

## TURKEY 2001-2004:

### IMF Strangulation, Tightening Debt Trap, and Lopsided Recovery<sup>1</sup>

June, 2004

*Erinc Yeldan, Professor of Economics, Department of Economics, Bilkent University, 06800, Ankara, Turkey*

[yeldane@bilkent.edu.tr](mailto:yeldane@bilkent.edu.tr)

<http://www.bilkent.edu.tr/~yeldane>

The 21<sup>st</sup> century witnessed the Turkish economy in a path just depicted as in the above title: *strangulation* by the neoliberal orthodoxy, orchestrated by the IMF; tightening of the *debt trap* and virtual collapse of the public sector to provide any social services to the people; and a *lopsided recovery* with a fast rate of growth and falling inflation amidst rising unemployment, declining real wages, and increased social exclusion and mass poverty.

Turkey experienced a very severe economic and political crisis in November 2000 and again in February 2001. The IMF has been involved with the macro management of the Turkish economy both prior to and after the November and February crises, and provided financial assistance of \$20.6 billions, net, between 1999 and 2002.

In this brief report, I will try to provide an assessment of the key macroeconomic developments in Turkey over the post-2001 crisis period.<sup>2</sup> In so doing, I will try to investigate, in particular, the (slippery) sources of the (speculative-led) growth, and also highlight the main indicators of culminating fiscal and financial fragility. I will also try to comment on the role of the IMF in implementing its new two-fold orthodox dogmas, viz. *inflation targeting* by an independent central bank and *primary surplus targeting* by the public finance administration. I will also analyze the true nature of the so-called façade of *expansionary* “fiscal contraction”, i.e. that attaining primary surplus targets will generate a crowding-out process *in reverse*, leading to expansion of private demand, hence output.

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<sup>1</sup> I am indebted to Cem Somel and Şaziye Gazioğlu, and to colleagues at Bilkent and at the Independent Social Scientists Alliance of Turkey for their comments and suggestions on an earlier draft of this paper. Needless to mention, none of them bear responsibility on the views and opinions forwarded in the text.

<sup>2</sup> A collection of papers on the evolution of the 2001 crisis along with some key references are provided in my web page: <http://www.bilkent.edu.tr/~yeldane/crisis.html> for the interested reader.

I will organize my observations under five sections. First, I provide a broad overview of the recent macroeconomic developments in Turkey. Then I report and study data on Turkish debt dynamics and on the intricacies of the IMF program. In section three I study the evolution of the key macroeconomic prices such as the exchange rate, the interest rate and price inflation. Labor markets and the evolution of real wages are investigated in section four. I provide a brief summary with concluding comments in section five.

## **I. Overview of Macroeconomic Developments**

The IMF intensified its supervision over Turkey beginning 1998 with the implementation of the “Staff Monitoring Program”. After a brief period of weakening of the relations due to the earthquake in 1999, Turkey has embarked in an ambitious exchange rate-based disinflation program under close monitoring by the Fund. With the collapse of the program in February 2001, a new round of stand by is initiated under the direct management of Mr. Kemal Dervis, who resigned from his post at the World Bank as Vice Chair and joined the then three-party coalition cabinet. Finally, in the November 2002 elections the AKP has come to power with absolute majority in the parliament and, despite its otherwise election rhetoric, embarked in a new and intensified adjustment programme with the IMF staff.

The current IMF program in Turkey relies mainly on three pillars: (1) fiscal austerity that targets achieving a 6.5 percent surplus for the public sector as a ratio to the gross domestic product; (2) contractionary monetary policy (through an *independent* central bank) that exclusively aims at price stability (via *eventually* inflation targeting); and (3) structural reforms consisting of many of the customary IMF demands: privatization, large scale layoffs in public enterprises, and abolition of any form of subsidies.

According to the logic of the program, successful achievement of the fiscal and monetary targets would enhance “credibility” of the Turkish government ensuring reduction in the country risk perception. This would enable reductions in the rate of interest that would then stimulate private consumption and fixed investments, paving the way to sustained growth. Thus, it is alleged that what is being implemented is actually an *expansionary* program of *fiscal contraction*.

On the monetary policy front, the Central Bank of Turkey was granted its *independence* from political authority in October 2001. Since then the central bank announced that its sole mandate is to restore and maintain price stability in the domestic markets and that it will follow a disguised inflation targeting until conditions are ready for full targeting. Thus, over 2002 and 2003 the central bank targeted net domestic asset position of the central bank as a prelude to full inflation targeting.

The growth path of the Turkish economy over the 1990’s had been erratic and volatile, mostly subject to the flows of hot money. In 2003 the economy has grown by 5.8% in real terms. Price movements were also brought under control through the year and the 12-month average inflation rate has receded from 29.7% to 18.4% in consumer prices and from 31.2% to 13.9% in wholesale prices. 2003 has also meant a period of acceleration of exports, and export revenues have reached \$50 billions over the year. Nevertheless, with the rapid rise of the import bill over the same period, the deficit in the current account reached \$6.8 billion (or

about 2.5% of GDP). Table 1 documents the main macro indicators of the Turkish economy under close IMF supervision over a five-year time horizon.

**Table 1. Basic Characteristics of the Turkish Economy, 1998-2003**

	1998	1999	2000	2001	2002	2003
<b><i>Real Rate of Growth</i></b>						
GDP	3.1	-5.0	7.4	-7.4	7.6	5.8
Consumption Expenditures						
Private	0.6	-2.6	6.2	-9.2	2.0	6.6
Public	7.8	6.5	7.1	-8.6	5.4	-2.4
Investment Expenditures	-3.9	-15.7	16.9	-31.5	-0.8	10.0
Private	-8.3	-17.8	16.0	-34.9	-7.2	20.3
Public	13.9	-8.7	19.6	-22.0	14.5	-11.5
Exports	12.0	-7.1	19.2	7.4	11.0	16.0
Imports	2.3	-3.7	25.4	-24.8	15.7	27.1
<b><i>As Ratio to the GNP (%)</i></b>						
Current Account Balance	1.0	-0.7	-4.8	2.4	-0.8	-2.9
Stock of Foreign Debt <sup>a</sup>	55.4	69.5	64.4	93.9	76.2	59.3
Budget Balance	-7.0	-11.6	-10.9	-16.2	-14.3	-11.2
Consolidated Budget Interest Costs	12.0	14.0	16.0	23.0	19.0	16.0
PSBR	9.2	15.1	12.5	16.4	12.6	8.7
<b><i>Macroeconomic Prices</i></b>						
Rate of Change of the Nominal Exchange Rate (TL/\$)	71.7	60.6	28.6	114.2	9.4	-9.8
Inflation (WPI)	71.8	62.9	32.7	88.1	31.2	13.9
Inflation (CPI)	84.6	68.8	39.1	68.5	29.7	18.4
Real Interest Rate on GDIs	29.5	36.8	4.5	31.8	13.0	17.0
Real Wage Growth Rates <sup>b</sup>						
Public Sector	-1.3	42.0	6.9	-11.5	0.6	-8.6
Private Sector	16.9	11.6	1.0	-14.3	-4.3	-1.4

**Sources:** SPO *Main Economic Indicators*; Undersecretariat of Treasury, *Main Economic Indicators*; Central Bank Annual Reports

a. Debt stocks are denominated in TL by using the end-of-year CB sale prices of exchange rates.

b. Data compiled from the Turkish Employers Association and the Confederation of Public Employers Unions, as reported in the Central Bank Annual Reports. Nominal wages are deflated using the CPI (1994=100).

The Turkish media and the official centers have hailed the “positive” rates of real growth as the end of the crisis and transition to sustained, long term growth. Furthermore, according to

the same circles, this achievement is the end result of the government's credible and decisive reforms. Accordingly, the current AKP government is following the IMF program in strong faith, and the "markets" are celebrating its successful "governance" with increased inflows of foreign capital and rising credit ratings.

Yet, such hasty and dogmatic assessments that tend to see the macroeconomic performance of an economy as only a matter of algebraic rate of growth calculations often overlook the structural bottlenecks and the conjectural shifts surrounding the commodity and the labor markets. The travestisites of financial orthodoxy often regard macroeconomic developments only from the point of view of short-run financial gain, and celebrate the speculative surges in the stock exchange and the financial markets as evidence of "growth and prosperity". However, they fail to note the underlying imbalances in the commodity markets and choose to remain silent against the culminating pressures of rising unemployment, falling wages, increased poverty and stagnating fixed investments.

In fact, developments in Turkey during 2002 and 2003 reveal that the growth performance has been thoroughly based on inflows of short-run international finance capital and on the conjectural developments in the international currency markets which enabled Turkey windfall gains of favorable terms of trade, none of which are sustainable even in the medium run.

Firstly, when we study the balance of payments (BOP) statistics closely, we see that the growth performance of the economy depended directly on inflows of international finance capital. Over 2003, the finance account of the BOP displayed a net surplus of \$5,972 billion. In contrast, the same account showed a surplus of only \$1,161 billion in 2002. If we add the unrecorded foreign exchange flows of \$4.975 billion displayed under the "net errors" account, we reach a total sum of \$10.9 billion of liquid inflows into the Turkish economy in 2003.<sup>3</sup> This magnitude is on the order of ten-fold compared to 2002, and clearly reveals the fragility of the sources of growth, Turkish-style.

Key aggregates of the Turkish balance of payments statistics are documented in Table 2. Data reveal that inflows of finance capital continued over the first quarter of 2004, and the current account deficit widened by \$5 billion over the first three months of this year. Instrumental behind this deficit is the surge in the merchandise trade deficit, which accumulated to more than \$5.1 billion over the same period. Calculated over *yoy*, the trade deficit exceeded \$20 billion and that of the current account deficit reached \$11 billion. Both figures compare unfavorably with the prelude of the February 2001 crisis, during when the foreign deficit reached similar magnitudes.

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<sup>3</sup> Central Bank of the Republic of Turkey (<http://www.tcmb.gov.tr>).

**Table 2. Key Aggregates in Balance of Payments (Millions US\$)**

	<b>Current Account Balance</b>	<b>Exports</b>	<b>Imports</b>	<b>Merchandise Trade Balance</b>	<b>Finance Account</b>	<b>Net Errors &amp; Omissions</b>	<b>Change in Reserves</b>
2002Q1	-637	8,829	-9,785	-956	878	-1,520	1,279
2002Q2	-809	9,447	-11,707	-2,260	-167	573	403
2002Q3	1,030	10,388	-12,717	-2,329	-1,113	603	-520
2002Q4	-1,106	11,460	-14,252	-2,792	1,563	493	-950
<b>Total 2002</b>	<b>-1,522</b>	<b>40,124</b>	<b>-48,461</b>	<b>-8,337</b>	<b>1,161</b>	<b>149</b>	<b>212</b>
2003Q1	-2,761	11,123	-13,522	-2,399	3,552	-1,277	486
2003Q2	-2,329	12,272	-15,501	-3,229	-615	3,655	-711
2003Q3	1,391	13,262	-17,350	-4,088	3,681	280	-5,352
2003Q4	-3,151	14,549	-18,867	-4,318	-646	2,317	1,480
<b>Total 2003</b>	<b>-6,850</b>	<b>51,206</b>	<b>-65,240</b>	<b>-14,034</b>	<b>5,972</b>	<b>4,975</b>	<b>-4,097</b>
2004Q1	-5,035	13,881	-19,012	-5,131	5,801	197	-963

Source: Central Bank ([www.tcmb.gov.tr](http://www.tcmb.gov.tr))

The main phenomenon behind the culminating pressures of foreign deficit is regarded as the inertia in the foreign rate of exchange of the Turkish Lira. The TL is reportedly on a “floating exchange rate regime” since the eruption of the February 2001 crisis. Since then the CB is loyally acknowledging that its main policy objective is price disinflation, and that it has no targeted exchange rate in mind, warranting sterilized interventions to the foreign exchange markets. Nevertheless, against the background of nearly 50 percent rate of inflation in cumulative terms over the past two years, the nominal value of the TL has been observed to remain virtually stagnant against the major currencies. In fact, the TL has appreciated *nominally* by 9.8% on average over 2003, despite an ongoing inflation of 18.4% in consumer prices in the same period.

It is clear that the abundance of foreign exchange in the Turkish asset markets lured by high real rates of interest led both to a surge in import demand fuelling growth, as well as provided the fiscal authorities with breathing space in their foreign debt servicing. It is to the issue of debt dynamics that I turn my attention now.

## II. Fiscal Balances and Dynamics of Debt under the IMF Programme

The Turkish foreign debt stock has reached US\$147 billion by the end of 2003. Considering that the foreign debt stock was \$131.2 billion in 2002, the observed magnitude reveals a rate of growth of 12.3%. However, with the *nominal* appreciation of the Turkish Lira against the US\$ in 2003, the ratio of foreign debt to GDP creates the illusion that it has fallen to 55% in 2003, contrasting with the 2002 ratio of 73.1%. Any depreciation of the TL value of the US\$ in the days to come would bring this ratio to higher levels, unveiling the true underlying dynamics of foreign debt.

The share of the public sector in aggregate foreign debt is approximately 40%. The Foreign debt stock of the public sector was \$40 billion in 1996, and increased to \$63.9 billion in 2002,

and to \$70.3 billion in 2003. The Data reveals, in fact, that the Turkish public sector has resorted to *domestic* debt finance rather than the foreign sources. Thus, the securitized stock of domestic debt which stood at TL3.3 quadrillions (\$29.3 billions) in 1996, increased to TL194.4 quadrillions (\$139.3 billions). This shows a cumulative increase of 4.7-fold in 7 years. Thus, aggregate public debt stock increased its ratio to GNP from 37.7% in 1996 to 81.7% in 2003. Even though the 2003 ratio seems to have recovered somewhat in comparison to the immediate post-crisis level of 88%, much of this recovery had been due to the appreciation of the TL which enabled a lower burden of the foreign debt measured in domestic currency. Thus, sustainability of this trend is yet to withstand the test of currency depreciations in the future. Table 3 depicts this information.

**TABLE 3: PUBLIC DEBT STOCK, 1996-2003**

(Billions US Dollars)

YEARS	DOMESTIC DEBT STOCK	FOREIGN DEBT STOCK	TOTAL DEBT STOCK	GNP	RATIO OF TOTAL PUBLIC DEBT STOCK TO GNP(%)
1996	29.3 ( 3.3 Quad. TL )	40.0	69.3	184.0	37.7
1997	30.7 ( 6.6 Quad. TL )	38.9	69.6	197.0	35.3
1998	37.1 ( 11.7 Quad. TL )	39.9	77.0	212.0	36.3
1999	42.4 ( 23.0 Quad. TL )	42.4	84.8	190.9	44.4
2000	54.2 ( 36.4 Quad. TL )	47.8	102.0	200.1	51.0
2001	84.9 (122.2 Quad. TL )	46.3	131.2	148.2	88.5
2002	91.7 (149.9 Quad. TL )	63.9	155.6	179.9	86.5
2003	139.3 (194.4 Quad. TL )	70.3	209.6	256.4-	81.7

Source: Undersecretariat of Treasury

## II-1. Portrait of the IMF's Financial Assistance and Its Disposition

Both the *Transition to the Strong Economy Program* and the *Letter(s) of Intent* that followed were administered under close supervision and financial assistance of the IMF. From July 1999 to date, the aggregate value of the IMF's officially approved assistance to Turkey amounted to \$31.9 billions, and the realized value of disbursements reached \$29.2 billions. I tabulate the detailed breakdown of these disbursements in Table 4.

**Table 4. Breakdown of the IMF's Financial Assistance to Turkey, 1999-2004**

1999 July-December, Staff Monitored Follow-up  
 2000-2002 Stand-by  
 2000 November / December Extra Reserve Facility following the November 2000 crisis  
 2001 February / March Extra financing in response to the February 2001 crisis  
 2002-2004 Stand-by  
 11 September extra financing due to the international crisis

*Total Approval:* 31,847 millions US\$

*Realized Dispositions (annually)*

1999	288	millions \$
2000	3,439	millions \$
2001	11,317	millions \$
2002	12,503	millions \$
2003	1,681	millions \$

*Total Disposition* : 29,228 millions \$

*Payments of Capital :*

1999	287	millions \$
2000	88	millions \$
2001	1,087	millions \$
2002	6,139	millions \$
2003	1,227	millions \$

*Total Payments* 8,827 millions \$

*Net usage : Total usage – Payments*

29,228 millions \$ – 8,827 millions \$ = 20,401 billions \$

Approved until the end of 2004: 2,610 millions \$

*Distribution of Aggregate Dispositions over 1999-2003 (end-of-year)*

IMF's Disbursement	29.2	billions \$
Payments of Capital	-8.8	billions \$
Payments of Interest	-2.2	billions \$
Net usage of funds	18.2	billions \$
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(Exchange rate correction)	1.0	billions \$
Usage from IMF's Stocks	21.6	billions \$
Interest Payments to the IMF	1.0	billions \$

*Functional Distribution of the Funds*

	<u>Total Usage</u>	<u>Total Payments (exclusive of Interest)</u>
Central Bank	15.6	9.1
Treasury	13.6	-0.3

*Source:* Undersecretariat of Treasury (<http://www.treasury.gov.tr>). I am further indebted to Nazif Ekzen for his invaluable help for construction of this table.

Given the above data, it is understood that netting out the payments of capital until 2003, Turkey received a total net sum of \$20.4 billion from the IMF during the crisis. According to the Program conditions, \$13.3 billions of this sum were used by the Treasury in budgetary finance of its domestic debt management; \$7.5 billions were used by the Central bank in strengthening its reserve position; and \$1.1 billions were used by the Treasury in its own reserves. It was also made clear by the Central Bank's governor Süreyya Serdengeçti, that the resources obtained from the IMF were to be used first and foremost in "... successful management of the failed banks taken under the control of the saving deposit fund, and to sustain the roll-over of the domestic and foreign debt repayments" (TSEP, May 2001).

Again in this conjuncture, the government has decided to issue treasury debt instruments (GDIs) totaling \$8 billions plus TL4.3 quadrillions (approx. \$4 billions) to the failed banks taken under the control of the *Saving Deposit Fund*, and a total of TL25.8 quadrillions (approx. \$25 billions) (again in GDIs) to the public banks which had experienced deteriorated asset positions due to "duty losses". Thus, throughout the months following the eruption of the February crisis, the government is observed to transfer an aggregate sum of approximately \$40 billions of fiscal resources to the banking sector. This sum reaches one-fourth of aggregate Turkish GNP.

I further display the costs of IMF financing over the following years. Table 5 reports on the calendar of repayments to the IMF between 2004-2007. Accordingly, total costs of borrowing from the IMF in terms of capital repayments and interest costs reached \$11.1 billion between 1999-2003. Total repayments to the IMF are planned to be \$25.2 billion over 2004-2007. Thus, Turkey will have made an aggregate debt repayment of \$36.3 billion to the IMF over 1999-2007.

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**Table 5. Debt Re-Payments Schedule to the IMF After 2004**  
(Billions US\$)

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Total</u>
<b>Capital</b>	<b>4.406</b>	<b>7.554</b>	<b>10.942</b>	<b>623</b>	<b>23.523</b>
<b>Interest</b>	<b>837</b>	<b>628</b>	<b>216</b>	<b>8</b>	<b>1.690</b>
<b>Total</b>	<b>5.241</b>	<b>8.182</b>	<b>11.158</b>	<b>631</b>	<b>25.213</b>

**Debt Re-Payments Realized to the IMF 1999-2004**

	<u>Capital</u>	<u>Interest</u>	<u>Total</u>
1999-2003 Realization	8.827	2.233	11.060
2004-2007 Repayments Scheduled	23.524	1.690	25.213
<b>Aggregate Cost</b>	<b>32.351</b>	<b>3.923</b>	<b>36.274</b>

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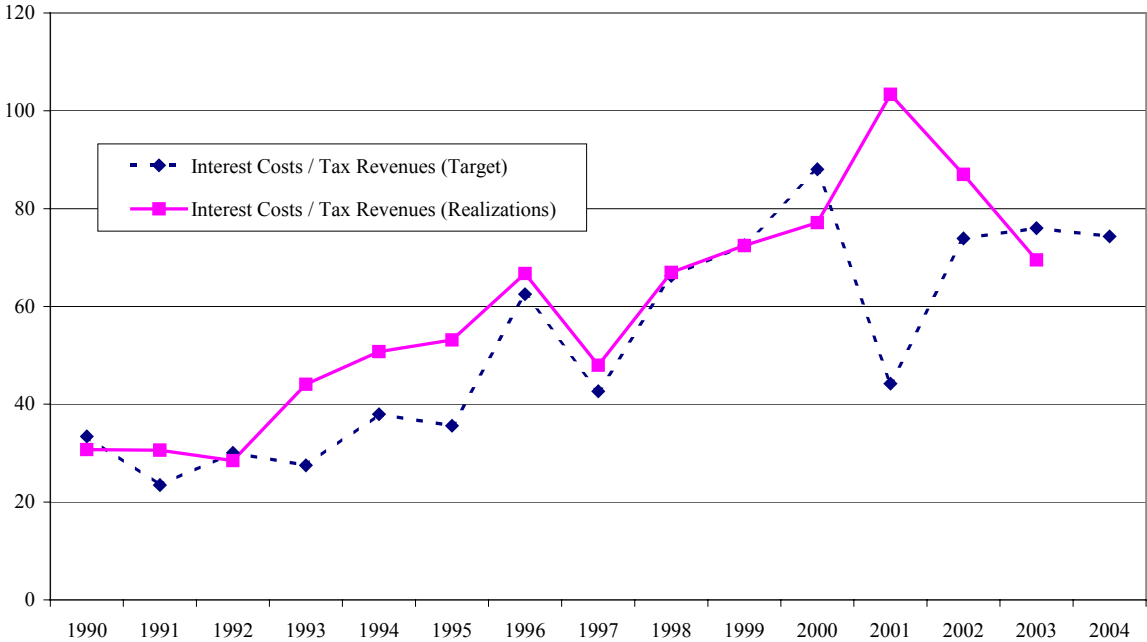
Turkey is planning to face this debt burden via drastic cuts in its non-interest fiscal expenditures, and thereby maintaining a primary surplus of 6.5% of GDP for the whole public sector (5% for the consolidated budget). In order to realize this target, it is stated in the series



of *letters of intent* that the nominal rate of increase in non-interest fiscal expenditures will be bounded by the nominal rate of increase of GDP. As GDP growth is affected by the fiscal stance, the deflationary dangers of this policy is obvious. Yet, at the same time no action is envisaged (besides the primary surplus targets) to limit the expansion of the interest costs on debt. A comparison of the interest costs as a ratio of aggregate tax revenues –targeted and realized—disclose the structural anomaly in Turkish fiscal planning exercises openly: Interest expenditures as a ratio of tax revenues reached 103.3% in 2001, and 77.1% in 2002. Under the crisis management targets, interest expenditures were fixed as 88.1% of the tax revenues in 2000, and 109% in 2001. In 2004, it was anticipated that the target of interest expenditures would be lowered to 74.3% of the tax revenue targets.

Figure 1 portrays these data on the ratio of interest costs to total tax revenues, both as targeted appropriations and also as end-of-year realizations. It is clear that while the public sector consolidated budget in the May 2001 *Letter of Intent* persisted in the policy of “facilitating a smooth roll-over of the government’s domestic debt” with a targeted primary surplus, it does not suggest any realistic measures to decrease the burden of interest spending program on the public disposable income.

**Figure 1. Interest Costs / Tax Revenues (%)  
Target and Realizations**



Thus, even though the interest costs continued to claim an increasing portion of tax revenues over the 1990’s, none of the governments showed the political will to tackle the problem of debt re-consolidation directly. Under conditions of maintaining the debt turnover via only primary surpluses, the fiscal authority has been deprived of any viable funds to sustain public

services on health, education, protection of the environment, and provision of social infrastructure.

Recent developments in the consolidated budget clearly reflect this mentality. In Table 6, I highlight some of the key magnitudes from the consolidated budget accounts. The government has targeted an appropriation of TL149.5 quadrillions (\$95.3 billion) as aggregate expenditures. Interest expenditures constitute TL66.1 quadrillions (\$44.1 billion), or about 44% of the total. As of May 2004, balance on the non-interest budget is observed to generate a (primary) surplus of TL 4.5 quadrillions (\$9.6 billion). This sum already reached 72% of the end-of-year target of TL20.2 quadrillions (\$13.5 billion). Thus the AKP government “successfully” followed the primary surplus targets for the fiscal year. Yet, at this stage it will be appropriate to question what the costs of this “success” had been in terms of the public services foregone.

**Table 6. Developments in the Consolidated Budget (Trillions TL)**

	2003		2004		Ratio to the End of Year Values (%)	
	End of Year	Jan-May	Appropriations	Jan-May	2003	2004
Tax Revenues	84,334	30,784	88,893	33,968	36.5	38.2
Total Expenditures	132,422	55,764	149,945	53,920	42.1	36.0
<b>Interest Expenditures</b>	<b>58,524</b>	<b>31,142</b>	<b>66,050</b>	<b>26,100</b>	<b>53.2</b>	<b>39.5</b>
Personnel Expenditures	28,166	11,538	32,187	13,783	41.0	42.8
Transfers to the Soc Sec Inst.	15,922	7,046	19,466	7,538	44.3	38.7
Capital Investment Exp.	7,475	898	6,409	727	12.0	11.3
Budget Balance	-39,773	-21,807	-45,836	-11,554	54.8	25.2
Non-interest Budget Balance	18,751	9,349	20,214	14,546	49.9	72.0

Source: Undersecretariat of Treasury ([www.treasury.gov.tr](http://www.treasury.gov.tr))

From Table 6 we document that, the first five months of public finance in 2004 disclose that interest payments on public debt constitute:

- 77% of total tax revenues;
- 1.9-fold of salaries and personnel expenditures of civil servants;
- 3.5-fold of public transfers to the social security institutions;
- 20.5-fold of direct income support payments to the farmers and rural workers;
- 35.9-fold of total capital expenditures for public education, health, and environmental protection services.

These observations clearly indicate the main objective of the Turkish fiscal administration under the IMF programme. Accordingly, the program tries to ensure first and foremost Turkey’s repayments of accumulated debt by way of an obsessive focus on the objective of “budget with a primary surplus”. As result of these policies, the boundaries of the public space are severely restricted, and all traditional economic and social infrastructure facilities of the public sector are being abandoned to the strategic interest area of foreign capital at the cost of extraordinary cuts in public spending and investments.

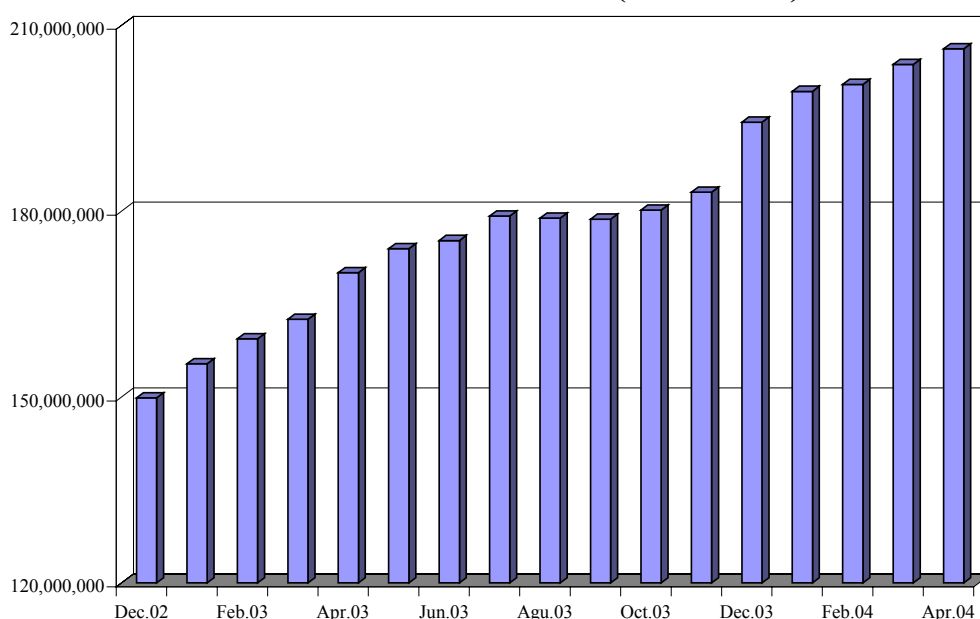
The natural question then arises: given the sizable fiscal contraction on public non-interest expenditures and cuts in public services, could the “successes” of primary surplus

performance generate the expected reductions in aggregate debt stock and lead to a fall in real interest costs? Data suggest that the answer to this question has been a clear “no” to- date. In the next section I study the behavior of the key macro prices given the logic of the primary surplus target.

### III. Key Macroeconomic Prices and Macro Aggregates

Given the successful implementation of the primary surplus target, I first report on the evolution of the public debt stock over 2003 to date. Monthly data on domestic debt is portrayed in Figure 2. As of April 2004, domestic debt stock stands at TL206.2 quadrillions (\$137 billion). Calculated in fixed 1994 wholesale prices, the domestic debt stock is observed to increase by 18% in real terms over the past 16 months. Thus, the disturbing evidence is that the debt stock has not been brought under control yet, even though the strict fiscal constraints have been successfully implemented.

**Figure 2.**  
**Domestic Debt Stock (Billions TL)**



#### III-1. Inertia of Real Interest Rates

It is clear that all macro policies in Turkey right now are aligned to attain the fetishized 6.5% primary surplus. The algebraic logic behind the primary surplus target is actually extremely simple, and relies on the following debt equation in reduced form:

$$\Delta d = d(i - \dot{y}) - z$$

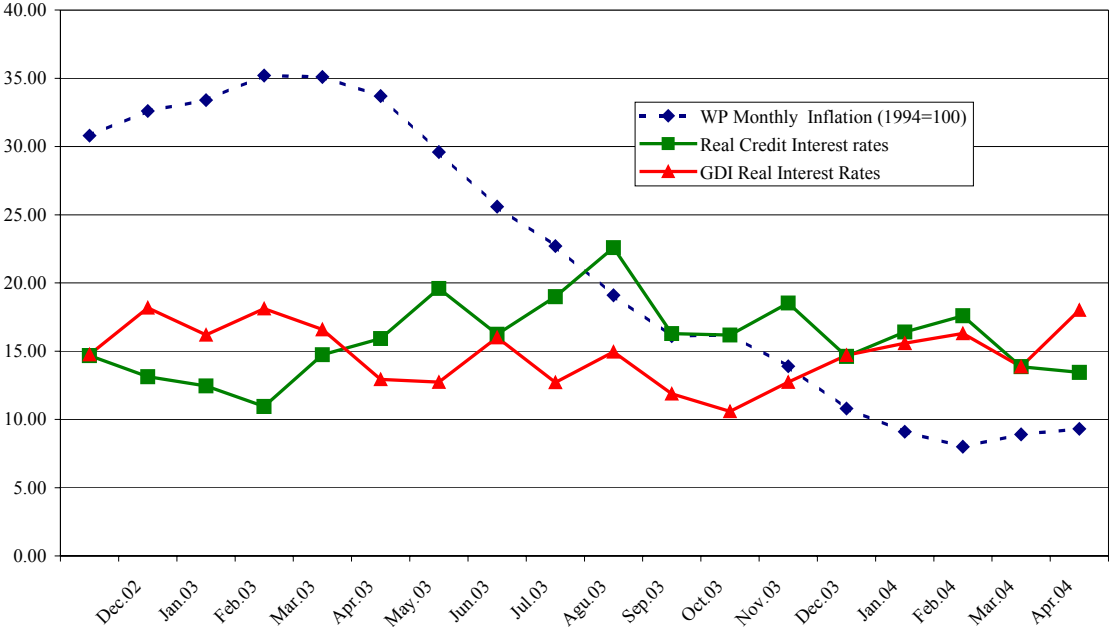
where,  $d$ : ratio of the debt stock to the GDP  
 $i$ : real interest rate  
 $y$ : real rate of growth of GDP  
 $z$ : primary surplus ratio to the GDP

and  $\Delta d$  denotes the time rate of difference in debt/GDP ratio.

Given the Turkish macroeconomic realities of 2004, letting  $d = 0.82$  (aggregate public debt to GDP ratio, see Table 3 above);  $y = 5\%$  (as targeted in a series of *letters of intend* over 2001 to 2006); and  $z = 6.5\%$ ; one can easily find that in order for the debt/GDP ratio to remain constant ( $\Delta d = 0$ ), the maximum real rate of interest should not exceed **12.9%**. This is the maximum possible real rate of interest on the government’s debt instruments (GDIs) if the debt ratio could ever be constrained.

In Figure 3 I portray the evolution of the GDI rate of interest as well as the credit interest rates, both in real terms. Data disclose very succinctly the heart of the problem: Turkish real interest rates are too high, and do not display any tendency to fall over the programme horizon. Contrasted over the last 18 months’ data on GDI interest rates, only in two months – September and October 2003—real interest rates are observed to fall under this threshold. This result refutes sharply the myth that successful implementation of primary surplus targeting fiscal administration would lead to a fall in the interest rates. This proposition simply fails the test of reality in the Turkish context, and as such, remains as an ideological dogma.

**Figure 3. Monthly Inflation and Real Interest Rates (%)**



What is also interesting to observe from the data disclosed in Figure 3 is that even though the inertia over inflationary expectations seems to have been broken especially after March 2003, the real interest rates sustain their inertia, independent of the logic of the fiscal balances. In fact, the GDI interest rates are observed to be on a rising path since November 2003 to date, despite the fact that primary surplus targets have been successfully attained beyond any concern.

The inertia of high real interest rates in the Turkish context can only be explained by reference to the mode of integration of the Turkish asset markets to the global financial economy at large. Turkey, like many of the other peripheral countries of late capitalism, has integrated with the world financial markets as a “new emerging market”. Simply put, the logic of the international financial system is that such young “emerging” markets should be able to offer significantly high real returns to global finance capital. The fierce competition among such economies often leads to a *race to the bottom* in order to attract inflows of short term liquid capital. As we have seen in section I above, the reliance of the Turkish economy on short term foreign finance is no simple matter; it is the *only* source of output growth feasible under the current contractionary monetary and fiscal environment. The strangulation imposed by the contractionary macro policies of the IMF orthodoxy can only be alleviated by the cost savings made available via cheap foreign exchange. In consequence, the flow of such funds necessitate maintenance of higher and higher real interest rates.

Under these conditions, the belief that achieving the primary surplus targets would automatically generate a momentum of positive business expectations, leading to a fall in interest charges and jump-starting economic growth is simply a myth out of touch with reality.

Again under these conditions, the simple algebra of debt dynamics reveal a plain policy conclusion, that the Turkish debt burden can not be handled via market operations achieving primary surplus targets and fiscal prudence alone, but it requires a detailed *re-structuring* of the terms of Turkish debt obligations with both the IMF and the banking community.

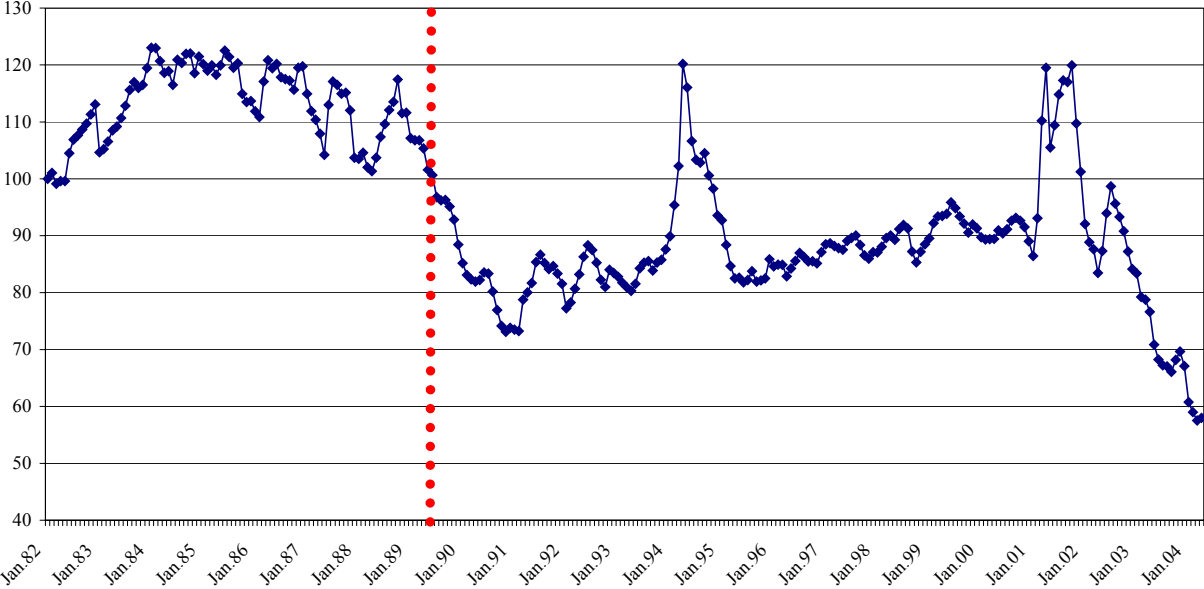
### **III-2. The Long Run Behavior of the Real Exchange Rate**

I have noted above that the TL is on an appreciating trend against the major currencies. In the last two years the price level in Turkey has increased by 50% in cumulative terms. Yet the foreign exchange rate of the Turkish Lira has remained virtually stagnant in nominal terms in the course of the same period. Thus, in spite of the “free floating” characteristic of the foreign exchange regime, the Lira is observed not to float at all. The pressures of international finance simply hold the necessary adjustments in the Lira at bay, and with excessive inflows, the Lira continues to appreciate at the expense of deepening current account deficits.

After the 1989 decision to de-regulate the capital account and to fully liberalize the financial markets, Turkey opened its domestic markets to the speculation of international finance capital. In this structure the Central Bank has lost its control over the money markets, and over the exchange rate and the interest rate, which latter actually became an exogenous variable, totally dependent on the decisions of international arbiters. This financial structure has trapped the Turkish economy in a policy of overvalued exchange rates and very high real interest rates, as argued above.

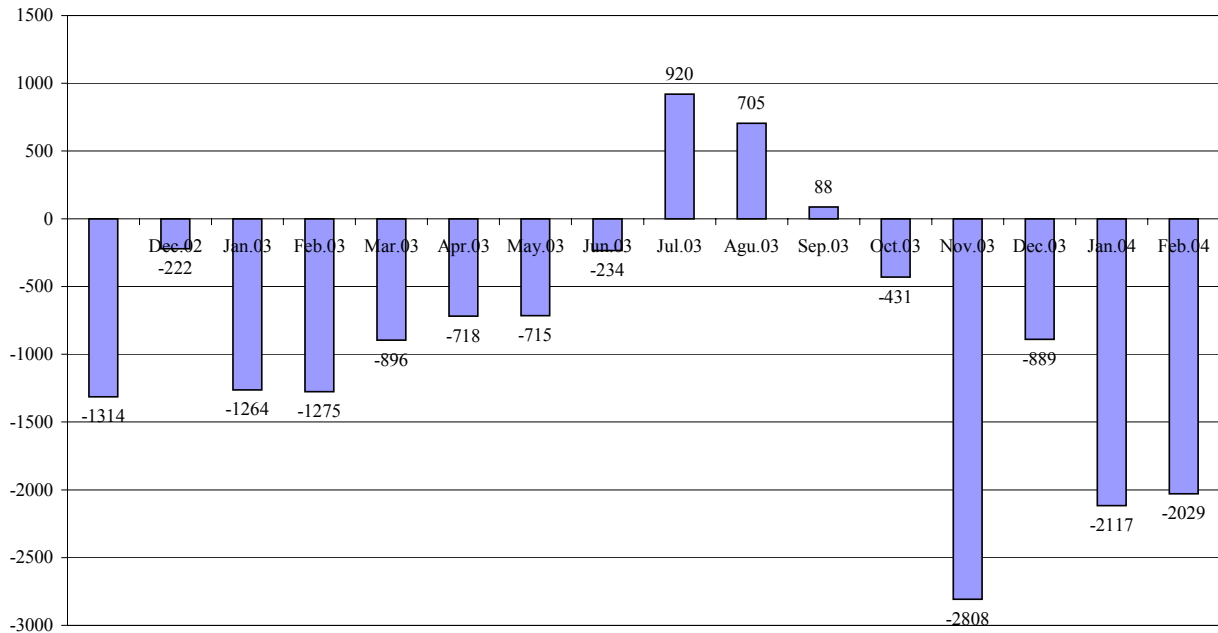
In Figure 4 below, the long term behavior of the real exchange rate of the Lira vis-à-vis the US\$ is depicted. The nominal conversion rate is deflated by the wholesale price index in Turkey in 1987 fixed prices (with the US inflation being assumed away). As can be observed, in December of 2003 the Lira was at its most appreciated point. The culminated appreciation of the lira since 1982 reaches 40%. In fact the Figure also narrates one more observation: after the 1989 decision of full de-regulation, the rate of exchange of the Lira against the major currencies has moved to a lower plateau structurally (showing appreciation of the Lira). Two “spikes” of corrective devaluations in 1994 and yet again in February 2001 worked to let the steam out and to correct the imbalance, but after each round the tendency towards appreciation resumed.

**Figure 4. Real Exchange Rate Index (1982 = 100)  
(Deflated by Fixed 1987 Wholesale Prices)**



This appreciation was mostly due to inflows of short-term financial capital (hot money). Such flows have enabled, on the one hand, accelerated growth through cheapening of imports, and on the other hand, they motivate speculative transactions in the financial markets. Yet, this “speculative-led growth” cannot be sustained for long, and each growth cycle (1990-93; 1995-98; 2000) has come to an abrupt halt with the crises of 1994, 1999, and 2001. Figure 5 below discloses the culminating pressures in the foreign market by portraying the monthly realizations of the current account deficits. The mode of deficit finance relies on an alarmingly fragile path and places the economy on a razor’s edge (unsustainable) balance.

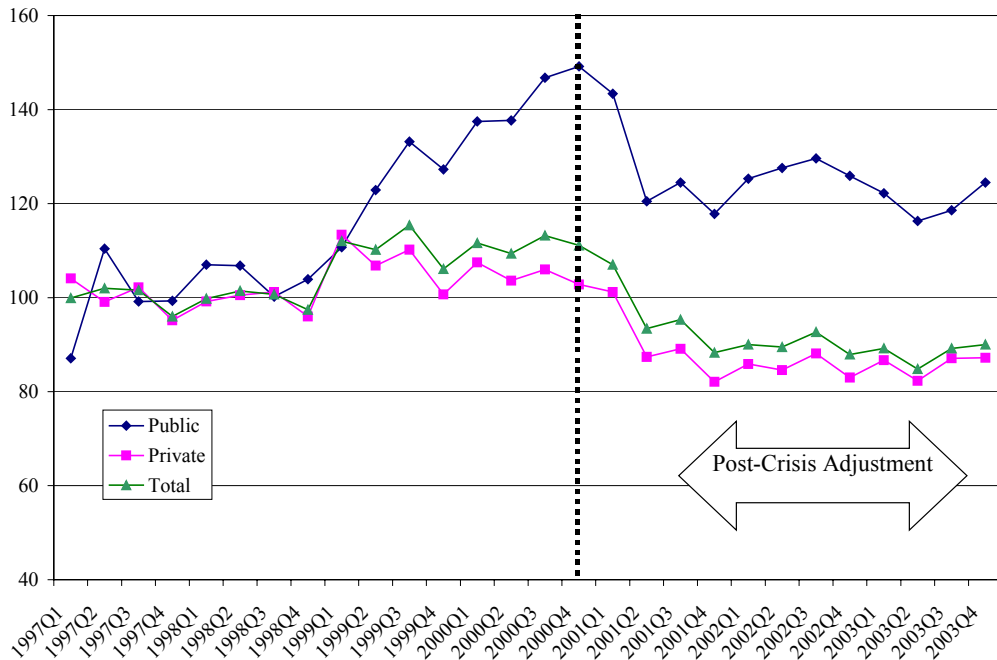
**Figure 5. Current Account Balance(Mill US\$)**



**IV. Labor Markets: Declining Real Wage Incomes, Rising Open Unemployment**

Such a transfer of the financial surplus through very high real interest rates offered to the financial system would, no doubt, call for repercussions on the primary categories of income distribution. It is clear that creation of such a financial surplus would directly necessitate a squeeze of the wage fund and a transfer of the surplus way from wage-labor towards capital incomes, in general. It is possible to find evidence of the extent of this surplus transfer from the course of private manufacturing real wages. Fig. 6 depicts the dynamics of the private manufacturing real wages. Real wages contracted severely after the 2001 February crisis and this collapse has not yet been compensated throughout 2002 and 2003. Calculated from the beginning of the IMF-led disinflation programme in early 2000 to the end of 2003, the decline in the private manufacturing real wages reached 18.9%. The decline of wages in the public manufacturing sector has been 9.5% during the same period. Viewed from a longer time horizon, if the index of real wages were assumed 100 in 1997, it is observed that they fell to 87.2 index points in the private manufacturing sector, and to 90.1 for aggregate manufacturing as a whole.

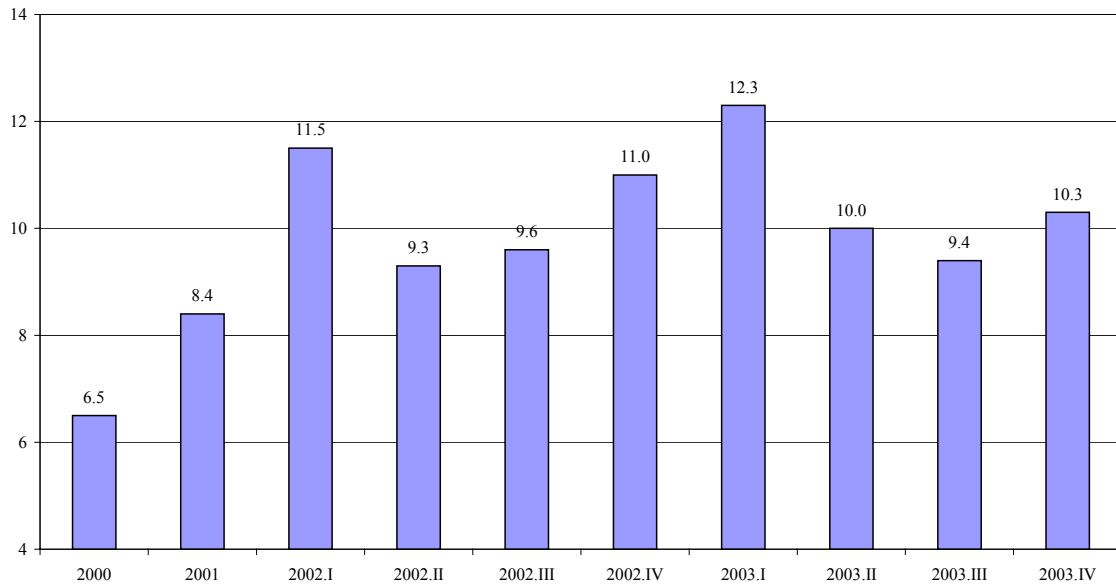
Figure 6. Real Wage Indexes in Manufacturing (1997=100)



Parallel to these developments in the labor markets, we witnessed a surge in the unemployment rates. *Open* unemployment rate was 6.5% in 2000. In 2001, the official rate of open unemployment rose to 8% in 2001, and accelerated to reach 10.3 in 2003. (See Figure 7). More alarmingly, the rate of unemployment among the educated urban young labor force is reported to have risen to 31.1% by the end of 2003. This ratio was 28.7% in 2001. Thus, the problem of unemployment persists and is actually deepening in the absence of new investments and an ideological preference towards contraction and austerity in the name of stabilization and debt repayments.



**Figure 7. Open Unemployment Rate (%)**



## **V. Conclusions: Unveiling the Façade of a Dogma**

The tacit dilemma faced by the Turkish authorities is simple, yet bitter: in order for the output growth to be maintained, the economy is addicted to short term foreign finance which in turn necessitates relatively high interest rates to be offered as a “new emerging market” in the global financial markets, which raises real interest rates to exorbitant levels even with high Turkish inflation rates. Yet, high real rates of interest run counter to the objective of debt sustainability via successful primary surplus operandi. Availability of cheap foreign exchange lured by attractive real returns thus far has become instrumental in reducing costs of imported intermediates and lowering inflationary expectations. It has also been the sole source of output growth in an otherwise contractionary macroeconomic environment.

However, such sources of growth virtually depend on the speculative caprices of the financial arbiters, and the increased fragility of the Turkish macroeconomic environment signals an unsustainable output performance for the days to come. Such “speculative-led” characteristics of the Turkish growth cycle resemble the 1990-93 and the 2000.I-2001.I cycles of (unsustainable) growth—crisis—post crisis adjustment, with bitter lessons that hopefully should have been well-understood by now. Yet, the pleasures of cheap foreign exchange bonanza together with high real rates of interest are too dear for the myopic speculators, domestic and foreign alike, and the dangers of such speculation-led accumulation seem, unfortunately, not to be appreciated yet by the so-called market participants.

The neoliberal dogma puts an almost religious faith in the stability characteristics of free markets. Accordingly, given the undistorted price signals of free markets (as well as that of a “floating exchange rate regime”), market participants would, in an optimizing framework, smooth out their expenditure plans, and that the realized production and expenditures patterns should be regarded as first best outcomes. The fact of the matter is actually quite a different

story with high and persistent real interest rates, and a self-distorting foreign exchange market operating through attacks of speculative hot money flows into the fragile and shallow asset markets, luring the residents in an ever-ending spiral of debt accumulation, increased dependence on imports, and jobless growth patterns.

In the summarizing words of the UNCTAD's *1998 Trade and Development Report*, "the ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. (...) In particular, financial deregulation and capital account liberalization appear to be the best predictor of crises in developing countries" (pp.v and 55). Economic crises are often associated with deterioration of the macroeconomic fundamentals in the recipient country. However, "such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies". (*ibid*, p. 56).

The simple and unrealistic models of *imaginary capitalism* prepared in the IMF's seminar rooms unfortunately still fail to grasp this plain, yet bitter, lesson that the crisis episodes of 1990's have taught us very clearly.