

Macroeconomic developments in Turkey: a long-term view

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From import substitution to free capital flows

Until the end of the 1970s, Turkey pursued an inward-oriented, or import-substituting, industrialization strategy. Two major crude oil price shocks in the 1970s and related balance of payments problems contributed substantially to a deep economic recession and a political and social crisis in the country. On the institutional and policy side, Turkey embarked on far-reaching structural reforms after 1979. In early 1980, in response to a balance of payments crisis accompanied by a deep recession and accelerated inflation, Turkey abandoned its inward-oriented development strategy and started to introduce free market-based reforms. After the introduction of a broad stabilization and liberalization programme in January 1980, the government was able to lower inflation and to accelerate economic growth. However, after 1983, the volatility of annual real GDP growth rates increased substantially and inflation speeded up again.

The 1980 stabilization and liberalization programme was designed to devalue the Turkish lira to eliminate its excess overvaluation, to increase the prices of public sector products and to remove restrictions on interest rates. Over the first four years of the programme, external liberalization concentrated on current account transactions. In 1981, the government took the first step from a fixed to a managed floating exchange rate system. In 1984, the citizens were allowed to open foreign exchange deposit accounts in Turkish banks. In 1989, the government finally took serious steps to liberalize the capital account, too.

The decade of crises, 1992-2002

Following the introduction of capital account convertibility, the overvaluation of the Turkish lira and high domestic interest rates on government bonds attracted short-term capital inflows to the country. Attempts to stop the devaluation-inflation spiral through exchange rate stabilization failed and led to an 'exchange rate' crisis in the first half of 1994, which was different from the 'balance of payments' crises typical of the 1970s. Similar to 1980, in 1994 the annual inflation rate exceeded 100%.

The Turkish governments introduced new disinflation measures to stabilize the economy after the 1994 financial crisis. However, these efforts in 1995, 1998 and 2000 failed to reduce the inflation rate to levels below 25% per year. The 1998 disinflation programme did not last very long; the Russian crisis in 1998, general elections in April 1999 and the devastating earthquake in August 1999 led to a deterioration of the fiscal balance of the public sector. The so-called three-year programme, introduced in December 1999, was essentially an exchange rate-based stabilization programme supplemented by fiscal adjustment and structural reforms. There were also measures to strengthen and regulate the banking sector. The main objective of the 2000-02 programme was to reduce inflation to single-digit levels in the medium term. The programme was also aimed at diminishing the public sector deficit, at fostering growth and settling a market-oriented economy via various structural adjustment policies. To achieve these targets, a tight monetary and fiscal policy and comprehensive structural reforms were adopted as main policy measures.

The main tool of the 2000-02 disinflation programme was actually the adoption of a crawling-peg regime: the percentage change in the Turkish lira value of a basket of foreign currencies was fixed for a period of a year and a half. Initially, the programme was quite successful. Interest rates fell sharply below expected levels, inflation slowed down significantly, and production and domestic

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demand started to increase. The programme achieved some remarkable results within a short period of time. Nevertheless, in November 2000 the extremely risky position of a medium-sized bank with large holdings of government securities in its portfolio triggered a liquidity crisis, which in February 2001 amplified to a fully-fledged financial crisis. The government had to abandon the crawling peg, no matter that it led to massive devaluation, and switched to a floating regime. Although factors such as the real appreciation of the Turkish lira may have played a role in developments pushing the economy into that crisis, the main reasons were the unsustainable domestic debt of the public sector and the unhealthy structure of the Turkish financial sector. Since then the policies of the Central Bank have been aimed at controlling the volatility of the exchange rate rather than targeting its level or direction, at the same time trying to bring down inflation.

Consolidation and recovery

To overcome the negative impact of the crisis, in May 2001 a more stringent version of the previous adjustment and reform programme was launched, this time however backed by the floating regime. In February 2002, a revised three-year plan for the period 2002-04 was adopted. The new plan contained provisions for fiscal adjustment to bring about debt sustainability. The second important issue was a reform of the banking sector through an operational and financial restructuring of public banks and improved regulation and supervision of private banks.

Early general elections on 3 November 2002 dramatically changed the political climate in Turkey. A single-party government based on a strong parliamentary majority was established. It opted for only minor changes of the adjustment and reform programme, which had to be negotiated with the International Monetary Fund. The current economic programme, in implementation since early 2002, has two overriding goals: to increase the resilience of the economy to shocks, and to ensure disinflation. In order to achieve these targets, structural adjustment policies are focused on

consolidating the banking sector, enhancing transparency in economic management and improving governance in both the public and private sectors. Fiscal and monetary policies have been shaped in a way that should ensure the sustainability of the government's fiscal position and bring down inflation permanently. To alleviate the effects of fiscal adjustment, the government strengthened some social policy instruments improving the situation of the most vulnerable groups of the society.

Current situation

In the three decades prior to the year 2002, Turkey was characterized by political instability, populist macroeconomic policies, moral hazard problems, huge public sector deficits, high real interest rates, an overvalued Turkish lira, strong currency substitution, large current account deficits, volatile short-term capital inflows and outflows, a fragile banking sector, volatile economic growth, and high and persistent inflation. The current single-party government seems to have increased its credibility, and the disinflation process has been going on. The real sector and the domestic banking system are recovering from the 2000-01 crisis, while nominal exchange rates have stabilized and nominal interest rates are falling. The level of gross foreign exchange reserves of the Turkish Central Bank is 38% above that prior to the crisis. A shift in economic agents' expectations from backward- to forward-looking has significantly contributed to the decline in currency substitution. In manufacturing, the increase in labour productivity is high after the 2001 crisis; growth of output is also high, but not sufficient to secure constant or increasing employment. Real wages fell by 18% due to the 2000/01 crisis and have not recovered since. The exports to imports ratio for goods was below 65% as of end-September 2004. Not surprisingly, it fell in the course of growth acceleration: in the first half of 2004 GDP grew by 11.9% year-on-year. The increasing deficit in net exports of goods is compensated by an increasing surplus in net exports of services, and hence the current account deficit showed some decline after March 2004.

Table 1

Turkey: selected macro indicators, 1990-2004

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP growth	9.3	0.9	6.0	8.0	-5.5	7.2	7.0	7.5	3.1	-4.7	7.4	-7.5	7.9	5.8	11
Inflation	60.3	66.0	70.1	66.1	105.3	89.0	80.4	85.7	84.6	64.9	54.9	54.4	45.0	25.3	8.6
Fiscal balance	-7.5	-10.2	-10.7	-12.1	-7.9	-5.1	-8.8	-7.8	-9.6	-15.7	-11.9	-16.2	-12.6	-8.6	.
Primary surplus	-2.4	-4.1	-4.5	-3.8	2.9	4.5	2.9	1.2	3.3	-0.2	5.7	8.0	6.9	8.4	.

Notes:

GDP growth: change in % over previous year

Inflation: change of the CPI over previous year (average)

Fiscal balance: in % of GDP; Public Sector Borrowing Requirement (PSBR) methodology; negative-sign means deficit.

Primary surplus: in % of GDP; fiscal balance excluding interest payments.

Source: Turkish national statistics.

Nevertheless, for the full year 2004 the current account deficit is likely to amount to 4% of GDP, against 2.8% in 2003.

In 2003, Turkey's GDP amounted to USD 240 billion, while the country's total external debt reached USD 146 billion; in the latter, the public sector including the central bank accounted for a share of USD 95 billion. As of mid-2004, the total amount of external debt was somewhat higher (USD 148 billion, with a public sector share of USD 92 billion). Finally, the overall public sector borrowing requirement (PSBR), as a measure of the public sector deficit in the broadest sense, has strongly diminished after 2001, thanks to a primary surplus that was permanently above 6% of GDP from 2001 onwards.

2004 is the last year of the current three-year macroeconomic programme. In mid-December 2004, Turkey and the International Monetary Fund completed talks on a new three-year stand-by agreement supported by a loan of USD 10 billion. The new three-year programme is aimed at reducing the country's debt to the IMF and at further reducing Turkey's chronic inflation. It foresees far-reaching structural reforms in the banking and social security systems, as well as in the field of tax collection. Indeed, there is a need for more structural reforms, stronger privatization

efforts and continuity in political and macroeconomic stability. Success in these matters will make it easier to advance in EU accession negotiations. On 17 December 2004 the EU decided to start accession negotiations with Turkey by 3 October 2005. Prior to that date, EU experts will complete a screening process, as EU Commission President Jose Manuel Barroso has reassured in an interview. The screening process is aimed at setting out the compliance of Turkish regulations with the detailed EU *acquis communautaire*.