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TURKEY: ON THE ROAD AGAIN*

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"I think at the beginning of 2002, if anyone had told you that Turkey could grow at 7.8 percent last year, around 6 percent this year, bring the inflation rate down to 20 percent at the end of this year, everybody would have known you were absolutely crazy. And yet it has been done, and the program is working."

Anne Krueger
First Deputy Managing Director, IMF
September 12, 2003

Imagine an economy with an ever-rising domestic debt and record level real interest rates, a high and persistent inflation, an extremely weak and shallow banking sector (occasionally, with some corrupt bankers), political instability, and a geographical location with constant turmoil in neighboring countries. On top of this situation, add a dramatic collapse of a fixed exchange rate based stabilization program that resulted in a market-forced devaluation followed by a floating exchange rate regime. Is it possible to conduct a policy such that the volatility of the exchange rate may be contained and the implicit inflation targeting may result in significantly lower inflation rates, while the real output growth picks up? The recent developments in the Turkish economy show that the answer is yes, but with a significant risk.

Following the February 2001 crisis, Turkish authorities faced several difficulties. They had to convince the public that the on-going stabilization program was in order and the coalition government was intact without any political uncertainty. The challenge for the Central Bank was to re-establish confidence and to contain volatility in financial markets, while pursuing an implicit inflation targeting policy in a floating exchange rate system. It was a daunting task in the sense that Turkey had a long history of high inflation, and had never experienced a free float. The collapse of the fixed exchange rate stabilization program further eroded the credibility of the Central Bank and reinforced the belief in Turkish economic circles that no policy announcement by the authorities could be fully trusted.

The appointment of a World Bank veteran Kemal Dervis as the State Minister in charge of the treasury (in effect, the whole economy) and the renewal of the stand-by arrangement with the IMF provided some relief in the spring of 2001. Nevertheless, some members of the coalition parties were uneasy about Dervis's economic views and there was a constant quarrel between Dervis and the cabinet members on issues concerning the conduct of the stabilization program. Finally, in the summer of 2002, the government announced its intention to go to early general elections, paving the way for another period of political uncertainty. Public opinion polls revealed that a newly formed center right party with strong conservative roots, the AKP (Justice and Development Party) would be a clear winner in the upcoming elections. The leading figures among the AKP administration exerted every effort to convince the market participants that the party was willing to continue with the existing stabilization program, while cautiously calling for strengthening the social components of the program. Nevertheless, there was an understandable uneasiness among both domestic and foreign investors since the party was new and its policy agenda was a "pandora's box". The AKP became a winner of November 3, 2002 elections with a strong majority in the Parliament.

Given the conservative characteristics and religious roots of the party, the concerns that the new government would pursue inward oriented policies were partly justified. The government faced its first international problem before the war in Iraq early 2003. The US request to use Turkey as a launching pad in the operation against Iraq left the government as well as the conservative members of the Parliament bewildered. A government motion to permit the passage of US troops through southern Turkey was not approved by the Parliament. Suddenly, the stock market went down, interest rates on both domestic and foreign debt stock started to rise and the government's ability to roll over the existing debt was in jeopardy. Once again, the government had to convince market participants that the stabilization and structural reform program was in order and the government would stick with sound fiscal policies and would keep good relations with international financial agencies, such as the IMF. Since then, every effort has been made by the AKP government to substantiate its claim that the economic program is intact.

Probably the most impressive policy action by the AKP government was taken in the summer of 2003. The Parliament passed a series of new legislative acts as well as radical amendments to existing regulations to bring the Turkish legal infrastructure in line with that of the EU. The IMF agreed to move part of Turkey's repayments to the Fund from 2004-05 to 2005-06, which increased the market sentiment in general. More recently, the relationship between Turkey and the US has been normalized and a low interest rate loan package from the US, totaling USD 8.5 billion, has been received. Furthermore, there have been encouraging signs that the government is serious in taking radical measures to fight corruption and to restructure the public sector. A voluminous report by a Parliamentary committee initiated by the AKP government lists hundreds of cases of wrongdoing and corruption in the public sector and recommends further investigation and restructuring. Recently, a criminal case was opened against the family of a local tycoon, Cem Uzan, when a series of investigations revealed that Uzans siphoned more than USD 6 billion from the family-owned bank. It is worth noting that the family has engaged in dubious activities across various lines of businesses for a long period of time. These developments and on-going fiscal discipline are welcomed by both domestic and foreign investors, and have further increased their confidence in authorities. As of October 2003, the Turkish economy seems to be back on track.

An impressive development has been observed on the inflation front during the AKP administration. Annual inflation went down from almost 100 percent to 20 percent. The changing nature of the currency substitution in the economy played an important role in this process. A recent study by the Federal Reserve reveals that around 60 percent of all US currency, or about USD 365 billion, is held outside the United States. In that study, Turkey ranks as the fifth largest U.S. currency holder with an estimated USD 10 billion in circulation. As any causal observation would suggest, the US currency in circulation in Turkey as a medium of exchange is only a small fraction of the Turkish lira in circulation. Therefore, it may be assumed that a significant portion of the US currency is held as a “store of value” which is labeled as “under the mattress” dollars. During the floating exchange rate regime, the economic agents realized for the first time in 20 years that there was a downward risk of holding a foreign currency. The average monthly change in TRL/USD exchange rate was 4 percent between January 1980 and December 2000 with almost all monthly changes being positive. After the float, the same monthly average is 0.6 percent with 14 months of negative and 13 months of positive change. In addition to this uncertainty, a severe recession in 2001 and a sharp drop in real income and real wealth as a result of the jump in general price level might have caused households to liquidate part of their wealth, accumulated as precautionary savings in the form of US currency. This and other developments in the supply side of the foreign exchange market helped the Central Bank to contain volatility and fight inflation. The annual inflation is expected to be less than 20 percent at the end of this year, significantly lower than 99 percent (WPI) or 68.5 percent (CPI) of 2001. The stalled nominal depreciation during the float was a major contributor to this result. Meanwhile since the fall in inflation was much less than the fall in nominal depreciation, the Turkish lira appreciated at record levels. This development has certain business cycle implications for the economy.

The Turkish economy is a textbook case study of boom-bust cycles generated in part by real exchange dynamics, especially after the capital-account liberalization in 1989. The mechanism that generates these cycles is as follows: In general, after a positive shock to the real exchange rate (an appreciation), the interest rate parity condition leads to a lower domestic real interest rate. In turn, this results in an increase in domestic demand, especially with respect to the private durable and semi-durable goods consumption, private investment, and stock replenishment. As a result, the economy starts to expand. On the other hand, the demand for imported goods increases and the current account registers a deficit. Eventually, a reduction in consumption and investment, and a real depreciation is inevitable because of resource constraints. Therefore, the economy experiences a recession with a "correction" in the nominal (and real) exchange rate.

The initial real depreciation in February 2001 was later reversed and the real exchange rate came down to its pre-crisis level in January 2002, exactly one year after the crisis. Despite some fluctuations, the appreciation continued and the real appreciation between 1995 and July 2003 was between 35 percent (WPI) and 45 percent (CPI), according to Central Bank figures. The negative effect of the substantial appreciation of the Turkish lira on the external competitiveness was offset to a large extent by a sharp increase in labor productivity and a fall in real wages during the same period. The labor productivity in the private manufacturing industry went up by 20 percent between February 2001 and December 2002, accompanied by a fall in nominal wages in USD terms. As a result, the unit wage index in the private manufacturing industry decreased by 30 percent in USD terms. However, this trend seemed to come to a halt in the first quarter of 2003, during which the unit wage increased only slightly compared to the first quarter of the previous year. It is crucial for the government to take further action to accelerate the structural reforms and attract a significant level of foreign direct investment to boost overall productivity in the economy. Otherwise, the current real exchange rate level may not be sustainable and the float period might turn out to be another episode of appreciation-depreciation and boom-bust cycles in the Turkish economy.

Another—perhaps the most important—risk remains in public finance. In its simplest form, the public debt dynamics are determined by the real interest rate, the real growth rate of output, and the primary deficit as a percentage of the real income. The general sustainability condition is such that the debt ratio should not be ever increasing, i.e., change in debt ratio should not be positive on the average in foreseeable future. The public debt-income ratio in Turkey increased dramatically after the February 2001 crisis, mainly as a result of the losses of public banks and the cost of the bailed out private banks:

Table 1. Public Debt-GDP ratio, in percent. Source: The Central Bank and the Treasury.

	1997	**1998**	**1999**	**2000**	**2001**	**2002**
Domestic	21.4	21.7	29.3	29.0	69.2	54.8
Foreign	20.0	19.4	22.6	23.7	32.1	35.1
	41.4	**41.1**	**51.9**	**52.7**	**101.3**	**89.9**

The ratio is expected to go down to 70 percent at the end of 2003, mainly as a result of real appreciation. Falling debt-income ratio is good news. The level of real interest rates would also be falling from the 30-40 percent range of previous years to around 15 percent at the end of this year. This is also good news. Assuming a 5-6 percent real growth rate, the debt sustainability condition requires a 6-7 percent primary surplus, just to keep the debt ratio constant. Fortunately, the government so far has been keen on securing this level of primary surplus.

Despite such positive developments, thanks to the AKP government, the current situation still remains fragile: an increase in the real interest rates as a result of an adverse shock to system; a significant real depreciation for the reasons mentioned above; and a slow down in the growth rate because of resource constraints would harm the economic recovery, increasing the required primary surplus. A glance at the budget figures reveals that the government is operating at the limit. The public investment expenditures are in their lowest level in real terms, signaling that the economic infrastructure is falling apart. Assuming no adverse shock to any of the variables, a 5-6 percent primary surplus for the next 2-3 years requires a significant cut in the public sector employment and/or real wages and salaries. Furthermore, the worsening trend in the social security system, in terms of large deficits, should be reversed immediately. Although the government has been compliant with the program so far, forthcoming local elections, increasing pressure from the public for populist measures and a strong resistance to restructuring and reform process may easily result in a reversal of the sound fiscal polices of recent months, and eventually may cause another calamity in the economy. On this front, the AKP government should give stronger assurances that its firm commitment to the program will endure.

In sum, the Turkish economy is on the road again. It is up to the Turkish policy makers to make sure that the country's economy will leave its grave problems behind and enjoy a bright future.