

NOTES ON TURKEY AND EUROPE: CONTRADICTIONS OF OPENING UP

Korkut Boratav,

April 2002

I. An overview of the post-1980 Turkish economy

Turkey's recent experience with liberalization and market orientation has a longer history than all other candidates for EU membership. The new orientation dates back to the orthodox stabilization program of 1980 which, also, incorporated by a sweeping liberalization of the domestic economy. Credit controls and centralized determination of interest rates were lifted in 1982. Tariffication of import quotas and QRs took place in 1984. Privatisation of state-owned enterprises was a slow, but ongoing process dating back to the late 1980s. The capital account was fully liberalized in 1989-1990. And, finally, a Customs' Union Treaty with EU became operational in 1995.

As things stand now, the Turkish economy is a fully liberalized one, domestically and externally. The average growth rate between 1981 and 2000 has been around 4.5% per annum. Excluding exceptional years (e.g. 2000, see below), current account deficits have been manageable: Growth rates around 7-8% generate moderate current deficits which, usually, do not exceed 1.5% of GDP. The economy has been experiencing chronic, inertial inflation since the early 1980s fluctuating between 35-100% per annum. The average rate of inflation for the 1995-2001 years was 69%, but drifting into hyper-inflation has not, yet, occurred.

These are common features for the post-1980 period. On the other hand, there was a significant break-point in macroeconomic relationships accompanied by deteriorations in certain indicators during recent years. As far as policy factors have been instrumental, the turning point has not been the 1994 Customs Union with EU, but the liberalization of the capital account in 1989.

II. Changing patterns between the 1980s and the 1990s

A. Emergence of a new financial cycle

A new financial cycle determined by predominantly autonomous capital movements started to dominate the growth process after the liberalization of the capital account, i.e. during the 1990s. The linkages between the growth process and the external world were radically different during the 1980s and the post-1990 years.

During the 1980s, growth rate was affected by fiscal, monetary and incomes policies and the response of (or autonomous changes in) the behaviour of households and firms. Capital movements were endogenously determined. The linkages were: **GDP growth**⇒**current deficits**⇒**capital inflows**⇒**external debt**. Average growth rate during the 1980s was 5.2% which generated an average current deficit/GNP ratio of 1% accompanied by inflows of foreign capital roughly reaching 1.5% of GNP.. The excess of capital inflows over current deficits is due to reserve accumulation which, at the time, was a function of import growth. Around 85% of capital inflows to Turkey are debt-generating. *Hence, a current deficit of \$1 had required capital inflows of \$1.5 resulting in a \$1.25 increase in the external debt stock.*

During the 1990s, using fiscal, monetary and incomes policies for demand management gradually disappeared and the growth rate became dependent on predominantly autonomous capital movements and, once again, the response of (or autonomous changes in) the behaviour of households and firms. The new linkages were: **capital inflows** ⇒ **GDP growth**⇒**current deficits**. GDP growth became predominantly dependent on the expansionary (contractionary) impact of foreign capital inflows (outflows) and a given rate of growth required significantly higher inflows than the preceding decade. (On the causal linkages between capital flows and domestic demand see below for an analysis of what happened in 2000 providing a typical picture.) On the other hand, two ratios remained broadly unchanged between the two decades: Debt-generating component of capital inflows and the elasticity of current deficits in response to GDP. Hence, during 1990-99, capital inflows reaching 3.4% of GNP led to an average rate of growth of 4.2% which resulted generating a

current deficit/GNP ratio of 0.8%. *Under these conditions a current deficit of \$1 is accompanied by (roughly) capital inflows of \$3 resulting in an increase of \$2.6 in the external debt stock.*

The two scenarios underlying the numerical examples correspond to same growth rates and current deficit levels, but to substantial differences in capital flows and external indebtedness. In terms of balance of payments accounting identities, the rising gap between capital inflows and current deficits during the 1990s is explained by (i) rising rates of reserve accumulation; (ii) rising and significant levels of capital outflows by residents and (iii) negative (and growing) errors and omissions (perhaps, to be interpreted as capital flight).

The changing pattern in the linkages between growth and capital movements in the post-1990 period generated four adverse consequences:

(a) *The growth of the external debt stock becomes delinked from the current account.* Hence, current deficits cumulated for 1989-99 had amounted to \$14.2 billions whereas the external debt stock had risen by \$60 billions during the same period. Because current deficits, *per se*, had been moderate and manageable, there is no difficulty in servicing the current liabilities, i.e. interest rate commitments, on the debt. However, when confidence turns sour due to various factors, i.e. when ratings for Turkey decline, **refinancing, rolling over the debt stock** becomes difficult. Amortization the principal of the debt by generating current account surpluses produces unbearable burdens on national economy. An economy with moderate external deficits becomes extremely sensitive to external respectability and is liable to fall under continual IMF supervision . This is the current situation in Turkey.

(b) *The volatility of the growth rate increases significantly due to a newly emerging boom-downturn-recovery cycle determined by capital-inflows and outflows.* The erratic nature of the growth process since the early 1990s is clear-cut: The boom years were 1990, 1992-93, 1995-97 and 2000. The downturns, which correspond to declining or negative capital inflows, were observed in 1991, 1994, 1998-99, 2001-2002.

(c) *When reversals in capital flows are substantial and sudden, the "downturn" phase of the cycle drifts into a financial crisis with very high economic and social costs* This was the case in 1994, 1998-99 and 2001. The reversal in foreign capital inflows (measured by the flows in the pre-crisis *minus* the crisis year) in the

three "bust" periods were \$19.1, \$7.6 and \$27.6 billions (resulting in contractions in GNP by 6.1, 6.1 and 9.4 per cents respectively.

(d) A domestic debt trap emerges as the other side of the coin: Part of the high capital inflows are realized by domestic banks borrowing abroad and lending to the Treasury at high (averaging 26% in real terms during 1995-2001) interest rates. The combination of high domestic interest rates with the undervaluation of foreign currencies (overvaluation of the Turkish lira) results in high arbitrage returns. If we exclude 1991 and 1994, the arbitrage rate of return on the dollar (as funds shift from the dollar into Treasury bills and back into the dollar) per annum averages 22.2% between 1989-2000. The fiscal system becomes dependent on short term borrowing abroad of banks. Current revenues can no longer cover interest obligations of the Treasury (which exceeded tax revenues in 2001). Either Ponzi financing becomes the rule; or, ultimately under IMF tutelage, partial amortization of the debt stock is attempted by the generation of primary surpluses from the budget. The end result is the incapacity of the government to provide essential public services.

III. Financial crisis and crisis management in 2001-2002

A. A crisis created by IMF

Since the end of 1999, the economy is being run by the IMF, first via an exchange-rate based anti-inflationary program (2000) and, by crisis-management in 2001. The present writer considers the financial crisis of 2001 as a creation of the IMF program. The following table summarizes what happened before and after the IMF programs. The inflation and exchange rate data are December-to-December values.

Economic indicators (%), 1999-2001

	1999	2000	2001
GNP growth	-6.1	+6.3	-9.4
Inflation	63	33	89
Current account/GNP	-0.7	-4.9	+1.0
Change in exchange rate= (\$1+0.77€)	58	22	114

What happened during these three years? (i) IMF takes over an economy in contraction, but with stable external accounts and no problem in refinancing her debt stock. (ii) The program generates a boom based on capital inflows, an unsustainable

external deficit, ultimately capital outflows and a financial crisis, all during a single year. (iii) IMF scraps the earlier model; imposes a severely contractionary package, leads the economy into its deepest peace-time recession. (iv) Comparing 1999 with 2001, the end result of IMF's involvement is higher inflation, a financial system in collapse, severe debt refinancing bottlenecks and a deep depression.

The anti-inflationary program of 2000 depended on: (i) a nominal exchange rate target as anchor; (ii) tight fiscal policies; (iii) quasi-currency board (i.e no sterilization) rules on money supply and (iv) so-called structural reforms. All fiscal, exchange rate and structural reform targets were attained and full compliance with the "no-sterilization rule" was realized.

How did the model collapse? Foreign capital inflows during the first ten months of 2000 reached \$15.2 billions leading to almost automatic monetary expansion. Interest rates on government borrowing declined dramatically from 104% in 1999 to 36% in 2000 resulting in a substantial increase on domestic demand based on credit expansion, leading to a 6.3% growth rate. Inflation slowed down, but remained above the exchange rate movement; hence, resulting in overvaluation of TL. Rising demand plus overvaluation combined with the delayed impact of customs union with EU¹ led to unsustainable trade and current account deficits. As the sustainability of the current deficit started to be questioned, the economy became extremely vulnerable to herd behaviour and speculative attacks of external agents. The program collapsed at the end of two attacks on the TL in November 2000 and February 2001. Substantial reserve depletion and 4-digit interest rates were unable to protect the peg; and, finally the government was forced to float the currency. By the end of the year, the currency had lost more than 50% of its value and the financial system had drifted into a disastrous banking crisis.

B. Crisis management under the IMF recipe

The severe 2001 contraction of GNP in 2001 (-9.4%) was, initially, triggered by the substantial reversal of foreign capital flows from +\$15.2 billions in the first ten months of 2000 to -\$12.4 billions during the following eleven months, equalling \$27.6 billions. Despite its direct responsibility on what happened the IMF

¹ EU-Turkey Customs Union became operational immediately after 1994 –a year of substantial devaluation of the TL. A slow pace appreciation during the following four years did not eliminate the competitive edge in favour of tradable sectors. The full impact of the Customs Union on the trade balance came into force in 2000 when high demand expansion, substantial and fast currency appreciation resulted in a \$ -22.3 billion trade deficit.

took over crisis management as well. This time, IMF adopted a severely contractionary stabilization package consisting of a freely floating exchange-rate, further fiscal tightening, tight monetary policy and still further "structural reforms". In return, substantial credits from the two Bretton Woods Institutions (BWIs) are being allocated to reach \$30 billions by the end of 2004.

Currently, the banking system remains paralysed, credit lines are closed and the economy gets bogged down in depression. In its depressed state, the economy generates a current account surplus, inflation starts to decelerate and a semblance of stability appears to prevail in exchange and interest rates –resembling a comatose patient with a low temperature. Perfect stability will be attained when she passes away.

IV. Some Reflections

Turkish society is currently being shaped by external agents: i.e by the BWIs in the economic and social areas and by the EU in the political arena.

The BWIs' management of the economic and social areas is crude, incompetent and primitive. It is built upon two pillars: An archaic stabilization model and standard IMF/WB recipes on structural and institutional reform. Documents prepared by BWI staff are being translated (and, in certain cases, slightly adapted) by the domestic economic team and forced through the Council of Ministers and Parliament, almost always linked to a specific loan package.

There is no enthusiasm and confidence in these policies on the part of national actors; but the political class (including the opposition) feels that there is no alternative which will provide the vital external funds. Helplessness, resignation and depolitization prevails within the ranks of popular classes. There is, however, a widespread conviction that the current immobility in the social front incorporates a potentially explosive situation.

Current policies are liable to generate destructive social and political crises. Four unorthodox and radical steps are necessary to break the vicious circle: (i) At least temporary, but effective, capital-controls; (ii) unorthodox methods to reduce the burden of the domestic debt, e.g. a partially confiscatory tax on the domestic holders of government debt papers; a consolidation or, even, a partial monetization of the stock of the domestic debt; (iii) the rejection of IMF-imposed government guarantees

on external private debt and (iv) a search for rescheduling the external debt stock while servicing its interest obligations.

EU's potential domination in the political sphere is taking place through the government's response to the Accession Partnership Document via a "National Program".

Full membership with EU has strong public support. The population at large feels that economic benefits (especially due to expectations on the free circulation of labour) outweigh costs.

However, compared with BWIs' control over the economy, EU's attempt to control the political sphere is generating much stronger resistance among influential circles, the political class and the military.. Complications generated by Kurdish and Cyprus issues is feeding a growing sense of disappointment. Eurosceptics strongly believe that EU is determined to reject Turkish accession and will always find political and economic pretexts to justify rejection. There is, also, a growing perception that EU-TC Customs Union was extremely wrong and Turkey turned out to be the losing party.

Turkish-European relations go back to several centuries. 20th century history has also left its mark. Aspirations to be accepted, respected as an equal ally or partner are mixed with scenarios of external (including European) conspiracies to divide up, undermine, weaken the country. Striving to comply with EU's demands, but being rejected at every step is considered to be humiliating by increasing numbers of people. The process, as it continues indefinitely, is feeding fundamentalist, chauvinistic, obscurantist and anti-democratic forces within society.

The present writer thinks that it would have been much better if Turkey had never applied for full membership. This is not based on an economic cost/benefit analysis; but rather on the pathological ideological and political consequences which the present impasse on membership is generating within the society.