994 economic crisis still persisted when the 2001 economic crisis happened. Hence, we argue that the 1994 economic crisis and the 2001 economic crisis were caused by the same economic factors, which as we have illustrated, are primarily the result of the government's inability to actively pursue sustained policy reform.

Macroeconomic fundamentals in the Turkish economy significantly deteriorated before each economic crisis. The PSBR ratio and the current account deficit rose steadily between 1989-1994 and 1995-2001; in other words, they only disappeared after each economic crisis. Likewise, the public deficit continuously increased between 1989 and 2001. The government attempted to curb the fiscal deterioration through stabilization programs; however, it could not realize the targeted goals of these stabilization programs. For example, for the growing public deficit problem, the government was unable to achieve the predetermined goals to increase public revenues and decrease expenditures. On the revenue side, the government failed to streamline the ineffective tax collection system and widen the tax base. While on the expenditure side, the government continued its agricultural support policies and transfers to the SEEs and social security institutions, which led to significant increases in public expenditures.

Before both of the economic crises, the government delayed necessary structural reforms and executed inappropriate economic policies, which distorted the government's fiscal situation. Before the 1994 economic crisis, the government changed its debt financing methods and began to rely heavily on the Central Bank's resources to finance the public deficit. In addition, the government delayed implementing disciplinary fiscal measures until after the crisis happened. Similarly, before the 2001 economic crisis, the government did not implement the structural reform measures of the 1999 stabilization program according to the preannounced schedule, reducing their projected impact on the Turkish economy. In addition, the 1999 stabilization program included some

inappropriate economic policies, such as the net domestic assets policy. Elekdag (2001) argues that the net domestic assets policy basically depended on inflows of “hot-money”¹⁵. This was not a very stable strategy when we consider the fact that Turkey could not attract significant amounts of foreign direct investment in the last two decades. Moreover, hot-money is highly risky and can be lost when another borrower offers a higher rate or creditors’ confidence in the government’s economic policies evaporates, just like before the November 2000 economic crisis.

On the other hand, after the 1994 economic crisis, the government did not implement necessary banking regulations to restructure the banking system in order to establish a strong financial system. Turkish banks remained highly vulnerable to shifts in the government’s economic policy. Excessive foreign borrowing of the banks increased their vulnerability to unexpected increases in the interest rates. Alper (2001) argues that the banking system overlooked currency and maturity risk due to high yields on government securities in real terms. As a result, the inadequate risk management coupled with poor banking system regulation and moral hazard caused by government guarantees prevented the establishment of a strong financial system in Turkey which, in turn, catalyzed the emergence of both 1994 and 2001 economic crises.

The similarities between the underlying causes of 1994 and 2001 economic crises demonstrate that the government failed to resolve the macroeconomic problems that started the 1994 economic crisis. The macroeconomic imbalances in the Turkish economy continuously deteriorated after the 1994 economic crisis and eventually culminated into another economic crisis in 2001. Therefore, in this respect, the 1994 economic crisis can be considered as an early warning for the 2001 economic crisis. In addition, since the government has still failed to conduct the needed reforms, this boom-bust cycle will continue over time and we can expect another crisis in the future.

¹⁵ Investment funds seeking high short-term yields. Borrowers enticing hot-money should be ready to lose it when another borrower offers a higher interest rate (Bank One 2001).

VI. CONCLUSION AND RECOMMENDATION

Chapter VI concludes our discussion on the 1994 Turkish economic crisis. We begin Chapter VI with a summary of the discussion we made on the 1994 Turkish economic crisis and then conclude the chapter with recommendations about how to prevent future economic crises in Turkey, based on the discussion we made in thesis.

A. SUMMARY

The 1994 economic crisis demonstrated how a government's inappropriate economic policies can cause an economic crisis in an economy with structural economic problems, such as high inflation and public deficit. The Turkish government, in such an economic environment, made significant economic policy changes prior to the 1994 economic crisis, which distorted the financial markets' confidence in the government's economic policies and started the economic crisis.

After examining the Turkish economic development efforts since 1980, we noticed that the events that eventually culminated into the 1994 economic crisis started mainly with the capital account liberalization in 1989. In search of additional resources to finance the widening budget deficit, the government completely liberalized the capital account; however, the government took no structural reform measures to improve its fiscal situation and reinforce the impact of the capital account liberalization on the Turkish economy. As a result, in a volatile economic environment with high inflation and increasing PSBR ratio, the government failed to achieve all the projected goals of the capital account liberalization, such as alleviating the crowding out impact of massive public borrowing and expanding investment funds to the private sector.

Following the capital account liberalization, high domestic interest rates caused a rapid increase in short-term capital inflows. As the amount of short-term capital inflows increased, the government became more dependent on short-term capital to finance the public deficit, increasing international creditors' influence on the interest rates and foreign exchange rates. Increasing foreign influence on both the interest rates and foreign exchange rates, however, significantly reduced the government's independence in designing monetary policies. The fear of capital flight became the dominant motive in the

government's economic policies and created an unsustainable commitment to high interest rates, which increased the cost of borrowing for the government (Balkan and Yeldan 2001).

The government, however, responded to the increasing cost of borrowing with temporary solutions rather than resolving the structural causes of high borrowing costs. For example, the government did not take measures to reduce public expenditures in order to improve the public deficit; on the contrary, it rather established mechanisms to expand borrowing from domestic resources, such as separating the liquidity ratio into highly liquid assets and government securities, creating a new market to sell government securities. On the other hand, the government's temporary solutions to alleviate the increasing cost of borrowing delayed permanent resolution of the Turkish economy's structural problems, intensifying their impact on the economy. The public deficit, PSBR ratio, unemployment, and the current account deficit continuously increased during the post-1989 period.

As the public deficit widened, the government increased domestic financing of the public deficit by increasing interest rates on government securities and adjusting liquidity requirement ratios. Meanwhile, commercial banks continued to attract hot-money through short-term capital inflows, which led to an excessive liquidity build up in the financial markets. The excess liquidity created an increase in price levels due to increased aggregate demand and led to depreciation of the Turkish Lira. On the other hand, the Central Bank did not have enough government securities to remove excess liquidity from the financial markets, which forced the Central Bank to increase overnight interest rates to remove the excess liquidity. This policy, however, led to an increase in the interest payments, which became a major burden on the government's consolidated budget after 1992. On the other hand, excessive liquidity build up and increasing overnight interest rates raised doubts in the financial markets about the sustainability of the government's economic policies, creating an appropriate environment for an economic crisis (Candemir 1994).

The weak macroeconomic fundamentals of the Turkish economy, however, do not necessarily mean that the 1994 economic crisis was unavoidable. Despite the government's loose fiscal policy and increasing public deficit in the pre-crisis period, the

Central Bank's foreign exchange reserve levels were steady, the margin between the official and parallel market exchange rates was very low, and the inflation rate was high but stable, around 65% for almost five years before the crisis event. Therefore, following Ozatay's (2000) argument, macroeconomic fundamentals in the Turkish economy did not move in accordance with the early modes of balance of payments crises; hence, the 1994 economic crisis was unexpected rather than unavoidable.

The government's inappropriate economic policy changes in the second half of 1993, rather than weak macroeconomic fundamentals, significantly catalyzed the emergence of the 1994 economic crisis. Increasing interest payments forced the government to consider reducing the interest rates as an important short-term economic policy objective. In line with this policy, the government reduced the interest rates on government securities and cancelled short-term maturity auctions in November and December 1993. This policy, coupled with the government's announcement that it would tax income earned in the government's securities market, drastically reduced demand for government securities. As the amount of borrowing from the domestic market decreased, the government relied heavily on the Central Bank's resources to finance the public deficit, further increasing liquidity in the financial markets. In the absence of offsetting fiscal measures, excessive liquidity build up increased inflationist expectations and started a rush to foreign exchanges in mid-January 1994, which triggered the 1994 economic crisis (Ozatay 2000).

The government responded to the 1994 economic crisis with a stabilization program on April 5, 1994. Following the announcement of the April 5th economic stabilization program, the government managed to stabilize the Turkish economy within a short period, thanks largely to the IMF support to the stabilization program. As the economy stabilized, however, the government delayed and discontinued implementing the stabilization measures, particularly the orthodox stabilization measures that were necessary to permanently resolve the structural problems of the Turkish economy. Improving macroeconomic stability encouraged the government to abandon the April 5th stabilization program and embark on new populist economic policies to gather political support for the early general election in December 1995. In the absence of structural reform measures, the government's expansionist economic policies swept away the

favorable impact of the April 5th stabilization program and once again started deterioration in the Turkish economy. The government's fiscal situation continued to worsen and necessitated another IMF-backed economic stabilization program in December 1999. Ironically, the government again strayed from the original stabilization program and failed to implement prescheduled stabilization measures as the macroeconomic stability increased, causing another economic crisis in 2001.

B. RECOMMENDATIONS

The World Bank approved a Programmatic Financial and Public Sector Adjustment Loan (PFPSAL) to Turkey on April 16, 2002. The underlying goals of the PFPSAL are to improve the Turkish financial sector and the public sector in order to strengthen fiscal stability and lay the foundation for a more effective government in line with international standards (World Bank Daily Webzine 2002). The key priorities of the program include:

1. Further modernization of the regulatory framework for banking activity.
2. Institutional development of the bank regulation and supervision agency (BDDK).
3. Problem bank resolution.
4. State Bank restructuring and privatization.
5. Structural fiscal policies in support of sustainable fiscal adjustment.
6. Public expenditure management reforms.
7. A government strategy to strengthen public sector governance.

The PFPSAL's priorities reveal that the structural problems of the Turkish economy, which created 2 major economic crises during the last decade, still exist. The government attempted to overcome the underlying problems of the Turkish economy with numerous economic stabilization programs; however, it failed to implement the reform measures of these stabilization programs properly and did not reduce the economy's vulnerability to economic crises (see Table 12). The Turkish political environment and weak financial system, coupled with the government's inadequate fiscal discipline, significantly contributed to the failure of the government's economic stabilization programs.

**Table 12. The Government's Major Economic Stabilization Programs
Between 1960 - 2002**

| | Date | International Support |
|----|---------------|---------------------------|
| 1 | January 1961 | IMF backed |
| 2 | February 1967 | IMF backed |
| 3 | August 1970 | IMF backed |
| 4 | April 1978 | IMF backed |
| 5 | July 1979 | IMF Backed |
| 6 | January 1980 | IMF and World Bank backed |
| 7 | April 1994 | IMF and World Bank backed |
| 8 | December 1999 | IMF backed |
| 9 | December 2000 | IMF and World Bank backed |
| 10 | April 2002 | World Bank backed |

Source: Turkish State Planning Institute (2001), Atiyas (1995), Kocaliogullari (1996).

Uncompromising political competition forced the government to set high economic growth targets and pursue expansionist public policies in order to prevail in the political competition. In the absence of checks and balances in the Turkish political arena, the government's preoccupation with economic growth, we argue, led to the 2 economic crises. Therefore, the lack of norms and mechanisms that would enable compromise and cooperation between political actors is a substantial threat to the success of any stabilization effort. The political parties should negotiate a solution to this problem.

Turkey's European Union candidacy is an opportunity for the political parties to establish required norms and mechanisms to overcome the democratic deficit that obstructs permanent resolution of the fundamental problems of the Turkish economy. For example, they should take measures to promote intra-party democracy. Political parties in

the Turkish political arena tend to be leader dominated clientelistic networks, which organize in a highly hierarchical manner. The highly hierarchical structure gives disproportionate influence to the leader, with little or no room for intra-party opposition. As a result, the lack of intra-party opposition blocks any kind of change toward greater transparency and accountability within political parties. Hence, political parties are more concerned with the distribution of public resources among their supporters than contributing to economic stabilization efforts that would permanently resolve the fundamental problems of the Turkish economy.

Both the 1994 and 2001 economic crises highlighted the vulnerability of the financial system to short-term capital inflows and the government's economic policy changes. Increasing short-term debt was also an indicator of the lack of confidence in the government's economic policies and structural problems in the Turkish economy. After the 2001 economic crisis, the government launched some structural measures, in close cooperation with the IMF, to strengthen the Turkish economy against further economic crisis and regain public support for its economic policies. The structural measures enabled the government to shift primary budget balances and the current account of the balance of payments from deficit to surplus; however, these measures were not sufficient enough to establish credibility in the government's economic policies. The existence of huge amounts of short-term debt to be refunded and high PSBR ratio still create doubts in the financial markets about the future economic policies of the government. For example, 40% of Turkey's Turkish Lira denominated debt is scheduled to mature between June 2001 and August 2002, which exposes Turkey to the danger that investors would refuse to roll it over at customary interest rates. The need to offer high interest rates, however, might raise doubts about fiscal sustainability, creating fears of a more general crisis. Therefore, the government's future economic policies should aim at restoring confidence in its economic stabilization efforts and extending the maturity of its debt stock at customary rates.

In an attempt to gain support to its economic policies, the government launched several exchange rate-based economic stabilization programs in the last two decades. The government, however, failed to achieve the projected goals of these stabilization programs, mainly due to uncoordinated efforts to implement the measures of the

stabilization packages. The success of exchange rate-based stabilization programs requires consistent economic policies and the government's commitment to implement all of the measures of the stabilization package.

Under the 1999 IMF backed economic stabilization program, for example, the government would impose a pegged exchange rate regime for 18 months and gradually abandon it after the deadline. The 18-month transition period would allow the government enough time strengthen the banking system and accustom the banks to a financial environment with greater exchange rate flexibility. This policy, however, created a moral hazard problem for both the banks and the government, which eventually led to the failure of the stabilization program and created the 2001 economic crisis. The pegged exchange rate regime socialized the exchange rate risk by committing the government to preventing the exchange rate straying from the targeted levels and compensating the banks for their losses should this policy failed. Since the government socialized the exchange rate risk, there were no strong incentives for the banks to strengthen their balance sheets or for the government to improve bank supervision. As a result, banks got used to earning easy profits via unhedged foreign borrowings to finance their high-yielding government securities purchases, as well as domestic trading in those securities. During the stabilization period, net open positions of the Turkish banks substantially increased and made them highly vulnerable to high exchange and interest rate increases. On the other hand, these short-term capital inflows enabled the government to finance the widening public deficit and reduced the government's incentive to enforce the new banking regulations. Moreover, the banking system's vulnerability against high exchange and interest rates prevented the government from adjusting the exchange rate regime when it came under pressure in November 2000.

After each economic stabilization program, particularly IMF backed stabilization programs, banks' excessive unhedged foreign borrowings substantially increased foreign currency in the domestic market and threatened the sustainability of the pegged exchange rate regime. In order to prevent this situation, the government should either tax foreign borrowing directly or require the banks to keep some portion of their foreign borrowings at the Central Bank with low interest for a certain period of time.

On the other hand, quasi-fiscal operations and political lending practices of the public banks significantly distort the banking system as a whole. Duty losses of the public banks amounted to 11.5% of nominal GDP at the end of year 2000. Under the 1999 stabilization program, the government took some measures that would enable the public banks operate under market principles. These so-called commercialization measures, however, were not enough to lift government's pressure on the public banks to extend subsidized loans to certain socio-economic groups. In order to prevent political interference with the public banks, the government should take steps to restructure and privatize these banks.

The government's experience with the 1999 stabilization program highlights the need for a strong banking system for the success of an exchange rate based stabilization program. Therefore, in its future economic stabilization attempts, the government should uncompromisingly implement necessary banking sector reforms simultaneously with the stabilization measures. Stricter supervision of the banking sector would prevent large fluctuations in the foreign exchange market and prevent politicians from misusing government resources.

In addition to the banking sector reforms, the government should take measures to improve its fiscal situation in order to succeed in its economic stabilization efforts. The government's inadequate fiscal discipline significantly contributed to the failure of past stabilization attempts. The government should strengthen its fiscal situation in order to remove doubts in the financial markets about its economic policies.

Sharp cuts in public spending, however, reduce aggregate demand and lead to low economic growth, which could threaten the sustainability of the stabilization program by reducing the tax base and eroding political support for austerity policies. In order to overcome this dilemma, the government should design a fiscal consolidation plan that will not reduce aggregate demand which, in turn, will not create or prolong an economic recession. Irish and Danish governments, which had overlarge public budgets in the 1990s, devised such consolidation plans to strengthen their fiscal situations (Eichengreen 2001). They adopted fiscal consolidation measures that simultaneously stimulated consumption and investment demands, which allowed economic growth and sustained the adjustment program both economically and politically.

The Turkish government can utilize Irish and Danish governments' experience and develop a similar fiscal consolidation program to improve its fiscal situation. In order to reassure consumers and investors and downsize the public sector, the government should focus on making sharp expenditure cuts rather than increasing taxes. In addition, the government should reinforce the fiscal consolidation measures with a currency devaluation, which would impart immediate stimulus to export demand and give domestic demand time to recover.

Implementing such a fiscal consolidation program, however, requires a strong government with sufficient political support to pursue the program. Considering the highly fragmented structure of the Turkish political arena, a potent one-party government is unlikely to come to office in the short-run. Therefore, the government should take additional measures to strengthen fiscal institutions in order to offset its governance deficiency. This would eliminate distortions to the economic-policy making process and enable the government to reduce perceived probability that economic policies will worsen in the future. In this respect, the measures for strengthening fiscal institutions could include: giving more economic agenda setting power to the finance minister who will rein in the tendency toward excessive outlays by the spending ministries, eliminating large fiscal imbalances between the central and local administrations, and imposing a hard ceiling on the overall size of the deficit to limit free riding by competing interest groups.

The PFPSAL agreement is a good opportunity for the government to strengthen the financial system and restructure itself in order to improve its fiscal situation. In the aftermath of the 2001 economic crisis, the government should not take the international support for strengthening the Turkish economy for granted and meet all the requirements of the PFPSAL and the December 2000 IMF backed stabilization programs if it does not want to experience any more economic crisis in Turkey.

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