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A Brief Account of the Turkish Economy, 1987–1996

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In 1980, Turkey started to implement a substantial market-oriented reform package. It received wide-range support from several international financial organizations, including the International Monetary Fund (IMF) and the World Bank. The effects of this program became evident in Turkey's improved economic performance in terms of relatively higher economic growth and a "healthy" balance of payments situation in the early years of the 1980s. However, the overall appearance of the macroeconomic picture has been quite bleak since the end of the 1980s.

More recently, at the beginning of 1994, the economy experienced a major financial crisis, triggered by concerns over the sustainability of current macroeconomic policies. The financial crisis also had a spillover effect on the real economy; the gross domestic product (GDP) fell 4.7% in that year. On 5 April 1994, the government launched a stabilization program in order to rescue the economy. A standby arrangement was approved by the IMF two months after the program. Nevertheless, it soon became clear that the program was destined for failure. Although the economy did not experience another exchange rate crisis or higher inflation immediately, by the beginning of 1995 there was an implicit consensus among market participants that the 5 April stabilization program had finished. At the time of the writing of this chapter, the government had invited a delegation from the IMF for consultation on a new standby arrangement. The committee left the country after a short review of the current economic situation and with proposals by the government for the near future. The diagnosed prospects for the economy were not promising: "[T]he Fund, unwilling to trigger a confidence crisis toward Turkey, will wait and watch for some positive signals" (*Financial Times* 29 October 1996: 3).

What went wrong with the exemplary economy of the 1980s? The aim of this chapter is to provide an overall picture of the Turkish economy, with emphasis on development in the real sector and fiscal and external imbalances, particularly after 1987.[1] The first section summarizes the growth performance of Turkey after 1987 by analyzing the underlying driving forces in the economy. The second section presents an overview of the public sector deficit and examines how the deficit was financed. The same section also gives a brief account of public debt during the period under consideration. The third section investigates developments in the external balance, citing how the policies since 1987 have resulted in the permanent deterioration of the balance of payments.

REAL ECONOMY: BOOM-RECESSION CYCLE

Persistent and slowly increasing high inflation has probably been the most important characteristic of the Turkish economy during the past two decades. Although there were seemingly ambitious programs to fight inflation, in hindsight it is evident that the policy-makers never attempted to strengthen public finances, which undoubtedly accounts for the inflation. Not facing any serious shocks to the price level, the system has developed the means of coping with high inflation. Given the past failures of "stabilization" programs, the public has grown reluctant to assign any credibility to new or seemingly well-designed inflation stabilization programs.

By late 1988, however, the Turkish Central Bank initiated a lower rate of devaluation policy in order to control inflation. Since there were no major changes in the other areas of policymaking, this policy switch may be interpreted as the Central Bank's concern for its own short-term credibility.

The possible effects of a non-credible exchange rate-based stabilization policy can be analyzed within the framework of a model developed by Calvo and Vegh (1991). It is well known that there are two explicit effects of this kind of policy on the inflation rate of home goods. First, the lower rate of devaluation has a dampening effect on the inflation rate of home goods. Second, the aggregate demand increase pushes the inflation rate up. Due to this second effect, the fall in the inflation rate of domestic goods is less than the fall in the devaluation rate. Although inflation falls at the beginning, it begins to rise with the anticipation of a higher devaluation rate, imminent at the end of the program. The result is U-shaped inflation during the course of the program.

Given a degree of capital mobility, it is reasonable to expect that nominal interest rates in the economy would necessarily fall as well. Since the effective price of consumption (and investment) is relatively lowered, and since the program is perceived as temporary, the intertemporal allocation decisions of the optimizing agents come into play, and the aggregate demand jumps up immediately. The greater the public belief that a "lower devaluation policy" is temporary, the greater the jump in the aggregate demand. As a result, the economy experiences a boom during the early stages of the policy. As time

passes, the aggregate demand eventually declines. If the program is adopted for a short time, the economy does not enter a recession prior to the end of the program. However, since the total output deviates from its long-run trend, it is inevitable that the economy will fall into a recession. The end result is an inverted U-shape representing the growth rate of the economy.

During the early stages of a lower-devaluation policy, the real exchange rate, defined as the relative price of non-traded goods in terms of traded goods, begins to increase; that is, the domestic currency appreciates. This is not surprising, as the inflation rate of home goods is always higher than the rate of devaluation. With an increase in the total demand stemming from inter-temporal substitution decisions, the trade account registers a large deficit. As time passes, the current account deficit increases, while the interest income on foreign assets decreases. In short, non-credible, lower-the-exchange-rate-based stabilization attempts will put the economy into a boom-recession cycle, bring about higher than average current account deficits, and give rise to a U-shaped curve for inflation and an inverted U-shaped curve for the real exchange rate.

The prediction contained in Calvo and Vegh's model is consistent with the stylized facts of both the Turkish economy and other high inflation economies (Vegh 1992). In Turkey, with the Central Bank's initial lower devaluation policy (1989–1990), the yearly change in the wholesale price index decreased to 44.1% (July 1990) from the pre-program peak of 80.9% (November 1988). Additionally, yearly changes in the consumer price index slowed during that period but were less pronounced than those cited for the wholesale inflation. That the Turkish economy has followed this pattern is reflected in Table 2.1.

The Turkish economy experienced a sharp increase in domestic demand as the model predicts. Private sector consumption increased in real terms 13.1%, and real private investment expenditure increased sharply by 19.4% during 1990. As a result, the yearly growth rate of the economy was 9.2% that year. The real exchange rate appreciated significantly during the program, and the external deficit registered a historical high of 4.3% of GDP in the same year.[2] As expected, the program was abandoned at the end of 1990, and the economy entered a growth recession in 1991.[3] Inflation was slightly higher than before the program, and the real exchange rate depreciated, albeit at a slower speed than it had previously appreciated.

The same policy was readopted in 1992–1993. The Central Bank, with a dominant position in the shallow foreign exchange market and with strong backing from the financial sector, started to slacken the percentage change in the exchange rate by the summer of 1992. The Turkish lira started to appreciate once again. Real private consumption increased by 8.4%, and real private investment increased by 35% in 1993, due to the perceived temporary nature of the program. The annual growth rate of GDP was 7.7%. The external deficit reached a new historical high at 5.6% of GDP.

Following a financial crisis at the beginning of 1994, the economy entered a depression.[4] The real gross domestic product fell 4.7%. Inflation was higher

than before, and the Turkish lira depreciated in real terms immediately. On 5 April a stabilization program was announced by the government. However, it was clear at the beginning of 1995 that the program was doomed to failure. Nevertheless, policy-makers did not seem to learn from past experiences. Instead of designing a new program containing structural reforms, privatization, and fiscal tightening to correct the fundamental problems in the system, they instead returned to the alluring hot-money policy. The Turkish lira began to appreciate, and the real exchange rate returned to pre-1994 levels. Real private consumption and real private investment have continued to increase during the last two years. The external deficit was 4.6% of GDP in 1995. It fell somewhat in 1996, but was still high. It would not be surprising to witness a new recession and a real depreciation of the Turkish lira in the near future.

Table 2.1
Growth Rate of Real GDP and Its Components

	1988	1989	1990	1991	1992	1993	1994	1995
GDP	2.3	0.3	9.2	0.8	5.0	7.7	-4.7	7.5
Private Consumption	1.2	-1.0	13.1	1.9	3.3	8.4	-5.3	7.6
Government Consumption	-1.1	0.8	8.0	4.5	3.8	5.4	-3.5	6.7
Private Investment	12.6	1.7	19.4	0.9	4.3	35.0	-9.1	14.9
Government Investment	-20.2	3.1	8.9	1.8	4.3	3.5	-34.8	-16.9
Export	18.4	-0.3	2.6	3.7	11.0	7.7	15.2	6.7
Imports	-4.5	6.9	33.0	-5.2	10.9	35.8	-21.9	30.0

Source: State Institute of Statistics, National Income Accounts.

One of the side effects of real exchange rate appreciation is indicated in the national income accounts. Without any significant change in real production, the entire economy suddenly looks and feels richer than previously. The overall growth of real GDP between 1987 and 1997 is approximately 41% (an average of 3.9% per year) in Turkey. However, the nominal GDP in dollar terms in 1987 was $87.3 billion. It is expected to reach $180 billion in 1996, an astonishing 110% increase in only nine years. In order to avoid any misleading conclusions, the comparison of the dollar-based macroeconomic indicators across the years should take into account the real appreciation or depreciation of the currency.[5] Table 2.2 summarizes other aspects of the Turkish economy over the recent past.

Table 2.2
Some Economic Indicators*

	1988	1989	1990	1991	1992	1993	1994	1995	1996*
Wholesale Price Index	67.9	62.3	48.6	59.2	61.4	60.3	149.6	64.9	89.3
Consumer Price Index	63.0	64.3	60.4	71.1	66.0	71.1	125.5	78.9	83.0
Exchange Rate (US Dollar)	66.0	49.2	23.0	59.9	64.7	59.9	170.4	53.9	75.0
Money Stock (M3)	62.9	82.1	46.9	60.6	62.3	51.5	124.3	100.4	
Money Stock (M1)	48.2	95.9	49.9	48.2	66.8	71.9	84.1	75.7	
Reserve Money	84.3	61.6	42.6	54.4	67.6	64.7	84.3	86.0	
FX Deposits (by residents)	84.5	46.1	70.7	143.3	132.1	125.8	151.4	100.0	
TL Deposits (Total)	64.0	80.1	46.4	61.6	60.1	47.4	128.6	102.9	
Interest Rate (TL terms)	68.1	59.8	56.9	88.0	97.8	90.2	146.6	134.6	121.4
Interest Rate (dollar terms)	1.3	7.1	27.6	17.5	20.1	18.9	-8.8	52.4	26.5

*Yearly percentage changes with the exception of interest rates. Interest rates are the compounded yearly interest rates of average 3-month treasury bill rates.

Source: State Planning Organization, State Institute of Statistics, Turkish Treasury, and the Central Bank. 1996 figures are the author's estimates.

PUBLIC SECTOR DEFICIT AND DEFICIT FINANCING

National savings (NS) in an open economy by definition is equal to the sum of private savings (PS) and government budget surplus (T-G). This aggregate also equals the sum of net exports (X-M) and gross investment (I):

$$NS = PS + T - G = I + NX$$

At first glance, it may appear that an increase in the public sector deficit causes a one-to-one decrease in the national savings. However, economic theory posits that this result is not always warranted. For example, according to the Keynesian approach, an increase in government consumption may lead to an increase in the total output, causing an increase in private savings and total

taxes. As a result, the relative decrease in national savings would be less than the relative increase in government expenditure. Similarly, the permanent income hypothesis asserts that only permanent increases in the government deficit matter. If the deficit is temporary, the effect would be minimal, according to this hypothesis. The strictest approach to the relation between government expenditure and total savings is the Ricardian equivalence hypothesis pioneered by Barro (1974). It denies the predictions of both the permanent income hypothesis and the Keynesian approach. Since an increase in the public deficit today implies an increase in taxes tomorrow, rational consumers would change their saving plans accordingly. Consequently, private consumption falls one-to-one after an increase in government expenditures or a decrease in total taxes. The result will be constant national savings.[6] Table 2.3 gives the breakdown of Turkish GDP by sectors, from 1987 to 1995.

Table 2.3
Components of GDP (%)

	1987	1988	1989	1990	1991	1992	1993	1994	1995
Private Consumption	68.6	65.2	67.7	68.7	68.1	66.8	66.5	66.1	70.4
Government Consumption	7.9	7.8	9.6	11.0	12.3	12.9	12.7	11.6	10.9
Private Investment	14.5	17.6	15.6	15.6	15.6	15.4	18.2	19.0	19.5
Government Investment	10.4	9.2	7.9	7.3	7.7	7.4	7.0	5.4	3.8
Change in Stocks	0.9	-1.0	0.7	1.7	-1.0	0.4	1.1	-3.1	0.0
Exports	15.6	19.2	16.7	13.3	13.7	14.3	13.5	21.3	20.0
Imports	17.8	18.0	18.4	17.6	16.4	17.3	19.1	20.3	24.6
External Deficit	2.2	-1.1	1.6	4.3	2.8	2.9	5.6	-1.0	4.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: State Institute of Statistics, National Income Accounts

No clear-cut evidence explains the possible effects of government spending on national savings in the literature. Recently, McCallum (1993) found for the major industrial democracies (G-7) and Organization for Economic Cooperation and Development (OECD) countries that a relative increase in the government expenditure causes a decline in national savings as a percentage of GDP. Selcuk and Rantanen (1996) report the following estimation results using quarterly data for the Turkish economy between 1987 and 1994.

$$CN = 0.49 - 1.36\ CG$$

and

$$CCA = -0.57 + 0.94\ CIG + 0.55\ CIP + 1.31\ CG$$

where C denotes the change over the same period of the previous year, N is the ratio of national savings to GDP, G is the share of government expenditures in GDP, IP and IG are the share of private and government investment expenditures in GDP and CA is the current account deficit as a percentage of GDP.

The first equation indicates that a one-percentage-point increase in government expenditures will result in more than a one-percentage-point decrease in national savings. The effect of an increase in the share of government expenditure strongly manifests itself in the current account deficit. According to the second equation, a one-percentage-point increase in government expenditures will increase the current account deficit more than one percentage point. This result implies that government expenditure in Turkey strongly crowds out net exports and does so more than investment. In summary, the findings of Selcuk and Rantanen (1996) show that public spending and private spending are complementary in the Turkish economy. An increase in government expenditure stimulates private spending and leads to a net fall in national savings.

Following the financial turmoil experienced at the beginning of 1994, the PSBR decreased to 8.3% in the same year and to 6.4% the following year. The decrease in the PSBR was a direct result of the measures administered in the 5 April program. Nevertheless, the medium-term outcome of the program was not a permanent improvement in the fiscal balance. This was due to the fact that the central government did not initiate an overall restructuring of public finances. The pillars of the program were premised on a drastic cut in real public sector investment expenditures and reliance on temporary tax increases.[7]

Once the program was abandoned, it was definite that the PSBR would assume its previous position. It jumped from 6.4% of GDP in 1995 to 9.6% of GDP in 1996.

If the Ricardian hypothesis can be rejected on empirical grounds, developments in the public sector deficit deserve more prominence in the economy. The public sector deficit in Turkey consists of the deficits of the consolidated budget, state economic enterprises, local administration, revolving funds, social security organizations, and extra budgetary funds. Table 2.4 provides a picture of Turkey's public finances over the last ten years. The public sector borrowing requirement (PSBR), as a percentage of gross domestic product, shows a rapid deterioration starting from 1987. After increasing from 3.8% in 1986 to 10.3% in 1991, the ratio hit a record level of 11.8% in 1993. This worsening fiscal situation was primarily caused by sharp increases in consolidated budget expenditures, unmatched by an increase in overall public sector revenues.[8]

There was a secular negative trend in public investment expenditure as a percentage of GDP between 1987 and 1993. The 5 April program caused a further fall in public investment expenditure. In 1994, the real investment expenditure by the public sector was 42% less than in the previous year. The following year registered another 20% decrease in real terms. Preliminary figures and forecasts reveal that there is no significant change in (real) government investment expenditures during 1996.

Table 2.4
Public Finance in Turkey (as a Percentage of GDP)[a]

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996[c]
PSBR[b]	6.1	4.8	5.4	7.5	10.3	10.7	11.8	8.3	6.4	9.6
Financing										
Domestic Debt	2.9	2.2	4.4	6.5	8.1	7.6	8.3	7.8	7.7	
Foreign Debt	2.7	2.1	0.8	0.9	0.5	1.5	1.5	-1.0	-2.2	
CB Advances	0.5	0.5	0.2	0.1	1.7	1.6	2.0	1.3	0.9	
Public Debt										
Domestic	5.8	5.7	6.3	6.2	6.8	11.8	12.8	14.1	14.7	18.0
Foreign	38.7	38.1	32.8	25.1	26.3	25.4	24.1	37.6	33.2	37.0
Total Debt	4.5	43.8	39.1	31.3	33.1	37.2	36.9	51.7	47.9	57.0

(a)The effect of real exchange rate appreciation shows itself specifically on the ratio of foreign debt to GDP. The total foreign debt of the public sector reached US $39.7 billion in 1991, whereas it was US $33.8 billion in 1987. This increase in the net burden on the economy does not indicate itself clearly on this table. See Table 2.5 for more details.
(b) Public Sector Borrowing Requirement.
(c) Author's estimate.

Source: Turkish Treasury.

Another development in the composition of public sector expenditure is that interest payments on existing government debt have increased to extreme levels. The bulk of this payment has been made to domestic T-bill and bond holders. By 1991, total interest payments (in real terms) were 50% higher than they were in 1987. There was an explosion in interest expenditures after 1991, that is, a 100% increase in two years and another 50% increase in the following three years (in real terms). As of August 1996, the yearly real interest payment in the consolidated budget had quadrupled since 1987.

From an "infinitely lived, identical individuals' macroeconomics" point of view, this may seem to pose no problem to the economy. The government continues to collect resources (in the form of taxes) from residents and provides the same resources back to residents (in terms of interest payments). However, it is usually not the same group of people who pay taxes and who collect interest payments. In *A Tract on Monetary Reform*, Keynes (1971) points out the social problems arising "when the State's contractual liabilities . . . have reached an excessive proportion of the national income. The active and

working elements in no community, ancient or modern, will consent to hand over to the *rentier* or bond-holding class more than a certain proportion of the fruits of their work" (Keynes 1971: 54, quoted in Spaventa 1987).

Galloping interest payments in real terms seem to be a combination of several factors. In order to understand these factors, it is essential to see the way a given fiscal deficit was financed in the past. During 1987 and 1988, domestic and external borrowing had a close to equal share in financing the fiscal deficit. Domestic debt on average accounted for 47% of the PSBR while foreign financing accounted for 44%. The remaining 9% was from the Central Bank resources (printing money). After 1988, there seems to have been a significant policy change in terms of financing the deficit and conducting monetary policy. With no attempt from fiscal policy-makers to correct existing imbalances, the monetary authority initiated implementation of a policy of monetary discipline in the economy. During 1989 and 1990, the share of Central Bank financing of the PSBR decreased to 2%, while the share of domestic borrowing increased to 84%. This shift in policy, coupled with an upward trend in the PSBR, resulted in a rapid increase in the domestic debt stock. By the end of 1990, the outstanding domestic debt reached $8.3 billion, twice the 1988 stock amount of $4.1 billion. Rolling over the existing debt and extra borrowing requirements of the public sector raised the domestic government debt to unprecedented level. The debt stock hit $17.6 billion by 1993, double that of two years earlier.

It is often argued that as long as the primary deficit (deficit net of interest payments) is negative, developments in the debt stock should not be a concern in the economy. This naive approach to debt dynamics ignores the fact that the difference between the real interest rate and the real growth rate of the economy is another important source of change in the debt stock. More specifically, the debt stock as a percentage of GDP will necessarily evolve according to the following equation (Selcuk and Rantanen 1996):

$$d_T = d_0 f^T + \textit{Summation } (j = 1 \textit{ to } T)\ (p_j - m_j) f^{(T-j)}$$

$$f = (1+r)/(1+g)$$

where d_T is the debt-GDP ratio at time T, d_0 is the initial debt stock-GDP ratio, p_j is the primary deficit as a percentage of GDP, and m_j is seigniorage revenue (as a percentage of GDP). The real interest rate r and the real growth rate of GDP g are assumed to be constant.

It is clear from the given equation that if the real interest rate paid on the existing debt deviates from the real growth rate of the economy, it is not sufficient to have a primary surplus in order to label the fiscal policy "sustainable." It can be argued that the seigniorage revenue places the policy into a sustainable path. However, it can be shown that the government cannot collect a high seigniorage revenue as a percentage of GDP if the economy is experiencing some degree of currency substitution (Selcuk 1996b).

The real interest rate paid on the existing domestic debt was negative in 1989 and 1990 in Turkey. Coincidentally, the interest rate on domestic debt in dollar terms jumped up during these years. Afterward, the real interest rate in domestic terms and the real interest rate in dollar terms have been very high. It is therefore appropriate to call the fiscal policy after 1987 "unsustainable."

It was obvious also to the market participants during the early years of the 1990s that the prevalent path of macroeconomic policy was unsustainable. An ever-increasing PSBR and worsening current account position in 1993, combined with poor handling of the extremely fragile system by policy-makers increased impatience in the market. As in any other fragile market where the currency is vulnerable to attacks, early 1994 saw a run on the Turkish lira after a small shock.

Data on public debt are provided in Table 2.5. Although the outstanding government debt decreased slightly in real terms in 1994 due to an increase in the price level and real depreciation, it began to accelerate in the following years. As of September 1996, government bonds and T-bills amounted to $28 billion and are estimated to reach $30 billion worth at the end of the year. Two and a half years after a major financial crisis with a spill-over effect on the real economy, the current macroeconomic indicators are no better than at the end of 1993. As a result, increasing nervousness, especially in financial markets, continues.

Table 2.5
Public Debt in Turkey ($ Billion)

	1988	1989	1990	1991	1992	1993	1994	1995	1996[a]
Domestic (DD)[a] $ billion	4.1	6.2	8.3	8.5	15.0	17.6	14.5	20.2	27.9
Foreign $ billion	34.6	35.2	37.8	39.7	40.3	43.5	49	56.3	58.0
TOTAL	38.7	41.4	46.1	48.2	55.3	61.1	63.5	76.5	85.9
Interest Rate on DD.									
TL terms (real), percent	3.1	-2.7	-2.2	9.9	19.2	11.2	9.4	31.1	21
$ terms, percent	1.3	7.1	27.6	17.5	20.1	18.9	-8.8	52.4	26.5

(a) as of September 1996. Interest Rates are calculated as [(1+r)/(1+p) = (1+I)] where r is the yearly compounded average interest rate of 3 month treasury bill, and p is the yearly percentage increase in consumer price index or TL/$ exchange rate.

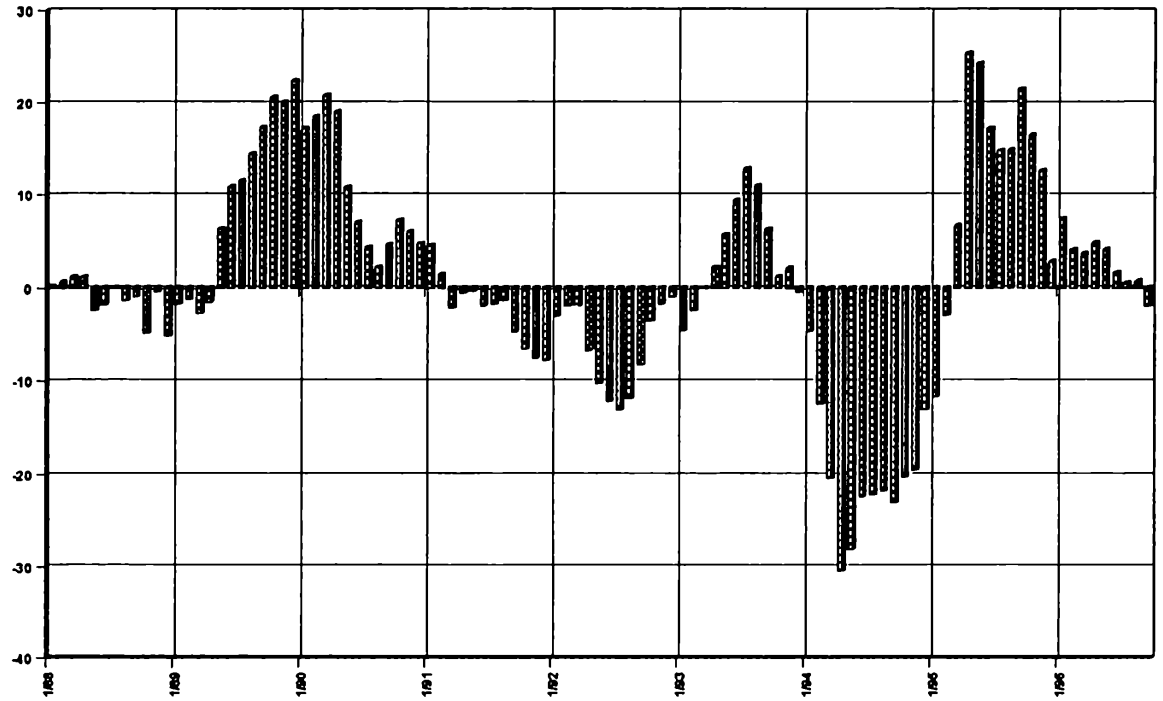
Source: Turkish Treasury.

EXTERNAL BALANCE

The most acclaimed success of the 1980 reform package was placement of the Turkish economy on an export-led growth path. The degree of openness in the economy increased dramatically during the 1980s. This was achieved through a liberalized trade regime, increased productivity, and a competitive real exchange rate policy.

However, there was a significant change in the real exchange rate policy in 1989, as mentioned in the first part of this chapter. The new policy became very influential in financial circles and had its intellectual adherents among the more elite technocrats in the government. Rüşdü Saraçoğlu, later the governor of the Central Bank, succinctly described the new approach in a paper on the role of the exchange rate in inflation stabilization, presented at a colloquium at the World Bank in 1985: "[A]n overvalued domestic currency may not be an inappropriate policy choice as long as foreign borrowing is readily available" (Saraçoğlu 1985). The behavior of the real exchange rate is shown in Figure 2.1.

Figure 2.1
Real Exchange Rate (Yearly Percentage Change)[a]



(a) An increase indicates appreciation.

Source: Data is from Reuters. The figure itself is compiled by the author based on the data.

Beginning in 1989, "the overriding goal of the Central Bank was to restore control of its own balance sheet. To achieve this goal, a monetary program was announced . . . Combined with lax fiscal policy, this resulted in high real interest rates and an appreciating real exchange rate, with consequences for

interest costs of the public debt and external competitiveness" (OECD 1995: 21).

A useful framework to study the long-run relationship between an independent fiscal authority and a not-that-independent monetary institution is the "unpleasant monetarist arithmetic" analysis developed by Sargent and Wallace (1981). In this framework, an independent fiscal authority determines the primary deficit, and a not-that-independent monetary authority adjusts its policies, sooner or later. Given a constant primary deficit, if the monetary authority picks up a lower rate of inflation today, it triggers higher inflation in the future. Then the question remains: Why does a central bank pick up a low inflation rate? There might be two answers to this question. The Central Bank may believe that the fiscal authority, having access to lump-sum taxes, will adjust its policies in the future. Another possibility is that policy designers at the Central Bank heavily discount the future in the Central Bank's utility function (Winckler, et al. 1996).[9]

Beginning in 1989, the capital account of the balance of payments, the behavior of which is described in Table 2.6, was liberalized and the Turkish lira was made fully convertible. This new policy provided a necessary condition for a real exchange rate appreciation policy, namely, that "foreign borrowing was readily available" for the economy. For the first time since the 1980 program, the Turkish lira started to appreciate quickly. The total appreciation between January 1989 and December 1989 was 22%. That year can be marked as Turkey's first brush with "hot money." This appreciation continued in 1990, albeit at slower speed than experienced in 1989.

Table 2.6
The Capital Account in the Balance of Payments ($ Million, Net)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996[a]
Direct Investment	106	354	663	700	783	779	622	559	772	440
Portfolio Investment	282	1178	1386	547	623	2411	3917	1158	1724	1450
Other long-term	1453	-209	-685	-210	-783	-938	1370	-784	-79	-460
Other short-term	50	-2281	-584	3000	-3020	1396	3054	-5127	2305	6160
Total	1891	-958	780	4037	-2397	3648	8963	-4194	4722	7590

(a) January–September.
Source: Turkish Central Bank.

A brief look at the capital account in the balance of payments reveals that short-term (net) foreign capital movements became the dominant player in the economy. During the last 10 years, there has not been a significant change in foreign direct investment. The portfolio investment item, mainly credits

obtained abroad by bond issues of the government, decreased in 1990 and 1991 as the direct result of the switch in the deficit financing preference of fiscal authority. Nevertheless, the item increased later, whenever the government was able to borrow from abroad.

The short-term capital movements item, on the other hand, shows greater variation. Although it had a yearly average of negative $134 million between 1987-1995, the standard deviation of short-term capital movements is $2.9 billion. This high standard deviation indicates vulnerability in the capital account and justifies the claim that the economy became heavily dependent on "hot money" after 1989. Because of this dependence, the proponents of the new policy have claimed that the capital account of the balance of payments is more important than the current account for the economy. The entire economic policy according to this approach should be designed to ensure that there is a constant inflow, or at least not an outflow, of foreign capital:[10] "[F]or example, if the macroeconomic policies designed to increase total yearly exports from $15 billion to $23 billion adversely affect the capital inflows-outflows by ten percent, your *loss* from capital movements would be approximately $20 billion" (emphasis added; Kumcu 1995).

The current account situation of the economy from 1987 to 1996 is shown in Table 2.7. As can be seen, it worsened immediately as a result of the real appreciation of the lira in 1989.

The behavior of the export-import ratio is shown in Figure 2.2. The export-import ratio fell below 0.60 by the end of 1990. The ratio had slightly increased between 1981 and 1989, reaching its maximum (0.87) in 1988. Despite the fact that the trade balance was substantially worsening, the current account yielded a surplus in 1989, thanks to a sudden increase in workers' remittances that year. The real effect of the "lower-the-devaluation" policy of 1989 was evident in the following year. The $1.0 billion current account surplus in 1989 turned into a record $2.6 billion current account deficit in 1990. A small depreciation, followed by a contraction in domestic demand, halted the process, and the current account yielded a surplus in 1991.[11]

Without any support from the fiscal authority to fight inflation, the Central Bank returned to a "higher interest rate-lower exchange rate depreciation" policy in the summer of 1992, and the Turkish lira started to appreciate again. The total appreciation during the seven-month period (August 1992–March 1993) was 18%. Once again, the export-import ratio began to fall, decreasing to 0.53 on the average in 1993. Other components of the current account did not register any improvements at that time. As a result, the current account deficit reached a historical high of 4% of GDP ($6.4 billion) in 1993.

Toward the end of 1993, poor handling of macroeconomic imbalances by policy-makers increased nervousness in the market. In January 1994, concerned about sustainability of the prevailing policies, the international credit-rating agencies, Standard and Poor's and Moody's, lowered Turkey's sovereign debt rating to below investment grade. This triggered a panic rush in the market.

The government, already preoccupied with an upcoming local election campaign, did not take any significant action for three months with the exception of increasing overnight interest rates. Between 20 January and 5 April, the overnight interest rate was never less than 120%, occasionally reaching very high levels. At one point it was a recorded 700%. A number of banks with short positions in foreign currency had a chance to close their positions during that period. As a result, the foreign exchange reserves of the Central Bank were depleted. In November 1993, the total foreign exchange reserves of the Central Bank amounted to $7.2 billion. In April 1994, the amount stood at $3 billion. Incidentally, the short positions of the commercial banks at the same period decreased from around $5 billion at the end of 1993 to $1 billion in April 1994.

Table 2.7
The Current Account in the Balance of Payments ($ Billion)

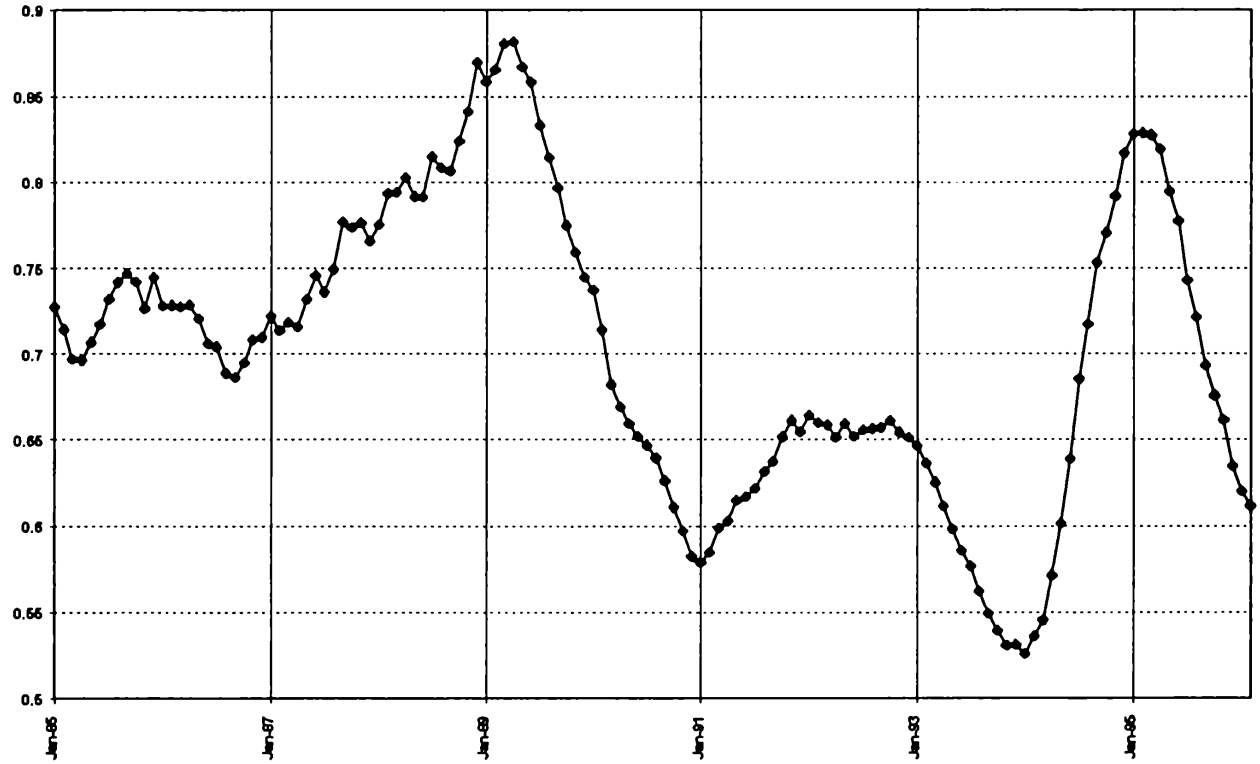
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
(1) Exports	10.3	11.9	11.8	13.0	13.7	14.9	15.6	18.4	22.0	23.5
(2) Imports	13.6	13.7	16.0	22.6	21.0	23.1	29.8	22.6	35.2	41.9
Trade Balance (1-2)	-3.3	-1.8	-4.2	-9.6	-7.3	-8.2	-14.2	-4.2	-13.2	-18.4
(4) Other Goods and Services (Credit)	4.2	6.0	7.1	8.9	9.3	10.4	11.8	11.7	16.1	20.5
(5) Other Goods and Services (Debit)	4.2	4.8	5.5	6.5	6.8	7.3	7.8	7.9	9.7	10.9
(6) Total Goods and Services (3 + 4 -5)	-3.2	-0.6	-2.6	-7.1	-4.8	-5.0	-10.2	-0.5	-6.8	-8.8
(7) Others (Workers' remittances, etc.)	2.4	2.2	3.6	4.5	5.1	4.0	3.8	3.1	4.5	4.4
Current Account Balance (6+7)	-0.8	1.6	1.0	-2.6	0.3	-1.0	-6.4	2.6	-2.3	-4.4

Source: Turkish Central Bank.

On 5 April, one week after the local elections and three months after the first run in the financial markets, a seemingly ambitious stabilization program was announced. The Turkish lira was depreciated in real terms by 30% between December 1993 and April 1994. An extremely high level of interest rates on three-month T-bills (yearly compounded 406% in nominal terms) right after

the 5 April program helped the government to borrow from the market and to roll over the existing debt stock. The foreign exchange reserves of the Central Bank began once again to increase. There was a sharp contraction in total imports. In the meantime, total exports increased dramatically. The export-import ratio rose above 0.8 in the third quarter. The current account registered a surplus of $2.6 billion in 1994.

Figure 2.2
Export-Import Ratio



Source: State Institute of Statistics.

Nevertheless, it was clear by the end of 1994 that the stabilization program was defunct. There were no permanent changes in fiscal policy, and inflation did not respond favorably to the onetime, temporary corrective measures taken in the 5 April program. The initial real depreciation was reversed, and the Turkish lira appreciated by 22 % between April 1994 and December 1994. In order to prevent a collapse in financial markets, policy-makers raised interest rates and further slowed the nominal depreciation. The alluring hot money policy was implemented once again at the beginning of 1995. Consequently, the export-import ratio began to fall, and the trade deficit increased to the 1993 level immediately. However, the current account deficit was not as large as in 1995 ($2.3 billion, 1.3% of GDP), this time thanks to some questionable, long-standing accounting practices by the Turkish Central Bank.[12] The current account deficit of only $4.4 billion (2.5% of GDP) in 1996 is again the result of the Central Bank accounting practice of considering an unknown foreign

current flow to the economy as current account income. This practice is justified as a reflection of unregistered exports, or so-called suitcase trade, with the countries of the former Soviet Union.

With no reserve depletion in the economy, some analysts are put at their ease on the external balance position of the economy. However, the current situation gives the impression that the equilibrium is unstable. As was mentioned before, the Turkish economy has become dependent on short-term capital inflows. The total short-term capital inflow in 1995 was $2.3 billion, roughly the same as the current account deficit for that year. This scenario seems to have been repeated in 1996. Developments in the "net errors and omissions" item in the balance of payments give further support to the claim that the external balance situation of the economy has become dependent on unreliable sources. The level as well as the variation of this item continue to increase over the years. The high degree of currency substitution in the economy might be a contributing factor to this phenomenon. Nevertheless, it bears little relevance whether the hard currency leaving the system is channeled into domestic residents' portfolios or into non-residents' portfolios.

In summary, the external balance of the Turkish economy has been volatile during the last 10 years, due to the real exchange rate policies preferred by policy-makers. Recurrent appreciation of the Turkish lira is causing a worsening current account balance situation. In the meantime, extremely high levels of interest rates in dollar terms attract short-term capital and delay the inevitable correction to macroeconomic fundamentals. Unless Turkish policy-makers adopt a well-designed stabilization program to address the underlying issues in the economy, it will be no surprise to see "corrections" repeated in the future.

These persistent macroeconomic imbalances cannot but affect the role that Turkey can play in the re-structuring of Central and Eastern Europe and Eurasia. That is, any new role for Turkey will be limited if it does not get its domestic house in order.

NOTES

1. See Öniş and Riedel (1993) and the references therein for a detailed account of the Turkish macroeconomic experience during 1951–1987. Tezel (1994) is one of the main reference studies of Turkish economic history up to 1950.

2. Data on the external deficit are given in the national income account information presented in Table 2.3. The balance of payments statistics may yield slightly different results. See the third section of this chapter.

3. The end of the program coincides with the Gulf War. As in any other unsustainable program, the arrival of bad news was blamed for the failure of the strategy by some critics. See Dornbusch, et al. (1995) for more details.

4. Standard & Poor's delivered the "bad news" this time. Some analysts still believe that if it had not been for that bad news, policy implementation could have continued unhindered.

5. This pronounced effect of appreciation was labeled as "a perpetual motion machine" by the main opposition leader of that time, who is the current president of the Republic, Suleyman Demirel. See Selcuk (1997).

6. The argument rests on the crucial assumption, among others, that "there is no liquidity constraint" in the economy. Note that there is another plausible explanation for an increase in national savings after an increase in the budget deficit: if there are strict government controls on domestic credit and capital flows, a decrease in government savings (i.e., an increase in the budget deficit) reduces the available credit to the private sector, causing an increase in private savings (Easterly and Schmidt-Hebbel 1994). Although capital flows in Turkey were not strictly controlled during the period under consideration, the available evidence shows that the Turkish economy was credit-constrained in international markets. See Selcuk (1996b) for an empirical investigation of consumption smoothing and the current account in Turkey.

7. Developments in public sector expenditures explain the main cause of the public deficit in Turkey. Total tax revenues as a percentage of GDP fluctuated around 12–13% between 1987 and 1995.

8. It is interesting that the decrease in the PSBR/GDP ratio in 1994 (by 3.5 percentage points) was mainly generated from the decrease in the share of real investment expenditure by the public sector in GDP (2.6 percentage points).

9. In fact, if a central banker believes that he has a limited term, future inflation may enter his utility function with a positive sign. Note that the utility function in question here is the central banker's utility function, not the central bank's utility function.

10. It is noteworthy that some officials regarded the capital inflows as "income," but not as a liability for the economy. The vice governor of the Central Bank during that period wrote: "[T]he size of the capital flows *income* or capital flows *expenditures* is interesting: in 1992, 81% of the total balance of payments *income* was capital flows *income*. This number increased to 86% in 1993" (Kumcu 1995).

11. Total official aids and grants from abroad were $1.1 billion in 1990 and $2.2 billion in 1991. This item is usually under $1.0 billion. In order to glean a better understanding of the developments in the external balance situation, this source of income should be disregarded in any analysis.

12. According to the Central Bank, if a Turkish resident exchanges a foreign currency for the Turkish lira without reporting the source of money, the total amount is accounted among "the other income" in the current account. "The other income" item shows a dramatic increase in recent years: $6.3 billion in 1994 increased by 50% and amounted to $9.6 billion in 1995, almost 50% of the total exports. The balance of payments statistics for the first three months of 1996 shows $3.3 billion as "other income."