

**ON THE STRUCTURAL WEAKNESSES OF THE POST-1999
TURKISH DIS-INFLATION PROGRAM**

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ABSTRACT

Turkey initiated an extensive dis-inflation program in December 1999 backed and supervised by The International Monetary Fund (IMF). The Program aimed at decreasing the inflation rate to a single digit by the end of 2002. It exclusively relied on a nominally pegged (anchored) exchange rate system for dis-inflation and on fiscal prudence. In November 2000, however, just after one year from its introduction, Turkey experienced a very severe financial crisis which deepened and continued to-date. In this paper we highlight the structural weakness of the exchange rate backed dis-inflation program as manifested in its liquidity creation mechanism in a small and fragile financial system such as Turkey. We document the fragility indicators of the Turkish banking system, and show that the dis-inflation program led to an increase of the vulnerability of the banking system throughout 2000/2001. Given the structural characteristics of the Turkish banking system, we argue that the orthodox policy of fully connecting the monetary expansion and liquidity requirements of the domestic economy exclusively to the speculative short term capital flows was clearly a design flaw, overseen by the IMF's technical expertise.

I. Introduction

Turkey initiated an extensive dis-inflation program in December 1999 backed and supervised by The International Monetary Fund (IMF). The Program aimed at decreasing the inflation rate to a single digit by the end of 2002. It exclusively relied on a nominally pegged (anchored) exchange rate system for dis-inflation which has been a major concern for the Turkish policy makers for over three decades. In November 2000, however, just after one year from its introduction, the country experienced a very severe financial crisis. More than US\$ 6 billions of short term capital fled the country, creating a severe liquidity shortage and sky-rocketing interest rates.

In Early December 2000, The government requested access to the Supplemental Reserve Facility of the IMF. The request was granted with US\$7.5 billions of additional support in December 22, and the technical targets of the monetary program have been revised. Only then continued implementation of the program could have been secured as the markets seemed to have calmed down. However, shortly after this rearrangement with the IMF, the public disclosure of a political dispute between the Prime Minister and the President of the

Republic on February 19, 2001 badly hit the uneasy markets. The Central Bank was forced to sell a large portion of its foreign reserves in an attempt to support the *Lira* as the short-term interest rates rocketed to above 5,000 percent. In what follows, the government could not endure the pressures of the markets any further, and declared the surrender of the pegged exchange rate system on February 22, thereby letting the exchange rates to free float.

Following the demise of the exchange rate based disinflation program, the newly appointed minister, Mr. Kemal Dervis (former Vice President of the World Bank), submitted a new letter of intent to the IMF. Finally in May 15, Mr. Dervis announced the invigoration of a new stabilization effort under the guidance of the “Transition to the Strong Economic Program”. As it was mentioned in its introduction, the new program would be the continuation of the previous disinflation program, and would be backed by a series of “structural reforms” aimed at strengthening the banking system and at transforming the “old ways of economic policy making”.

The September 11 terrorist attack undermined the implementation of the program, affecting investors’ perceptions adversely. The Turkish government requested, in turn, a new three-year stand-by arrangement for offsetting the detrimental effects of the external shock. The Fund accepted the new letter of intent dated January 18, 2002 with a considerable amount of financial support.

The last two stand-by arrangements should clearly be regarded as the continuation of the disinflation program launched at the end of 1999, and were implemented after the destructive results due to its failure. Thus, the main framework of the program itself, as well as the crisis episode have constituted an extensive source of debate since its implementation.¹ In particular, it was alleged by the former deputy managing director of the Fund, Mr. Stanley Fischer,² that the difficulties in Turkey relate more to the banking sector and to the deterioration of macroeconomic fundamentals. In particular, according to Mr. Fisher, the underlying cause of the crisis was due to the *failure to undertake corrective fiscal measures* against the deteriorating current account balances, rather than any errors in program design concerning the exchange rate backed dis-inflation.

It is the purpose of this paper to assess this assertion given the available macroeconomic evidence from Turkey. In particular, we highlight the structural weakness of the exchange rate backed dis-inflation program as manifested in its liquidity creation mechanism in a small and fragile financial system such as Turkey. An analytical inquiry into the structural causes of the Turkish crisis is clearly not limited to a theoretical curiosity, as such an inquiry has clear implications for stabilization policy and for the culpability of the IMF-style austerity programs. Given the painstaking financial crisis episodes of the 1990's in the developing world, such a stock-taking on the theoretical underpinnings of the orthodox stabilization plans is both timely and urgent. The paper is planned as follows: In the next section we highlight the underlying liquidity generation mechanism of the 2000 Turkish dis-inflation program. We document the fragility indicators of the Turkish banking system in Section III, and argue that the dis-inflation program led to an increase of the vulnerability of the banking system throughout 2000/2001. In Section IV we briefly overview the fiscal fragility indicators of the

¹ The underlying elements of the disinflation program and the succeeding crises are discussed in detail in Yeldan, 2002; Boratav and Yeldan, 2002; Ertugrul and Selcuk, 2002; Eichengreen, 2001; Gencay and Selcuk 2001, Alper, 2001; and Yeldan, 2001.

² Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct? (Distinguished Lecture on Economics in Government) *Journal of Economic Perspectives*, 15(2): 3-24, Spring, 2001.

public sector and study the behavior of the interest rates under the program. Finally in Section V we summarize and offer some concluding comments.

II. The Liquidity Generation Mechanism under the Disinflation Program

The Program limited the monetary expansion to changes in the net foreign asset (NFA) position of the Central Bank, and fixed the Bank’s stock of net domestic assets (NDA) at its December 1999 level. It was further announced that the CB would be allowed to change its net domestic asset position within a band of +/-5 percent of the monetary base, to be revised at three-month intervals.

The implication of the rule necessitated the following identity.

$$\text{Monetary Base} = \text{Net Foreign Assets} + \text{Net Domestic Assets}$$

Consequently, as a result of the restrictions set on the upper ceilings of the net domestic assets, the program limited the monetary expansion only to increases in the stock of net foreign assets.³

Thus, according to this rule, the liquidity generation mechanism available to the CB practically entailed a regime of a semi-currency board in its monetary operations. Within this mechanism the monetary policy is restricted to the direction of the foreign exchange flows, and as such, the most important element to be able to sustain the liquidity needs of the economy would depend upon the properly continuation of the foreign credit flow into the system.

The fact that the expansion of the monetary base was ultimately linked to the foreign exchange inflows indicated that the CB was committed to the strict rule of *no-sterilization* throughout the program. In this manner, it was expected that the liquidity available in the domestic economy would be managed by the interest signals in smoothly operating financial markets; rising domestic interest rates would invite foreign inflows allowing for monetary expansion. Excess liquidity, in turn would be signaled through lower rates of interest, letting foreign capital outflows to bounce once again the equilibrium level of liquidity in the domestic financial markets.

Yet, with the eruption of the first warning crisis in November 2000, and then again in February 2001, it was clear that the basic foundations of the liquidity creation mechanism were at fault. In fact, given the shallowness and fragility of the Turkish financial system, it proved incapable of bringing forth such smooth adjustments towards equilibrium as was envisaged by the program designers. In Table 1 we lay out the basic characteristics of the financial system.

<insert table 1 here>

³ Yet, it is clear that from the point of view of the CB’s analytical balance sheet, expansion of the monetary base would only be possible through increased foreign earnings which would not call for an increase in the foreign liabilities of the CB. This means that the CB would not be able to increase the stock of money supply by, for example, borrowing foreign exchange from the banking system or by using IMF’s credit facility. The CB would be able to issue Turkish Lira and expand its monetary base only by purchasing foreign exchange from the banking sector in a manner where its foreign liabilities would not be increased.

As indicators tabulated in Table 1 reveal, the strategy of “public sector deficit financing based on short-term foreign borrowing” led the banking system to be more vulnerable against the foreign exchange and interest risks. Increasingly unhedged risk-taking behavior, coupled with a remarkable build-up of the short positions in foreign currency in the banking sector, raised serious doubts about the sustainability of the short-term capital inflow-based public debt management policies. Despite this fact, the dis-inflation program chose to rest the domestic liquidity creation mechanism on unsustainable short term capital flows, which by their very nature, are excessively volatile, excessively erratic, and are subject to herd psychology.

As manifested in Table 1, total assets of the banking sector to the ratio of GNP stood at around 80%. On the other hand, the sheer size of the volume of short term foreign capital flows intermediated through the banking sector is clearly indicative of their gross volatility and erratic movements. The volume of inflows of banking credits abroad reached to US\$122.6 billions in 1999, and to US\$209.6 billions in 2000. Consequently, the ratio of short term debt rose abruptly over 2000. Yet, the authors of the *Letter of Intent* had envisaged that possible increases in CB reserves would be able to match the increase in outstanding short term foreign debt, and that Turkey would be able to remain sound externally. However, during the course of the year the banking sector had succeeded in increasing the net inflows of foreign credit by US\$4.7 billions to reach a total of US\$11.1 billions. During this process, total short term debt stock of the banking sector had increased to US\$16.9 billions from its level of US\$13.2 billions. The lure of the uncontrolled flows of speculative gains clearly unleashed all its might throughout 2000, during when the currency risk was eliminated and the whole liquidity generation mechanism was based on the short term, hot money inflows.⁴

Another indicator of structural fragility present in the system pertains to the degree of dollarization. Measured as the ratio of foreign exchange deposits to total deposits of residents, this ratio, which was as high as 55% in 1995, stood at 45% just before the inception of the program. The ongoing currency substitution had severely limited the capability of the monetary authority to control the domestic liquidity.

Thus, ignoring these historical attributes and structural characteristics of the banking system, the orthodox policy of fully connecting the monetary expansion and liquidity requirements of the domestic economy exclusively to the speculative short term capital flows was clearly a design flaw, overseen by the IMF's technical expertise.

III. The Program Increased the Vulnerability of the Banking System

The underlying cause of the Turkish currency crisis cannot be attributed to the failure of the fiscal and / or monetary authorities in maintaining the main targets of the program. Throughout the year, exchange rate devaluation followed the programmed schedule, and the Central Bank successfully controlled expansion of the monetary base by constraining its net domestic asset position within the program limits. Similarly, the fiscal operations were in line with both the revenue and expenditure targets, and the non-interest primary balance on the

⁴ According to Boratav and Yeldan's (2002) calculations, before the November 2000 crisis non-residents have brought a total of 15.2 billions \$ of “hot money” into the Turkish asset markets, while the residents enabled an *outflow* of 5.3 billions \$. Thus, during the course of the program, much of this accumulated short term debt had financed residents' capital flight.

consolidated budget succeeded in attaining the end-of-year target by as early as September.⁵ Yet, the crisis conditions emerged in due course, mainly as a result of the increasing fragility in the financial system. This fragility, in turn, was generated by the uncontrolled and excessively volatile capital flows with an exceedingly speculative component. Under the liberalized (open) capital account system, capital inflows intrinsically necessitated a higher rate of return on domestic assets in comparison to the rate of depreciation. This commitment stimulated further foreign capital inflow, and the domestic currency continued to appreciate inviting an even higher level of speculative capital inflow.⁶

In the context of the Turkish dis-inflation episode, debt financed public deficit and rapid acceleration of private expenditures escalated inflows of short term foreign capital, and severely increased the vulnerability of the shallow banking system. As a result, the ratio of the short-term foreign debt to The Central Bank's international reserves rose secularly throughout the program. (Table 1). This ratio is regarded as one of the crucial leading indicators of external fragility. It could be argued that the value of 60 percent for this ratio is considered as a critical threshold from the point of view of international speculation. (See, e.g., Kaminsky, Lizondo and Reinhart, 1998). It is alarming to note that in Turkish case, this particular ratio has never fallen below the 100 percent mark since the liberalization of capital account in 1989. Thus, the Turkish financial system has been operating constantly under the "danger zone" for past twelve years as far as this indicator is concerned. During the implementation of the disinflation program this ratio rose up to 112 percent in June 2000, and to 147 percent by December 2000.

Thus, the implementation of the Program itself increased the financial fragility of the domestic asset market. The combined effect of an easy deficit financing policy, together with its liquidity creating mechanism allowing for no-sterilization, had induced many commercial banks to shift their asset management policies toward bond financing activities. The share of government debt instruments in total assets rose from 10,3 percent in 1989 (completion of capital account liberalization), to 21.3 percent in 1999, and to 19.8 percent in 2000. The growing willingness of banks to increase their bond financing activities under these conditions has increased the fragility of the financial sector against uncovered interest risk. In addition, aggressive security management policy of some commercial banks raised further doubts concerning their sustainability.

It has to be further noted in this context that, since the liberalization of the capital account in 1989, the asset and liability structures of the banking system changed substantially. The liability dollarization ratio increased from 25 percent to 48 percent at the end of 1999. In the same period asset dollarization rose from 26 percent to 38 percent, and the share of the dollar denominated deposits rose up to 55 percent. Short term foreign capital inflow-based deficit financing policy of the government accompanied by high real rates of interest incited the commercial banks to extend their short positions in foreign currency, overlooking prudential asset-liability management.

⁵ The non-interest –primary– budget surplus was targeted at 3.1% of the GDP within the program. The end-of-year realization reached to 5.4%. Clearly, the fiscal austerity objectives were reached by far under the program. See, Yeldan (2002) for further discussion on the fiscal stance of the Turkish public sector in 2000.

⁶ Elements of this *vicious cycle* are well-known and are studied extensively in the literature. See, e.g., Diaz-Alejandro (1985), Velasco (1987), Dornbusch, Goldfajn and Valdés (1995), Calvo and Vegh (1999), Adelman and Yeldan (2000), and Polanyi-Lewitt (2001).

In Figure 1 we portray the foreign versus domestic (TL) liability and asset structure of the banking system over the 1990's. The secular rise of the *open position* of the banking system after 1996 is clearly visible. During the implementation of the program, with the elimination of currency risk, the net short position of the banking system nearly doubled, deepening the vulnerability of the banking system against foreign currency risk. (See also, Eichengreen, 2001).

<insert Figure 1 here>

In sum, the program and its liquidity creation mechanism deepened the vulnerability of the banking system against the market risks which have been inherently culminated since the liberalization of capital movements.

IV. The Structure of Fiscal Fragility and the Behavior of Interest Rates

Given the past experience on exchange-rate-based stabilization programs, it is now regarded as an *empirical regularity* that they initially generate a demand-based expansion accompanied by rising and usually unsustainable trade and current deficits followed by a contractionary phase –the magnitude of which depends on the size of the earlier external deficits. During the course of implementation, these programs are often associated with the build-up of a bubble in the asset markets. Yet, as the fragility of the banking system against market risks rise and doubts about the program's sustainability are intensified, capital inflows reveal a “sudden stop”, heavily squeezing liquidity and rocketing domestic rates of interest.

This sequence is well matched with the traditional transmission mechanism of exchange rate based stabilization programs,⁷ and, in particular, the November 2000 and February 2001 crisis episodes in Turkey.

In a financially shallow economy and a fragile banking system, the first disrupting effect of sudden stop and capital reversal is observed on the interest rates. This is due to the fact the transmission of any monetary disturbance to the rest of the economy is conducted by interest rates and exchange rates. Yet, since the exchange rate-based disinflation programs are explicitly designed to cut off any corrective adjustments of the exchange rates, the full effect of the monetary disturbance is bound to take place on the real interest rates.

In the Turkish context, this mechanism can be summarized by following causal relation: The un-sterilized changes in net foreign assets of the central bank induced changes in the monetary base, and those were transmitted to the other real and nominal variables by changes in the interest rates, as exchange rates were nominally anchored. Under these conditions, the effects of the speculative capital movements on the interest rates would be magnified. The program overlooked this causal relation and ignored its destructive effects in a fragile banking system.

⁷ An overview of such *exchange rate-based* disinflation and stabilization is summarized in Calvo (2001), Calvo and Vegh (1999), Amadeo (1996), Agenor (2000), Akyuz and Cornforth (1999), Calvo, Leiderman and Reinhart (1996), Diaz-Alejandro (1985), Kaminsky and Reinhart (1999), Frenkel (1995), and Agenor and Montiel (1999, chp. 8). For individual country experiences see also Corbo (1985), and Edwards and Edwards (1991) on Chile; Dornbusch and Werner (1994) on Mexico; Patinkin (1993), and Bruno (1993) on Israel; and Dornbusch (1995), Frenkel and Fanelli (1998) on Argentina; and Eichengreen (2001) on Argentina and Turkey.

In fact, the starting conditions of the program openly revealed the structural fragilities of the fiscal accounts and the consequent vulnerability of the financial system against interest risks. The data depicted in the Table 2 indicate the deteriorated fiscal stance of the economy. The program took over a financially fragile fiscal position of 11.6 budget deficit-GNP ratio, with interest costs on domestic debt reaching 13.7 of the GNP. In addition to the fiscal deterioration, accrued *duty losses* (quasi-fiscal deficits) of the public banks reached to 12 percent of the GNP (more than 50 percent of their total assets) in 2000. These accrued but unpaid duty losses created a very heavy pressure on the liquidity requirement, and increased the distortionary effects on the rate of interest.

Critical indicators on domestic debt management underscore the sensitivity of fiscal balances to the interest rates: interest payments on domestic debt claimed a rising portion of tax revenues of the consolidated budget in the 1990's. In 1999, this ratio stood at 66.4 percent of the tax revenues. Similarly, the fact that the net new domestic borrowing constituted half of the existing stock of domestic debt over the 1990's clearly revealed the *Ponzi*-character of unsustainable debt management. Interest payments on domestic debt as a ratio of net new domestic borrowing reached to 97.9 percent in 1999, and was 87.5 percent in 1999, just before implementation of the program.

<Table 2 here>

Given these structural conditions, the program should have envisaged the destructive effects of a possible liquidity squeeze on the interest rates and on the fiscal balance. Under conditions of such interest risk with a pacified central bank, having all macro adjustment mechanisms tied to the interest rates constituted a clear theoretical oversight. The Central Bank was deprived of all its traditional tools of austerity and crisis management and was left defenseless against possible "speculative attacks" and "sudden stops". Under these conditions, it has to be no surprise that the viability of the program would finally suffer at one point when the "uneasy speculators" shift focus, and decide to reverse their flows, leaving the incipient country illiquid and dried out.

V. Conclusions

The Turkish crisis which came in the aftermath of an exchange rate-based disinflation attempt, followed all the well-documented empirical regularities of such programs: a demand-based expansion accompanied by rising and usually unsustainable trade and current deficits followed by a contractionary phase –in the form of liquidity squeeze; sky-rocketing interest rates, and negative growth. The main weakness of the 2000 dis-inflation program was its exclusive reliance on speculative short term capital inflows as the source of liquidity generation mechanism. Overlooking at the existing structural indicators of financial fragility and resting the liquidity generation mechanism on speculative in –and –out-flows of short term foreign capital, the program has left the economy defenseless against speculative runs and a "sudden stop".

The failure of the Program cannot be completely tied up to lack of ability of the Government to undertake accurate actions. By deepening the vulnerability of an already shallow and fragile financial system, the underlying liquidity generation mechanism raised doubts about sustainability of the Program itself.

In sum, muddled with short sighted myopia and speculative herd behavior of domestic and foreign financial arbiters, the IMF-directed Turkish disinflation episode all too clearly spells the dangers of restricting the monetary policy of an economy to speculative in-and-out-flows of short term foreign capital, which by itself, is excessively liquid, excessively volatile, and is subject to herd psychology.

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Table 1. Basic Characteristics of the Financial System

	Banking Sector Foreign Credits			Net Short Term Capital Flows (Bill US\$)	Current Account Balance / GNP	Total Foreign Debt / GNP	Short Term Foreign Debt / CB Reserves	Currency Substitution ^a
	Total Assets of the Banking Sector / GNP	Volume of Inflows (Bill US\$)	Volume of Outflows (Bill US\$)					
1995	52.2	76,427	75,626	3,713	-1.4	42.8	126.7	54.8
1996	59.4	8,824	8,055	5,945	-1.3	46.2	106.6	50.9
1997	65.9	19,110	18,386	1,761	-1.4	47.8	96.2	48.6
1998	69.4	19,288	19,225	2,601	1.0	50.9	107.6	45.1
1999	92.1	122,673	120,603	759	-0.7	55.7	101.3	45.2
2000	82.8	209,432	204,691	4,035	-4.8	58.3	147.2	44.1

a. (Rate of Dollarization): Ratio of foreign exchange deposits to total deposits of residents.

Sources: Central Bank Balance of Payments Statistics; SPO Main Economic Indicators.

Figure 1. Foreign Assets, Liabilities and Open Positions of the Banking Sector

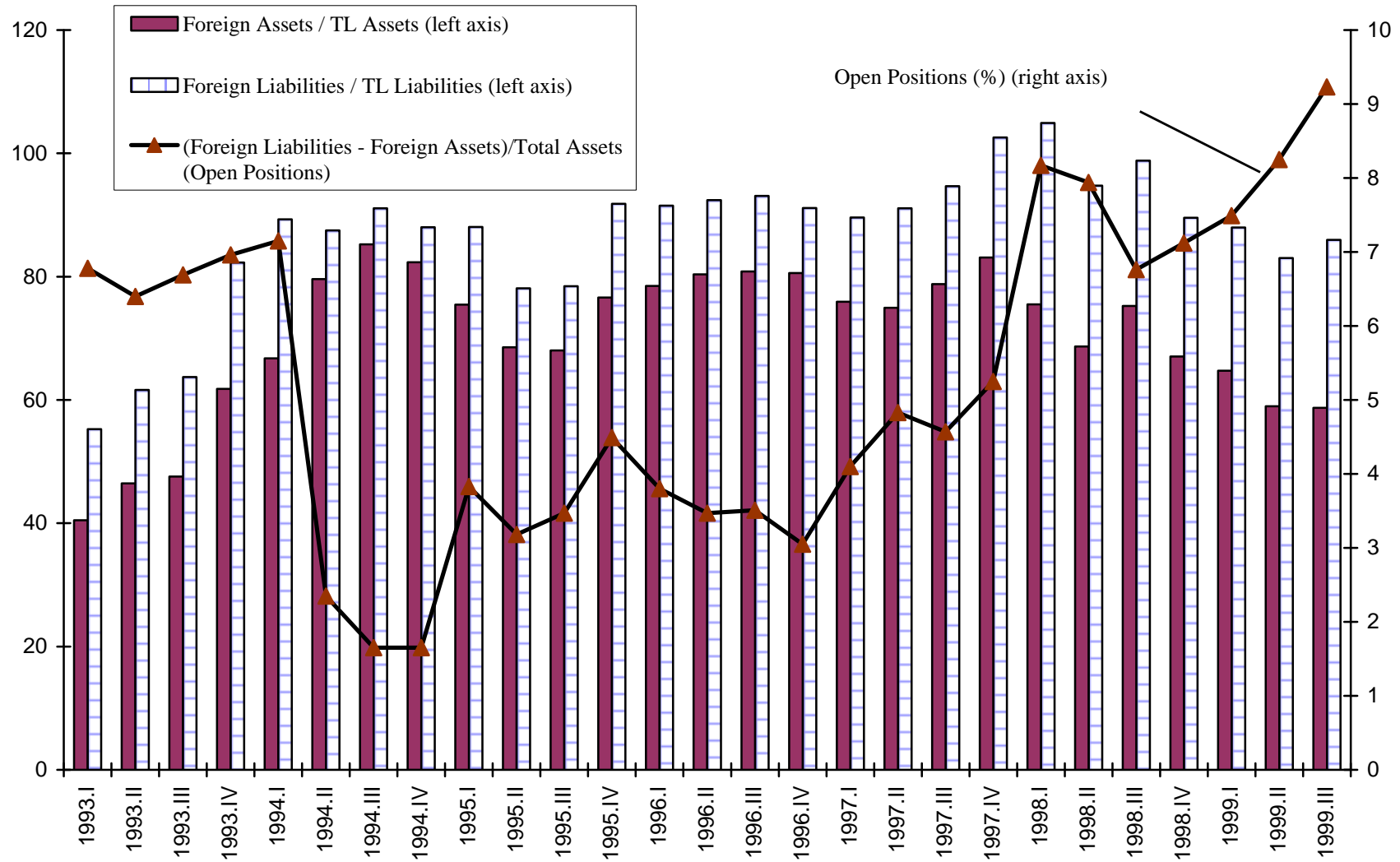


Table 2. Fiscal Indicators: Turkey, 1995-2000

	1995	1996	1997	1998	1999	2000
<i>As Ratio to the GNP (%)</i>						
PSBR	5.2	8.8	7.6	9.2	15.1	12.5
Budget Balance	-4.0	-8.3	-7.6	-7.0	-11.6	-10.9
Non-interest Primary Budget	3.4	1.7	0.1	4.7	2.1	5.4
Stock of GDI's ¹	14.6	18.5	20.2	21.9	29.3	29.1
Interest Payments on:	7.5	10.2	7.7	11.7	13.7	16.4
Domestic Debt	6.2	9.0	6.7	10.6	12.6	15.3
Foreign Debt	1.3	1.2	1.0	1.0	1.1	1.1
Interest Payments / Total Tax Revenues (%)	43.9	59.2	41.7	61.0	66.4	63.7
Interest Paym. on Dom. Debt / Net New Dom. Borrowing (%)	93.7	83.1	63.5	97.9	87.5	137.8
Net New Dom. Borrowing / Domestic Debt Stock (%)	52.4	57.8	52.4	49.5	49.3	37.1

Sources: SPO Main Economic Indicators ; Undersecretariat of Treasury, Main Economic Indicators.

(1) Government Debt Instruments. (Gov. Bonds + Treasury Bills). Exclusive of Central Bank Advances and Consolidated Debts.