CONVERTIBILITY THEORY & EVALUATION OF TURKISH LIRA CONVERTIBILITY

A THESIS

Submitted to the Department of Management and the Institute of Management Sciences of Bilkent University in Partial Fulfillment of the Requirements For The Degree Of Master of Business Administration

By

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BILKENT UNIVERSITY, ANKARA

FEBRUARY, 1990

CONVERTIBILITY:

THEORY

&

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I certify that I have read this thesis and in my opinion it is fully adequate, in scope and in quality, as a thesis for the degree of Master of Business Administration.

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ABSTRACT

CONVERTIBILITY : THEORY AND EVALUATION OF TURKISH LIRA CONVERTIBILITY

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The purpose of this thesis is to evaluate the convertibility of Turkish Lira in the light of economic policies in Turkey since 1980 and the recent regulations which are announced by the government in August,1989 known as 'Decree no: 32 '. For this purpose in the first part of the thesis a theoretical framework is established where the definition, the types, and the prerequisite conditions for convertibility are presented. In the following part of the thesis the convertibility of Turkish Lira is investigated in the light of the prerequisite conditions and it is found out that none of these conditions were present in Turkey, therefore, it is concluded that Turkish Lira is far away from convertibility since shifting to convertibility before fulfilling these conditions will not provide a successful and sustainable progress for Turkish economy.

ÖZET

KONVERTİBİLİTE : TEORİ ve TÜRK LİRASI'NIN KONVERTİBİLİTESİ'NİN DEĞERLENDİRİLMESİ

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Bu tezin amacı , Türk Lirası'nın konvertibilitesini, 1980 yılından beri Türkiye'de uygulanmakta olan ekonomik politikaların ve hükümetin 1989 Ağustosu'nda yürürlüğe koyduğu 32 sayılı resmi kararnamenin ışığı altında değerlendirmektir. Bu amaçla tezin ilk bölümünde konvertibilitenin tanımını, çeşitlerini ve gerekli önkoşullarını içeren teorik bilgi verilmiştir. Bunu takip eden bölümde ise Türk Lirası'nın konvertibilitesi gerekli önkoşulların ışığı altında incelenmiş ve bu koşulların hiçbirinin tam olarak sağlanamadığı anlaşılmıştır. Bundan dolayı Türk Lirası'nın konvertibiliteden uzak bir konumda olduğu, önkoşullar sağlanmadan geçilecek konvertibilitenin de Türk ekonomisi açısından başarılı ve de sürekli bir atılım olamayacağı sonucuna varılmıştır.

ACKNOWLEDGEMENTS

I gratefully acknowledge patient supervision and hepfull comments of Assist. Prof. Gokhan CAPOGLU, throughout the preperation of this study. I am also indebted to my family who provided me with the encouragement throughout the long days devoted to developing this thesis. In doing so, they made room in their lives for me to work and gave up much of the time I might have shared with them.

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INTRODUCTION:

In an open economy each country entertains economic relations with other countries since no country is self sufficient. So the economic activities extend beyond its boundaries where money is the medium of exchange of goods and services.

If each country's currency unit was valid only in their territory, then this fact would have caused complications in the economic relations of countries: Debts and claims among residents of different countries can not be settled by a direct payment from one to the other, because the creditor has no use of debtor's currency in his country, whilst the debtor does not ordinarily dispose of the currency which render its services to the creditor. In international payments therefore convertibility of currencies is essential to multilateral trade and its development, because if the currencies were inconvertible then the international trade should have consisted of barter trade only. Whenever international payments are free, foreign currencies are interchangeable there is said to be unlimited currency convertibility both at home and abroad for that country's currency.

If Turkey is concerned, Turkish Lira does not have such an unlimited currency convertibility both at home and abroad. The recent regulations which are printed in the Official Daily Paper on August,11,1989 known as Decree no : 32 , are aiming to take some steps in the convertibility of Turkish Lira. But these regulations still have some limitations and restrictions which shadow unlimited convertibility.

This subject will be investigated in two parts. In the first part the theoretical and the conceptual framework will be established for the concept of convertibility where the definition , the types , the prerequisite conditions of convertibility will be presented.

In the second part , convertibility of Turkish Lira will be evaluated under the light of the economic policies in Turkey since 1980's and the recent regulations (Decree No:32) in the foreign exchange policy.

This thesis aimes to evaluate the recent regulations toward the convertibility of Turkish Lira with regards to their efficiency , effectiveness and timeliness.

P A R T – I

I. CONCEPTUAL FRAMEWORK FOR CONVERTIBILITY :

I.1. Definition of Convertibility :

Convertibility is defined as the exchange of a country's currency unit freely with other country's currency units under the guarantee of the home country. In other words, convertibility means that the national currency has the same functions it has in the home country , out of the borders also.

I.2. The Types of Convertibility :

There are two types of convertibility which are full and partial :

I.2.a. Full Convertibility:

A currency is considered fully convertible if its holders can convert it freely without a government licence to any other currency, regardless of either the purpose of conversion or the identity of the holder. Full convertibility takes place when there is no foreign exchange control, trade limitations and bilateral clearing agreements.This type of broad and unlimited convertibility generally do not exist in the world.

I.2.b. Partial Convertibility:

In practice partial convertibility takes place in the following forms according to the limitations introduced by the government :

1- Partial convertibility according to the purpose of the conversion:

Type 1 : Current Account Convertibility,

2- Partial convertibility according to the identity of the holder:

Type 2 : Convertibility for Non-residents,

Type 3 : Convertibility for Residents,

3- Partial convertibility restricted according to regions :

Type 4 : Regional Convertibility,

4- Partial Convertibility restricted according to the bureaucratic barriers :

Type 5 : Convertibility for Central Banks.

I.2.b.1. Current Account Convertibility :

International economic transactions are recorded in balance of payments which consists of current and capital accounts. Current account records the exports and the imports of goods and services, whereas capital account records the transfer of capital assets among countries. If there is a limitation with respect to the purpose of conversion then it is either for current account transactions or for capital account transactions. In this context always the partial convertibility occurs as a restricted convertibility for capital transactions.

This means, a currency can be convertible for current account transactions but subject to government controls with respect to capital transfers. This type of convertibility is known as current account convertibility and was adopted by many European countries in the 1950's as a first step toward full convertibility.In other words, the residents of a country can't exchange home country's currency freely with any other currencies for the purpose of capital transfer to foreign countries.In parallel, non-residents can't make capital transfers from foreign countries by the use of the home country's currency unit.Therefore in the case of current account convertibility residents of a country can't make investments in foreign countries , and the non-residents can't transfer their capital investments to their own countries after they close down (divest) their investment in the home country.

To illustrate this concept suppose that a German bank which holds an amount of Turkish Lira, wants to exchange our currency with DM , Dollar or another foreign currency unit via a Turkish bank.In this situation the Turkish government may question the source of TL that the German bank holds and also the kind of transaction which gave rise to this, because Turkish government makes current account transaction versus capital account transaction distiction in convertibility. Since there is a restriction for capital transfers, the German bank has to prove that they earned that amount of Turkish Lira after a current account transaction with a Turkish firm or a businessman.If the real transaction giving rise to this is a capital transfer then it is impossible to convert that amount of Turkish Lira which the German bank holds,with the foreign exchange that a Turkish bank or the Central Bank of Turkey holds.So convertibility may be restrained according to the purpose of conversion by the government.

I.2.b.2. Convertibility for Non-residents :

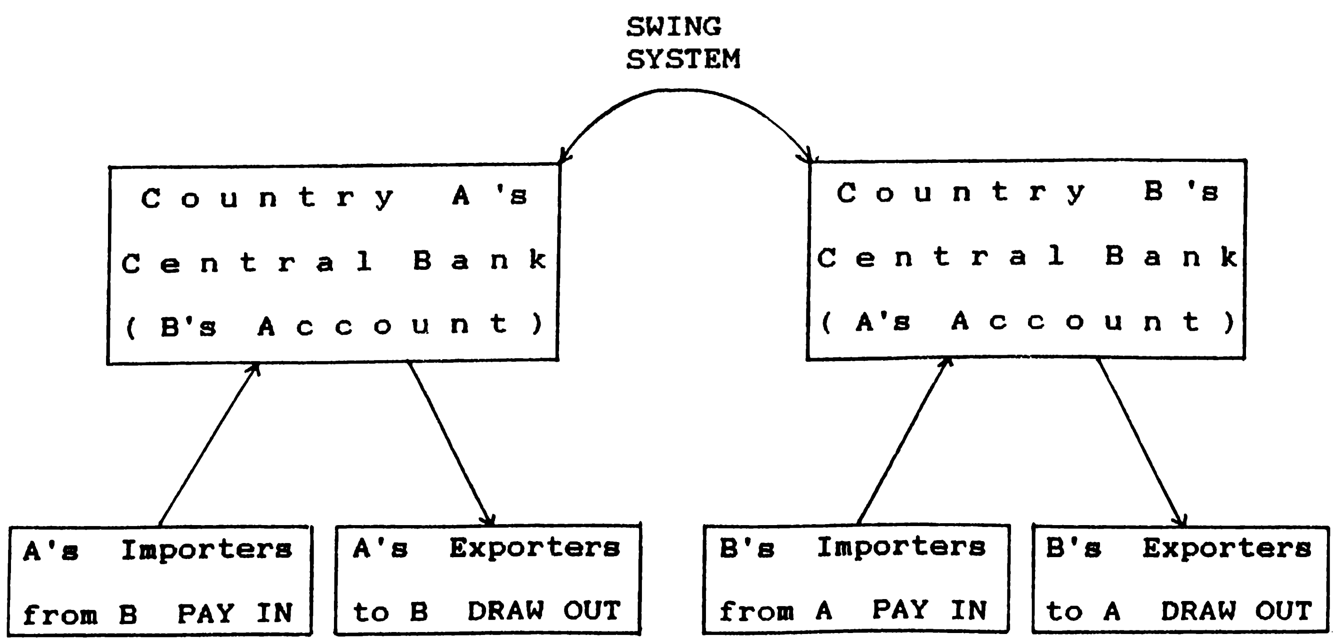
A more important distiction relates to the holder of the currency: that is residents versus non-residents of a country.Here the criteria for identifying the residents and non-residents of a country must be highlighted : Non-residents include the people living out of the borders of the country and residents include people living inside the borders. So the criteria is not the nationality of people but it is the residence of people within the borders of the country. According to this type of restriction there are two types of partial convertibilities which are convertibility for non-residents and convertibility for residents.

When a country imposes exchange control, its currency becomes inconvertible for its own residents. But once the payment is made to a foreign person or corporation under the control authority, the foreigner is free to use the it anywhere and convert it to any other currency.In other words, the currency is convertible when held by the non-residents of the country concerned.

So according to the economic conditions of the country the government may not give the rights offered to non-residents to its own residents. This type of partial convertibility is known as non-resident convertibility.

Such non-resident convertibility disappears if the country enters upon bilateral clearing agreements in addition to exchange control.

At this point the meaning of bilateral clearing agreements will be explained: If a country doesn't have foreign currency reserves, or it has a negligible amount, and still wishes to stimulate private trade, it may impose exchange clearing agreements.Such agreements are designed to permit trade by a multitude of exporters and importers working independently of one another but without the transfer of foreign exchange. A typical agreement between countries A and B would work as follows: Each country's central bank establishes an account for transactions with the other country as illustrated in the following figure:



A's importers from B pay in their own currency into B's account in A's central bank while exporters to B draw payments from the same account. Likewise B's importers from A make payments in their own currency into A's account in their central bank, while exporters to A are paid out of the same account.

If the bilateral trade position balances over the month, then the two accounts will show zero balances. So the trade between the two countries is reduced to barter trade conditions, and no foreign exchange transfer takes place.

But if the bilateral trade position is out of balance some complications arise : If A's account in B's central bank shows a surplus then B's account in A's central bank shows a deficit. In this situation B could pay up its deficit by tranferring the accumulated surplus in its central bank to A's central bank , but that would involve transfer of foreign exchange , which is what the whole system is set up to avoid. In order to prevent such complications, the two countries agree in advance on a mutual line of credit known as the swing system since it can shift directions. But this agreement is valid upto a predetermined level. Only if the cumulative deficits exceed the limit, the debtor country is obligated to pay up in gold or dollar or in any other foreign currency.

A network of 400 such agreements covered Western Europe immediately after World War II , as every nation had bilateral agreements with each of the other countries.

I.2.b.3. Convertibility for Residents :

In this type of partial convertibility only the residents of a country are given the rights of buying foreign currencies both for the purposes of current and capital transactions , for international payments and transfers. This type of convertibility is more effective for the liberalization of imports and the economy than convertibility for non-residents.

I.2.b.4. Regional Convertibilty :

This type of partial convertibility can be applied either within a region of a country known as free trade regions (such as Mersin free trade region in Turkey) or among two or more countries (such as European Monetary System). The European Monetary System (EMS) has been in operation since March 13, 1979 with the participating countries Belgium, Denmark, France, West Germany, Ireland, Italy, Luxembourg and Netherlands. These countries form a community where they apply regional convertibility among themselves. The regional convertibility among EMS countries develop the trade among these countries by facilitating payments and transfers among them.

In regional convertibility , non-residents of the region are not given the privileges of convertibility.

I.2.b.5. Convertibility for Central Banks :

In this type of partial convertibilty, only the central bank and some commercial banks are authorized to control the payments, transfers, and foreign exchange transactions that arise due to current account transactions. Since the receivables due to current account transactions are convertible for only central banks , the residents can not buy foreign currency freely. But for the country whose currency is convertible, it doesn't really matter whether the residents or the central bank of country X has the right for convertibility.

Since the commercial banks are obligated to hold a certain amount of foreign currency in the central bank of their country, the central bank has the right to intervene the commercial banks to provide the required amount of foreign currency for the purpose of international payments. If the foreign exchange transactions are managed efficiently by the central bank without causing any delays in payments and transfers then this type of control by the central bank does not contradict convertibility principle.

Upto this point the types of convertibility are discussed , but more important than this issue will be the discussion of the necessary prerequisite conditions of convertibility decision for a country's currency unit.

I.3. The Prerequisite Conditions for Convertibility :

The prerequisite conditions are classified into two groups which are internal conditions and external conditions for convertibility. Note that these conditions must be satisfied before shifting to a convertibilty system because otherwise the success of convertibility system is highly risked.

I.3.1. External Conditions :

There are four external conditions which will be discussed here :

I.3.1.1. Trade Balance :

Trade Balance is not only the first condition that must be satisfied before shifting to convertibility, but it is also a primary condition for the continuation of convertibility system because trade deficits reduce the foreign currency reserves of a country.

It is not recommended to apply convertibility in an economy where the trade balance is always in a deficit, which is arising from the structure and development level of the country. Therefore for a country which can't achieve a level of exports that will balance imports, convertibility must not be considered. Note that although there is a chronic trade deficit in USA , convertibility is applied successfully because the foreign currency reserves of the Central Bank of US is more than enough to compansate this deficit and to allow the smooth operation of convertibility. Besides the rest of the conditions are fully satisfied in USA.

If exports are always below imports in a country , then some precautions must be taken to increase exports rather than decreasing imports to achieve trade balance. If exports are insufficient due to the inefficiency of the production technology, which is the scenario in the less developed countries, then the recovery of this situation can occur by the realization of long term strategies for improving the structure of the economy.

I.3.1.2. Foreign Currency Reserves :

There must be sufficient amount of foreign currency reserves which is directly related to supply and demand conditions for a foreign currency. Although the first condition mentioned above is satisfied, it doesn't necessarily guaratee the equilibrium of the supply and demand for the foreign currency. Some seasonal or long term fluctuations may occur in foreign currency supply. Therefore there should be reserves in hand to compansate the deficit in the foreign currency demand either due to international payments due to convertibility requirements.

It should be noted that reserve requirements increase after shifting to convertibility system due to the following reasons :

1- By shifting to convertibility countries come closer to eachother in economic relationships and therefore become more sensitive to external effects. External effects increase the importance of foreign currency reserves, so reserve requirements are higher after shifting to convertibility.

2- The people who are given the rights of convertibility will demand a foreign currency in exchange with their national currency unit. Therefore foreign currency requirement will increase after convertibility.

3- Since the control over the international payments are relatively reduced after convertibility, foreign currency reserves will be required to compansate balance of payments deficits.

4- Capital transfers may be permitted which increases the intensity of the foreign currency reserve requirements.

5- After the announcement of convertibility, some speculations may arise about foreign exchange rates : People may speculate that their currency will devaluate due to shifting to convertibility, so these cause instantaneous increases in foreign currency requirements.

Therefore for all the above reasons , there must be a means of compensating the extra demand for foreign currencies after shifting to convertibility which can be done by an increased amount of reserves. The necessary amount of reserves depend on the economic condition of the country and the type of convertibility which is applied.

I.3.1.3. Realistic Exchange Rate Policies & the Stability of the Exchange Rates :

Realistical exchange rate policies aim to balance the supply and demand for a foreign currency. If the exchange rate can not satisfy the equilibrium of supply and demand for that currency, then it leads to the collapse of the convertibility system.

At the same time some other considerations must be made for achieving a realistical exchange rate: A realistical exchange rate must take into account the purchasing power parity in order to reflect the price differences between the home country and the foreign country.

This will balance the supply and demand for the foreign currency. Moreover, if the price and cost level of the home country and the foreign country are similar, there will be similarities with respect to the economic policies and this will induce stability of trade between the two countries. Additionally, realistic exchange rates reduce big fluctuations in the exchange rates, so it will help stable exchange rates which are very vital for convertibility system , because wide fluctuations reduce the trust to the national currency which is very hazardous to convertibility concept : Unstable currencies won't be demanded for any purpose by the people.

Therefore convertibility can be accepted by the one way decree of a country, but it is not put into action until it is accepted by the other countries. The foreign countries don't accept the convertibility of a country if it doesn't have a stable exchange rate policy which is far from sudden and wide fluctuations that occur frequently. Therefore, if the national currency is not strong enough with respect to the facts mentioned for stable exchange rates, then it is not wise to consider the convertibility of that currency.

I.3.1.4. The Existence of a Foreign Exchange Market :

Foreign exchange market is the foundation block of convertibility. This market can either be a controlled market or a free market. Moreover, fixed or flexible exchange rate systems can be applied. But a realistic exchange rate system must exist whatever the type of the market is. Additionally, this market must be linked to the world's leading foreign exchange markets such as Wall Street and Tokyo markets.

In order to reduce the risk of devaluation especially in flexible exchange rate systems, foreign exchange transactions with a maturity should also be present in this market. Therefore, the sensitivity of convertibility to exchange rate fluctuations will be reduced to a minimal level.

I.3.2. Domestic Conditions :

There are three domestic conditions which will be discussed here :

I.3.2.1. Economic Structure and Development Level :

The economic structure of a country must be suitable for efficient production and a high output level which will be sufficient enough to meet the demands of the residents and the potential non-residents as well. What is meant by the development level of the country is not only related to the production capacity and export facilities, but also related to the economic and political stability, because an economy which is still in development stage can not maintain domestic balances.

Convertibility is not a process operating itself, rather it requires some associations such as foreign exchange, money and capital markets which are related to the development level of the country.

I.3.2.2. Domestic Balances and Price Stability :

Domestic balances and price stability is necessary both before and after the convertibility decision is taken by the government.

If in an economy , the domestic balances are built up on some temporary precautions then the country is more sensitive to external effects because of the unstable equilibrium. Therefore domestic balances must be built on permanent and strong foundations.

At the first glance the domestic balances may seem to be unrelated to convertibility, although the reverse is true : Domestic balances support external balances and external balances support convertibility system in return.

Price stability must be maintained in order to increase the international competitiveness of the country's products and to prevent domestic markets from becoming more attractive than international markets. Also price stability is necessary to prevent inflationary pressures which collapse convertibility system.

I.3.2.3. Political Stability and Confidence :

Since convertibility issue of a currency is evaluated by the foreigners , the country must give confidence to the foreigners both from the political stability point of view as well as from economic stability point of view. The long-term stability of economic and political issues will increase confidence in the world. The holders of the national currency will not exchange it with other currencies and they will use the money for current account transactions or continue holding the money in their pocket since they are confident that the economic stability will not change over time.

The same confidence is valid for capital transfers in the country. The foreign investors will not divest their investment unless they are faced up with sudden policy changes especially in the case of their short term investments.

I.3.3. The Evaluation of the Prerequisite Conditions :

The conditions listed under the headings of external and domestic conditions are not independent of eachother; they are all linked. These conditions are necessary for the success of convertibility decisions. The above conditions must be continuously satisfied in order to increase the economic confidence of the foreigners in the home country , to increase the monetary stability, to stimulate demand for the national currency by reducing or eliminating the holding risk of the currency.

P A R T – I I

II. EVALUATION OF TURKISH LIRA CONVERTIBILITY :

II.1. Foreign Exchange Policies in Turkey until 1980 :

Until 1930 , as an extension of the Ottoman Empire period Turkish Lira was convertible as a natural outcome of the Gold Standart regime. During the 1924-29 period following the establishment of the Turkish Republic , due to the restrictions brought by the Lausanne Agreement , the government could not intervene to the international economic relationships . Therefore the foreign exchange regime was free and Turkish Lira was convertible in this period : The transfer of gold and foreign exchange out of the borders and spot and forward operations were free in foreign exchange markets in this period (1).

In 1929 the restrictions of Lausanne Agreement were released , at the same time a new period started in the Turkish economy during which the burden of the first installment of the Ottoman Empire's debt, and the costs of nationalization of railway facilities and Haydarpasa Harbour caused negative pressures on the balance of payments. Therefore the government had to take some precautions in order to stop the devaluation of Turkish Lira . In May 1929, " Securities and Foreign Exchange Law " is issued, which prohibited the buying and selling of foreign exchange in the free market in order to prevent speculative fluctuations and by the introduction of this law convertibility of Turkish Lira was abandoned. This law didn't include decrees toward the protection of national economy in exports and imports. Besides it was inadequate in

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(1) Abusoglu, Omer, "Convertibility of Turkish Lira", Istanbul 1986, pp.66-67

preventing the speculative fluctuations , therefore a new law is issued in February 1930 which was numbered 1567 and known as " The Law for the Protection of the Value of the Turkish Lira ". This law gave the rights of regulating and restricting the buying and selling of foreign exchange, common stock and bonds to the government. Also the government was given the authorization of regulating and restricting the transfer of the above mentioned items abroad. Later on, based on the law numbered 1567 the government issued many decrees (2). Although this law was aimed to be temporary in nature, in 1970 the validity of this law is extended for an unlimited time. For half a century, from 1930's through the end of 1970's - except for a short lived liberalization in 1950-53 - Turkey followed an inward-looking economic strategy with heavy reliance on government intervention (3). Besides controlling trade and capital transfers, the government set ambitious industrial growth targets through its leading role in the economy based on the establishment of the State Economic Enterprises (SEEs). SEEs accounted for a large share of the productive capacity in the economy and had unlimited access to financial resources. Besides they were highly protected against foreign competition in the form of import and export licencing requirements, quotas, high tariffs, and subsidies. The first two five-year plans during 1963-72 formalized the inward-looking approach (4). Therefore until 1980 the issue of Turkish Lira convertibility was not in the agenda of the Turkish governments.

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(2) Bener, Erhan, "Money and Foreign Exchange Controls in Turkey" , Ankara, pp. 88-89 . Also see pp. 93-284 for detailed information about the government regulations and decrees during 1930-67 period

(3) Kopits, George, "Structural Reform, Stabilization and Growth in Turkey,IMF Occasional Papers 56, May 1987, page 2

(4) Kopits , ibid page 2

II.2. Structural Reform Policies in Turkey after 1980 :

There are three major reform packages which will be discussed here since they have direct implications for the convertibility of Turkish Lira These regulations are known with the dates on which they are approved by the Council of Ministers which are 24 January 1980 , 4 February 1988 and 11 August 1989 respectively.

II.2.1. 24 January 1980 Reform Package :

24 January 1980 reform package was approved to make fundamental economic transformations from an inward-looking economy to an outward-looking economy. In the late 1979 Turkish economy was in a crisis because foreign exchange inflow was insufficient, exports reduced %20 in real terms, external debts were postponed and Turkey had little or no credibility internationally, decrease in production caused idle capacity in the economy which increased production costs, inflation rate reached %63.9 and real interest rates were negative and exports to imports ratio dropped to %45 (5). 24th January reform package was aimed to control inflation and to solve balance of payments problems in Turkey by shifting to market economy and increasing the economy's international competitiveness. The basic principles of this package can be summarized as :

- to increase the share of the private sector in the economy,
- to liberalize imports in order to initialize external competition in the economy,

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(5) Yildiz, Rifat, " Convertibility: Theory, Application in Industrialized Countries, Experiences in Developing Countries , the Necessary Conditions for Turkey " , Ataturk University Publications, No:639,Erzurum 1987, pp. 200-201.

- to let the private sector prices and interest rates free , and to apply a realistical exchange rate regime,
- to liberalize foreign exchange operations in order to establish confidence in the economy and to integrate with the international financial markets (6).

After 24th January, the government deregulated interest rates, allowed banks to issue negotiable certificates of deposit, freed private sector prices as well as SEE's prices. Also some changes are made in foreign exchnage regime and foreign trade towards relaxing some restrictions which will be discussed in details in the following pharagraphs due to their implications for convertibility.

1 - Changes in Foreign Exchange Regime : In addition to domestic price liberalization, the authorities decided that the exchange rate should reflect market conditions as well (7). Therefore as a first step Turkish Lira is devaluated by %35.7 and exchange rates are adjusted frequently by the intervention of the Central Bank until 1st May 1981 (8). From May 1981, the authorities instutionalized the policy of broad maintenance of an unchanged real effective exchange rate through daily changes in the nominal rate, and the flexible determination of the exchange rate was further liberalized by permitting banks to set their own rates within a specified band of up to %8 in either direction around the Central Bank rate; the band was removed alltogether in July 1985 for free determination of the exchange rates (9).

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(6) Ozal, Turgut (Prime Minister), Tercuman Newspaper , 24.1.1986

(7) Kopits, ibid. page 12

(8) Annual Report of the Central Bank of The Republic of Turkey, 1980 , page 55 and, 1981, page 48

(9) Kopits, ibid. page 12

However, in early 1986, due to the considerable differences in the exchange rates of the Central Bank, the commercial banks and the free market, Central Bank took some measures which were in opposite direction with the previously mentioned measures: Central Bank devaluated Turkish Lira in terms of convertible foreign currencies around %5-7 , a band of %1 was reinstated around the Central Bank exchange rate which meant the abolishment of the free determination of the exchange rates by the banks.

In addition to the above mentioned changes, the restrictions on foreign travel are released and the amount of permitted foreign exchange per travel for each person is increased from $500 to $1000 (10) and Turkish residents were given the right of carrying foreign exchange in their pockets besides accepting foreign exchange for the services given to foreigners in Turkey. In 1984 Turkish residents were given the right of capital transfer upto $3 million after taking permission from the government (11). Moreover, the foreigners were permitted to transfer their profits abroad , and to buy real estate in Turkey provided that they pay in foreign exchange. Domestic banks were allowed to engage in foreign exchange operations within certain limits in proportion to their foreign exchange liabilities (12) and Turkish residents were given the right of holding foreign exchange deposits yielding interest in banks. The banks were free to use these foreign exchange deposits in the transfer of import costs,in giving credit to exporters and construction

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(10) Annual Report of Central Bank of the Turkish Republic,1983, page 39

(11) Annual Report of Central Bank of the Turkish Republic,1984, page 37

(12) Kopits, ibid. page 12

firms which are working abroad. Therefore with these rights given to the banks steps toward partial convertibility was taken for imports, exports and construction services given abroad.

2 - Changes in Foreign Trade : This issue will be discussed in two parts as changes in import regime and changes in export regime :

a - Changes in Import Regime : The 24th January reforms aimed to dismantle import restrictions in order to stabilize the domestic prices and to force domestic producers compete with foreign products. In order to eliminate the trade barriers as a first step, advance deposit requirement rates were relaxed from %40 to %3.75 for industrial imports and to %7.5 for commercial imports (13). Commercial banks were allowed to retain a higher proportion of foreign exchange receipts. In January 1981 the Quota List was abolished and a large number of items was transferred from List II(items whose imports are subject to licence) to List I(list of freely imported items) At the beginning of 1984 import liberalization started again and roughly %60 of imports previously subject to licencing was transferred to the newly created Fund List (The list covering luxury goods imported upon payment of a specific levy in addition to tariffs) or became freely importable.During 1985, the Prohibited List was reduced from 500 to 3 items (narcotics,weapons, and ammunition) and the number of import items on the Permission List was reduced from 1000 to 245 (14). The above mentioned changes in the import regime was toward the liberalization of imports which is another step towards partial convertibility.

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(13) Yildiz, ibid. page 209

(14) Kopits, ibid. page 11

b - Changes in Export Regime : It is well known that in order to establish balance of payments equilibrium the most efficient long term precaution is the improvement of the level of exports,and to rise the share of industrial products within the export mix. Since Turkey had an inward-looking economy, it was problematic to restart exports. One of the most important reasons for that was the overvalued Turkish Lira.Therefore with the introduction of 24th January reform, Turkish Lira was devaluated and flexible exchange rate system was applied. Besides, as incentives tax rebates were given to exports,and formal procedures for exports were eased and simplified. Also in 1985 exports in terms of Turkish Lira are legalized towards the partial convertibility of Turkish Lira.

In addition to the changes in import and export regimes some regulations are made for attracting foreign investment : A foreign investment department is established under the juristication of the State Planning Organization,and Turkey has negotiated with the competent authorities of a number of industrial countries to sign bilateral investment treaties that provide for national treatment, settlement of disputes, and protection against inconvertibility and expropriation. At the beginning of 1986 there was a major relaxation of foreign investment regulations; for most activities, the limit on foreign ownership was abolished and the minimum export requirements were released (15). These regulations were further steps toward partial convertibility for non-residents since they were given the right of transferring capital abroad.

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(15) Kopits, ibid. page 12

Evaluation of 24 Jan. 1980 Reform Package in its 10th Anniversary:

It has been 10 years since this reform package is being applied but the main economic indicators reflect that this package was not effective in realizing its aims that were discussed above : Within these 10 years inflation reached %72.6,external debts increased by %160 and reached to 35.3 billion dollars(it exceeds 37.2 billion dollars if the military FMS credits are included),the budget deficit which was % 3.6 of GNP in 1980 didn't decline and it is still around % 3.4 of GNP in 1988 , the trade deficit which was 2.8 million dollars in 1979 reached to 3.9 million dollars within the first 11 months of 1989, and the real GNP growth rate reduced from %4.1 in 1981 to %0.2 in 1989. Only one indicator improved : It is the current account balance which gave a surplus in 1988 and 1989 (16). The trend in these indicators for 1979-89 period can be observed from the following tables :

T A B L E 1 : GNP, BUDGET DEFICIT, CURRENT ACCOUNT BALANCE

	GNP (Billion TL)	BUDGET DEFICIT (Billion TL)	BUDGET DEFICIT % of GNP	CURRENT ACCOUNT BALANCE (Billion TL)	CURRENT ACCOUNT BALANCE % of GNP
1980	4435	- 160	3.6	- 3210	72.4
1981	6553	- 96	1.5	- 1984	30.3
1982	8735	- 143	1.6	- 1167	13.4
1983	11549	- 221	1.9	- 2234	19.3
1984	18375	- 979	5.3	- 1407	7.6
1985	27789	- 787	2.8	- 1013	3.6
1986	39309	- 1406	3.6	- 1528	3.9
1987	58390	- 2598	4.4	- 982	1.7
1988	102442	- 3440	3.4	1503	1.5
1989	n.a.	- 3695(*)	n.a.	298(**)	n.a.

(*) First 10 Months
(**) January-August
n.a. : not available

Source : Central Bank

(16) Anka Economic Bulletin : Year:15,No:3650, December 1, 1989, pp.5-6

T A B L E 2 : GNP, AGRICULTURE & INDUSTRY REAL GROWTH RATES

	REAL GROWTH RATES (% Increase)		
	GNP	Agriculture	Industry
1979	0.4	2.8	-4.7
1980	-1.1	1.7	-3.0
1981	4.1	0.1	9.1
1982	4.6	6.2	6.3
1983	3.3	-0.1	6.4
1984	5.9	3.5	8.8
1985	5.1	2.8	6.6
1986	8.1	7.6	11.1
1987	7.4	2.1	9.7
1988	5.2	6.3	5.6
1989(*)	0.2	-10.0	1.5

(*) SIS's Estimates based on first 6 months

Source : State Institute of Statistics

T A B L E 3 : EXPORTS, IMPORTS & TRADE DEFICIT

	FOREIGN TRADE (Million $)		
	Exports	Imports	Trade Deficit
1979	2261	5069	-2808
1980	2910	7909	-4999
1981	4703	8933	-4230
1982	5746	8843	-3097
1983	5728	9235	-3097
1984	7134	10757	-3623
1985	7958	11343	-3385
1986	7457	11105	-3648
1987	10190	14163	-3973
1988	11662	14340	-2678
1989(*)	10249	14208	-3959

(*) First 11 months

Source : State Institute of Statistics

T A B L E 4 : INFLATION RATE

	INFLATION RATE (%)
1979	63.9
1980	107.2
1981	36.8
1982	25.2
1983	30.5
1984	50.3
1985	43.2
1986	29.6
1987	32.1
1988	68.3
1989	72.6

Source: State Institute of Statistics

II.2.2. 4 February 1988 Decree :

4 February 1988 Decree was announced as a reaction to the difference between the exchange rates of the Central Bank and Tahtakale free market which was around 20 to 30 percent (17). This difference was a potential barrier for governments expectations of shifting to convertibility. This decree was aimed to reduce the amount of Turkish Lira in circulation, and to prevent the speculative fluctuations in the exchange rates. The decree involves the following regulations :

- The interest free advance deposit requirements for imports are increased in order to reduce the demand for foreign currency or to postpone the demand for a period. This regulation was aiming to reduce the import prices which were increased due to high level of demand.

- Exporters are given incentives for transferring their foreign currency revenues to home as soon as possible after these revenues are

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(17) Money and Capital Market , March 1988, page 6

realized. Also some measures are taken for the delayed transfers of these revenues. This regulation was aiming to increase the foreign currency supply and to reduce the prevailing exchange rates.

- Banks'interest rates for time deposits are increased in order to reduce the high demand for consumption. Also the interest rates of the sight deposits without a maturity are increased in order to close up the gap between the return on this type of deposits and foreign currency sight deposits. This regulation was aiming to reduce the demand for foreign currency and to reduce their prices.

- Reserve requirements are increased in order to prevent the collected deposits, due to increased interest rates, from entering the circulation in the economy again (18).

These regulations are short term oriented in nature because the high interest rates may attract the savings in the economy to the banks in the short term , but in the long term these deposits will yield high interest gains at the end of their maturities , therefore there will be a huge increase in the amount of money in circulation if precautions are not taken by the authorities. On the other hand, continuation of the policy of high interest rates reduces investments because of increasing cost of credits and leads to price increases in line with increasing cost of production.

This decree had a positive outcome in closing up the gap between the exchange rates of the Central Bank and the free market but it didn't yield the expected results towards improving the economy :The high rate of inflation stood as the biggest obstacle in front of the economic development and the expectations for shifting to convertibility.

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(18) Money and Capital Market, March 1988, page 11

II.2.3. 11 August 1989 Decree :

11 August 1989 Decree announced radical changes in the decree related to the "Protection of the Value of Turkish Lira". The liberalization related to Turkish Lira and foreign currency is expanded, and some measures toward convertibility have been introduced with the same decree. This decree mainly rest on the foreign currency policies. There were pressures on the monetary balances because, the exchange rates were below the inflation rate, the demand for foreign currency was not at the level of requirements of the economy, and foreign currency reserves were increasing. These pressures were one of factors leading to this decree in order to stimulate the demand for foreign currency and to gain advantages in cost of production through reducing the cost of imports (19).

The following reforms are made with this decree (20) :

- All Turks are entitled to buy foreign currency upto $3000 from banks and other authorized dealers for use in any way they wish,

- Exporters are entitled to withhold 30 percent of their foreign currency revenues when transferred home within 90 days,

- The limit for foreign currency sale by individuals is raised from $100 to $1000,

- The amount of TL that may be taken abroad is increased from the equivalent of $1000 to $3000,

- Gold exports and imports are liberalized,

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(19) Quarterly Economic Report , Union of the Chambers of the Commerce, Industry , Maritime Trade and Commodity Exchanges of Turkey , July-September 1989, pp. 10-11.

(20) Anka Review, Vol:10, No:496, August 15,1989, pp. 7-8

- The limit for precious stones and jewelery carried by passangers raised from $3000 to $15000; posessions in excess of that limit may still be taken abroad provided that thay have been declared upon entry into the country or their local purchase has been certified,

- Advance payment requirements is removed for exports on credit basis,

- Residents in Turkey are entitled to transfer home or withhold abroad their foreign currency revenues for the services they have provided to the residents of the other countries,

- The ministerial authority concerning the transfer of Turkish capital is raised from $3 million to $25 million,

- Imports by refugees and migrants , and transfer of wealth by Turkish residents are liberalized,

- Non-residents are allowed to transfer the revenues and proceeds of the real estate they have purchased in Turkey with foreign currency,

- The use of the Turkish Liras that were blocked in Central Bank accounts before the publication of the decree has been set free,

- Residents in Turkey are entitled to raise cash and non-cash credits abroad provided that the ministry is informed about the credit agreements,

- The banks are entitled to extend loans with a duration of a minimum of three years to foreign trade companies and residents in Turkey who are entitled to raise loans abroad under investment incentive certificates,

- The amount of foreign currency that may be taken abroad is increased from $1000 to $3000 or its equivalent.

Moreover, customs tariffs and funds have been widely decreased in imports of a wide range of items such as chemical products, iron and steel products, motor vehicles, electrical tools and some foods.

The partial achievement of the balance of foreign payments, surplus in the current account transactions attained for the first time in the previous year and foreign currency reserves which seemed to be sufficient, have encouraged the government to take the above decisions.In an economy experiencing a stagnation, such balances can temporarily arise, therefore, the foundation of the decree do not seem to be quite concrete. The decisions will not contribute much to the economy . One other aspect of the decisions is related to the reduction of the customs tariffs which is related with industrialization : Excess protectionism will not be useful on the long term basis but rapid drop of the rates of protectionism will obstruct the long term industrialization since the establishment of new industries and the flow of investment to these sectors will stop (21).

The government authorities are claiming that by the application of the above decree, Turkish Lira has been shifted to convertibility system.But it can't be claimed that Turkish Lira becomes convertible by entitling every citizen to buy foreign exchange upto $3000 without preconditions and by allowing the transfer of the Turkish Lira outside the country. One can talk about convertibility when Turkish Lira is in a position in which it can be sold or purchased which depends on the existence of the prerequisite conditions for convertibility in the economy.

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(21) See footnote (19)

II.3. Evaluation of the Prerequisite Conditions for Convertibility in Turkey:

Although all of the above mentioned decrees were announced in order to take some steps toward the liberalization of foreign exchange regime and international trade, it was also aimed to create the atmosphere necessary for shifting to convertibility of the Turkish Lira. In this section the prerequisite conditions which were discussed in Part I, section I.3, will be evaluated from Turkey's point of view in order to conclude whether the atmosphere for the convertibility of Turkish Lira is created or not.

II.3.1. Evaluation of the External Conditions:

II.3.1.1. Trade Balance:

It was said that it is undesirable to apply convertibility in an economy where the trade balance is always in a deficit, because this deficit reduces the foreign currency reserves of the country's central bank . From Table 3 one can conclude that the structure necessary for convertibility has not been established in the economy yet. The trade deficit followed a declining trend till the end of 1988 but it exceeded the deficit in 1988 within the first 8 months of 1989.

It may be argued that, although Turkey has a chronic trade deficit, the reductions in the foreign currency reserves can be financed by the surplus in the service sector which arise especially due to tourism. But for the case of Turkey, the tourism sector will not be a sustainable source, if the declining trend in this sector goes on like this.

The following interpretations can be done for exports and imports which built up the trade balance :

a - Exports : Following 24 January 1980 reforms Turkey's exports expanded significantly as can be observed from Table 3 . The average annual increase of exports between 1979-1988 has been %20.The ratio of meeting import expenditures through export revenues (exports/imports ratio) has increased from %37 to %81 between 1980-1988 which was an indication of the success of the export policies. During the years of the outward oriented policies, the growth rate of the GNP also developed continuously. However, Exports/GNP ratio rose from %5 to %17 between 1980-1988 since the development of exports has been at a higher rate than the GNP (22).

b - Imports : The average annual growth rate of the imports has been around %8 against %5.5 average growth of the GNP.The rate of increase of imports was not the same for every year, for example, with the partial lifting of restrictions and the transition to liberalization imports rose by %56 in 1980 and by %13 in 1981. In 1986 Imports declined by %2 due to the decline in petroleum prices. As factors influencing imports vary, in some years imports have been below the programme targets and in some years were above programme targets, therefore, the policy for liberalization of imports must be implemented in stages , with a long term strategy.

Although the above developments are undergone one can't talk about a positive development in the trade balance, moreover further

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(22) Economic Report 1989 , Union of the Chambers of Commerce, Industry, Maritime Trade and Commodity of Turkey, pp. 211-223

deterioration of the trade deficit is expected. This expectation has two basic reasons which will be discussed here (23) :

- A portion of the exports are linked to imports in Turkey. This link(or dependency) is high in industrial products, therefore increase in exports will also stimulate imports for such products,

- The basic reason for the increase in exports are due to the utilization of the idle capacities in the factories rather than a structural change in the economy. Therefore, it is claimed that the level of exports reached to its limit so that no one would expect big jumps in exports.

In the light of the above discussions one can say that the expectations of a recovery in the trade balance is not realistical without some structural developments in the production capacity of the economy. Therefore, trade balance is an obstacle for convertibility of Turkish Lira.

II.3.1.2. Foreign Currency Reserves :

It was said that reserve requirements increase after shifting to convertibility due to the reasons mentioned in Section I.3.1.2 . The foreign currency reserves of the Central Bank must be above a certain level in order to compansate the fluctuations in exports, sudden price increases of the imported products, and temporary deficits caused by short term speculative outflows. Central Bank of Turkey increased its holdings of foreign currency reserves in order to support the liberalization policies in foreign exchange and foreign trade (24). Due

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(23) Abusoglu, ibid. page 86

(24) Yildiz, ibid. page 245.

to this policy in 1989, Central bank holds foreign currency reserves which can compansate imports for 4-5 months (25). Whereas huge amounts of external debt payments exert a burden on these reserves. Therefore under such an external debt problem the amounts of reserves are not sufficient for convertibility , so these reserves must be increased further. But it should be kept in mind that reserve holding costs are very high because, in order to built up the required amount of reserves, the vital resources for the economy will be kept idle to the cost of sacrifice from economic development.

Besides Turkey has not fulfilled all the obligations of the IMF agreement for shifting to convertibility. IMF will approve the convertibility of Turkish Lira after Turkey starts applying the 8th paragraph of the IMF agreement which states that there will be no limitations on the current account transactions and the Central Bank of the Turkish Republic will be obligated to buy the Turkish Lira reserves in the hands of the foreigners (both non-residents and foreign central banks) if required by these foreigners , in exchange with foreign currency. Therefore this will also create additional burden on the foreign currency reserves of the Central Bank. Moreover, the amount of Turkish Lira reserves of the foreigners can't be estimated, so no one can guarantee that the foreign currency reserves of the Central Bank will be sufficient for shifting to convertibility. At this point, the case for England must be recalled : English government didn't take into account the sterling reserves in the hands of the non-residents when they shifted to convertibility in 1947. Therefore, 6 weeks later, they

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(25) Money and Capital Market, August 1989, page 18

had to abandon convertibility of the sterling because the foreign currency reserves of the Central Bank of England ,which was though to be sufficient,wasn't even sufficient to meet the demands of the foreigners.

II.3.1.3. Realistic Exchange Rate Policies & the Stability of the Exchange Rates :

In August 1988, with a change in the financial market regulations , Central Bank shifted to the determination of the exchange rates by market mechanism daily with minimum government intervention. For this purpose a foreign exchange market is established within Central Bank as will be discussed in the next section (Section II.3.1.4). As one of the partners,Central Bank generally sold foreign exchange in this market (26). But the resulting exchange rates are underpriced due to the excess supply of the Central Bank arising from the recent current account surplus. The prevailing exchange rates in Turkey can't be sustainable since the overvalued Turkish Lira built up pressure on the exporters by reducing their profit margins, causing reductions in the main source of foreign exchange inflows to the economy. As a consequence , this may lead to the collapse of the convertibility system.

Convertibility regime is not a one way street : The government of a country may announce that their currency is convertible but it is not effective until the convertibility of that country's currency is accepted by the other countries which depends on the stability of the exchange rate policy prevailing in that country. In Turkey one can hardly talk about the stability of the exchange rates because at any

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(26) Annual Report of Central Bank of the Turkish Republic,1988, page 41

time the government can announce unexpected decrees concerning the foreign exchange regime - recall how many times the Central Bank changed the regulations concerning the foreign exchange after the announcement of 24th January reform package ; some of the measures were in opposite direction with the earlier measures.

II.3.1.4. The Existence of a Foreign Exchange Market :

It was said that the presence of a foreign exchange market is the foundation block of the convertibility system. On 14th September 1988 the Central Bank of Turkey established a foreign exchange market within its organizational structure in order to regulate foreign currency flows, to use the foreign currency resources in the economy more efficiently, and to create a market economy environment where the exchange rates of Turkish Lira with respect to foreign currencies are determined according to the supply and demand characteristics of the market economy. This market is criticized as an artificial and local market which doesn't represent all the economy due to the limited number of legal entities. Although this market is supposed to be free from government intervention as much as possible for the healthy operation of market mechanism, Central Bank intervenes in this market whenever there is an uncontrollable gap between the exchange rates of the Central Bank and the free market which keeps increasing day by day. For example, Central Bank intervened in this market two times in September 1988 and in December 1988 after the establishment of this market within four months time. These interventions indicate that there is a problem in the operation of this market which is probably due to the undervalued exchange rates which are far away from meeting the expectations of the free market. Therefore the efficiency of this market must be improved by enlarging its boundary to include more partners who have the power of influencing the prevailing exchange rates in the country. Besides it is vital that this market is linked to the world's leading foreign exchange markets such as Wall Street and Tokyo markets where Turkish Lira will be quoted as a prerequsite condition for convertibility system to operate smoothly.

II.3.2. Evaluation of the Domestic Conditions:

II.3.2.1. Economic Structure and Development Level :

It was said that the economic structure and development level of a country must be suitable for efficient production and a high output level to meet the demands . In Turkey it is well known that due to the economical instability and tight money policy of the government, the investments in the manufacturing industry declined , if not stopped. Therefore one can conclude that the economy is reached to its production capacity which can not be increased further, unless the investments in the manufacturing industry are stimulated by the government for the sustainability of convertibility in the long run. Besides the real GNP growth rate declined from %5.2 in 1988 to %0.2 in 1989, agriculture sector declined %10 within 1989 with respect to the level attained in 1988 as can be seen from Table 2 . Therefore the economy is showing signs of recession.

II.3.2.2. Domestic Balances and Price Stability :

The most important indicator of the domestic balances in the economy is budget balance. There is a permanent budget deficit problem in Turkey which fluctuates between % 1.5 - 5.3 of the GNP as can be seen from Table 1. The excess of the government expenditures over tax revenues are financed by domestic debts and printing money. The currency in circulation, which was 4.3 trillion TL at the end of 1988, reached to 8.3 trillion TL by the end of 1989, and to 9.3 trillion TL by the end of February 1990. Inflation rate reached to %73 in 1989 since the increase in the currency in circulation stimulated inflation besides other factors as can be seen from Table 4. In such an economy with chronic budget and trade deficits, combined with high inflation rates one can't mention price stability. In Turkey inflationary pressures are high enough to collapse the convertibility system in the long run because with such high inflation rates Turkish Lira will not be a credible currency due to lack of confidence in its stability,and as a natural outcome of this issue not only the foreigners but also the Turkish residents will escape from their own currency. Therefore the government has to control inflation, which is the greatest obstacle in front of the success of convertibility regime, in order to reestablish the credibility of the Turkish Lira.

II.3.2.3. Political Stability and Confidence :

As well as economic stability, political stability is an important issue for the success of the convertibility system in a country because political confidence also stimulates the demand for a currency In Turkey sudden and frequent policy changes reduce political stability especially for the residents of the country. The government is more cautious in the policies concerning foreign investment due to a fear of escaping them from Turkey.

P A R T – I I I

III. CONCLUSION :

Although decrees towards liberalizing foreign exchange and foreign trade in Turkey are announced since the beginning of 1980's these didn't yield the expected results towards improving the economy for shifting to convertibility. After evaluating the prerequisite conditions for convertibility in Turkey it is concluded that Turkish lira is far away from convertibility since non of the prerequisite conditions were fully satisfied. There is no relationship between full convertibility and the recent decree no:32 as claimed by the government authorities. These regulations are only little steps toward liberalization since with the restrictions involved in this decree even the conditions for partial convertibility are not fulfilled.

The following structural changes should have been done by the government prior to convertibility system was mentioned :

- The dependency of exports to the imports of raw materials should have been decreased ,

- The contemporary technologies should have been introduced in the production sector in order to use scarce resources efficiently and to increase competitive power in international markets,

- The credit rates should have been decreased in order to reduce the huge gap between the deposit and credit rates which have negative effects on cost inflation,

- Foreign exchange, money and capital markets should have been widespread in the economy which would have been linked to eachother through central computer networks.

In addition to the basic structural changes discussed above the government should have overcame the difficulties for fulfilling the prerequisite conditions for convertibility.

In the light of the analysis made in this study it is concluded that shifting to convertibility in Turkey before fulfilling the prerequisite conditions will not provide a successfull and sustainable progress for the Turkish economy.

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