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The political economy of reform failure and macroeconomic mismanagement

Turkey, 1980–2002

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5.1 Introduction

Turkey's post-1980 history of macroeconomic and political developments under the neo-liberal model is observed to suffer persistent difficulties and wide fluctuations in national income and rates of capital investment, with conflicting policy adjustments. This observation pertains despite the overall thematic continuity with the ambitious programme of economic liberalization and market-led adjustments put into full force during the early 1980s led by the military government and its civilian successors. Currently the most distinguishing aspects of the Turkish political-economy context remain the persistence of price inflation under conditions of a crisis-prone economic structure; persistent and rapidly expanding fiscal deficits; marginalization of the labour force along with the dramatic deterioration of the economic conditions of the poor; and the severe erosion of moral values with increased public corruption.¹

It is the purpose of this essay to identify and study the main stylized facts and processes characterizing the dynamic macroeconomic adjustments of Turkey since the inception of its reforms towards global integration – namely, post-1980s. In what follows, we will regard the state not as an exogenous entity consisting of reform-minded techno-bureaucrats, but rather as an active agent in addressing the often conflicting demands of various social classes and interest groups. We regard the macroeconomic results of this political-economy game as a direct outcome of the endogenously driven cycles of growth, stagnation, delayed stabilization reforms, and crisis. Following the main thematic motivation of this research project, we trace the policy-reform failures not to the inapt short-sightedness and irrational behavior of a set of exogenously given ignorant bureaucrats; but, rather, to the resolution of the social conflict in the creation and distribution of economic surplus wherein the state has found itself as a regulatory agent. In this context, of particular importance is our investigation of culminating inherent tensions of macroeconomic disequilibria embodied in the process of integration to the world markets under conditions of a poorly supervised banking system and underdeveloped, fragile domestic asset markets.

The essay is organized under five sections. In the next, we provide a broad overview of the recent macroeconomic history of Turkey. We find it analytically convenient to decompose this path into three major subperiods partitioned by the strategic steps of commodity trade liberalization in 1980, and then the financial liberalization of 1989 which led to the full de-regulation of the capital account. This latter reform effectively completed the full integration of the domestic market to the global financial markets. We address the modes of accumulation and surplus creation under all three sub-periods separately, and investigate the inherent disequilibria under each episode. A detailed analysis is carried out on the rise of the public-sector deficits, especially following 1990, and the macroeconomic consequences of the expanding fiscal gap on the commodity and the financial markets. The general equilibrium characteristics of the national economy under the constraints of an open macroeconomic environment are discussed in [section 5.3](#). Here, we further introduce the elements surrounding the demise of the IMF-led disinflation programme of 2000 and the February 2002 crisis. [Section 5.4](#), in turn, offers a game-theoretic approach in identifying the main actors and their strategic role in generating dis-equilibria and in sustaining inflationary expectations. Finally, the essay concludes with summary comments in [section 5.5](#).

5.2 Phases of macroeconomic adjustment in Turkey

The 1972–2001 evolution of the Turkish economy is portrayed in [Table 5.1](#). Overall, it is possible to distinguish three distinct cycles of growth-crisis-and-adjustment under the post-1972 Turkish historical path. The first covers broadly the period 1972–9, with its main attribute being the deepening of the import substitutionist industrialization strategy. This period, often regarded as the second phase of import substitution, is characterized by the implementation of a vigorous public investment programme in heavy manufacturing and capital goods. The foreign-trade regime was heavily protected via quantitative restrictions along with a fixed exchange-rate regime which, on average, was overvalued given purchasing parity terms. The state was both an investing and a producing agent with state economic enterprises (SEEs) serving as the major tools for fostering the industrialization targets.

In retrospect, the underlying political-economy basis of the ISI strategy was one of grand, yet delicate, alliance between the bureaucratic elites, industrial capitalists, industrial workers, and the peasantry (Boratav, 1983; Boratav *et al.*, 1984). Private industrial profits were fed from two sources. First, the protectionist trade regime enabled industrialists to capture oligopolistic profits and rents originating from a readily available, protected domestic market. Second, the existence of a public-enterprise system with the strategic role of producing cheap intermediates enabled the private industrial enterprises (and the rural economy) to minimize on material input costs. Industrialists, in turn, “accepted” the conditions of a general rise in the manufacturing wages, and an agricultural-support programme which induced the domestic terms of trade to favour agriculture.

The import substitutionist development strategy reached its limits at the beginning of 1976 when financing of the balance of payments and industrial investments became increasingly difficult. The foreign-exchange crisis of 1977–80 brought together the cessation of the civilian democracy and imposition of a new constitution and labour codes regulating the industrial relations under a military regime.

A structural-adjustment programme was introduced in January, 1980 under the auspices of the international centres such as the World Bank and the IMF. The period 1981–7 was marked with commodity trade liberalization and export promotion along with a price reform aimed at reducing the state’s role in the economic affairs.² With the adoption of an open pro-export stance and the introduction of a crawling-peg regime of exchange rate administration based on daily adjustments of the *Lira*, the real rate of exchange depreciated by almost 70 per cent until 1988. Subsidies on manufacturing exports were also significant, averaging around 25 per cent of the value of manufactured export revenues, reaching a peak of 35 per cent in 1983. The most important component of the subsidy was the production tax rebates, which accounted for about half of the subsidies granted in 1982 and 1983, and amounted to as much as 75 per cent of the total subsidy rate in 1984 (Milanovic, 1986; Yeldan, 1995). In addition to being a source of high losses to the central government budget,³ the subsidization scheme was held responsible for “export-oriented rent-seeking” by way of over-invoicing of exports and through the emergence of the so-called “fictitious exports”.⁴

Export promotion was further supported at the institutional level via creation of specialized export firms under the status of Foreign Trade Companies (FTCs). FTCs were built upon the East Asian model of export promotion, and were thought to function as the long arm of the domestic industrial capital in reaching the foreign markets at a centralized scale. Those FTCs that were able to meet specific export volume targets were granted additional subsidization by the government. Thus, it was through the FTCs that the large-scale, export-oriented capital could enmass the rents of the new trade regime.

FTCs, by law, were not allowed to engage in production and investment activities. However, they evolved as “the marketing outlets of domestic corporations, [and] organic links exist[ed] between FTCs and the major domestic industrial, trading or construction conglomerates” (Önis, 1992:77–8). According to calculations in Önis, the share of FTC-based exports in total exports increased steadily to a peak of 49.6 per cent in 1986.

Consequently, the degree of concentration of FTC exports remained high, with the top four contributing about a third, and the top eight registering about half of the export revenues in 1988. Clearly, this observed pattern of

Table 5.1 Phases of macroeconomic adjustment in Turkey, 1972–2001

export orientation generated strong pressures of non-competitive pricing and accumulation behaviour in the industrial commodity markets, and also gave way to intense “rent-seeking” behaviour among the industrial conglomerates, their financial extensions, and the government.

Given all this promotion and support, export revenues increased at an annual rate of 15 per cent during the decade, and gross domestic product rose at an annual rate of 4.2 per cent in 1981–2, and 6.5 per cent in 1983–7. The period, however, was also characterized by severe erosion of wage incomes via hostile measures against organized labour. The suppression of wages was instrumental both in lowering production costs and in squeezing domestic absorption capacity. Through this manner, an exportable surplus could have been generated which found its way to the newly growing Middle Eastern markets with heavy use of export subsidies. Consequently, the share of wage-labour in private manufacturing value added receded from 30 per cent to 20 per cent, and in public manufacturing from 27 per cent to 15 per cent between 1980 and 1988. In contrast, the average mark-up rate (profit margins) in private manufacturing increased from 31 per cent to 38 per cent (Yeldan, 2000).

It has to be noted that one of the major components of this wage-suppression mechanism was the continued price inflation, enabling both the real wage squeeze to be captured as surplus profits for capital, and also inflation tax revenues for the state. Implemented under a regime of continued currency depreciation supplemented by direct export incentives, inflation policy did not seem to lead to any loss of competitiveness of Turkish exportables.

This “classic” mode of surplus creation reached its economic and political limits by 1988. Coupled with a new wave of populist pressures under the approaching civilian elections, organized labour succeeded in attaining significant increases in wages. Furthermore, the rural economy witnessed a significant improvement in its terms of trade vis-à-vis the industry. Finally, beginning in 1989, there had been a major shift in the public-expenditure accounts towards populist patterns with an overall increase in both the share and level of public salaries. With possibilities of further surplus extraction via wage suppression limited, the state’s involvement in economic matters has to be intensified in order to sustain the level of capital incomes, and this called for an actual increase in the economic and administrative interventions of the state despite the officially stated stance.

One of the leading revelations of the state’s continued role in surplus re-distribution in the 1990s was in the realm of its taxation policy. In retrospect, the post-1988 populism could evidently be financed by expanding the tax base and moving towards a more “fair” tax burden on the working classes. Yet, the strategic preference of the state was the maintenance of its present stance towards evasion of taxable capital incomes and enabling a mechanism of surplus transfer by way of a lax attitude towards the so-called unrecorded private transactions. Consequently, the state apparatus turned into a bastion of privilege as it assumed a regulatory role in the creation and absorption of the economic surplus, and the fiscal balances have taken the major brunt of adjustment. Thus, the main macroeconomic policy response to the increased wage costs and the shift of the rural terms of trade was the rapid widening of the fiscal gap, and the sustenance of the profitability of private capital. As a major indicator of the (functional) distribution of income, for instance,

the share of interest income in total gross domestic product rose to 8.4 per cent in 1991, and to 15.2 per cent by 1998 from its minuscule share of 0.7 per cent in 1980 (Yeldan, 2000). Simultaneous to this development was the rapid rise of the borrowing requirement of the public sector, as the ratio of the PSBR to the gross domestic product rose to 10.3 per cent in 1991, and to 12.1 per cent in 1993.

Given all this, it is clear that the widening fiscal deficit and the macroeconomic disequilibria it generated should be understood in the context of the historical role of the state in sustaining capital incomes against the faltering performance of the export-led growth patterns along with the rapid increases in costs of wage-labour. As extensively discussed in Yeldan (1995) and Köse and Yeldan (1998), the fiscal deficit of the Turkish state in the early 1990s does not necessarily imply a problem of “bureaucratic mis-management” in the abstract, but is a reflection of the administrative and socio-economic policies on the part of the public sector, which were deemed necessary to sustain the generation of economic surplus for the private capital. The state has used its taxation-cum-subsidy policies and the prices (losses) of its production enterprises as the strategic instruments of this historical manoeuvre, and financed its fiscal deficits via forced savings by way of price inflation and increased domestic indebtedness through securitization at very high real rates of interest.

5.2.1 *The rising fiscal gap: the role of the state in regulating income distribution*

The post-1990 macroeconomic balances recorded an unprecedented rise in the fiscal gap. The period witnessed a series of reluctant and failed attempts of tax reform. The succession of short-lived coalition governments are all observed to rely on indirect taxation as budgetary revenues. In the meantime, *net factor earnings* dwindled abruptly over 1989/1991, and *current transfers* (consisting mostly of expenditures on servicing domestic debt and transfers to social-security institutions) rose steadily over the decade.

[Table 5.2](#) documents the main fiscal indicators of the public sector, presenting the relevant data in real 1987 prices using the wholesale price indexes. The erosion on factor income in the early 1990s reaches almost 5 per cent of the GNP, while the rise of the current transfer expenditures

Table 5.2 Public-sector balances (real 1987 prices, billions TL)^a

exceed 125 per cent in real terms over 1992 to 1996. These developments led to a sharp decline of the disposable income of the public sector. The collapse reaches 45 per cent when contrasted across 1992 and 1996. The saving performance of the public sector, likewise, broke down and turned negative after 1991. The state acted as a net dis-saver for the whole decade – with the single exception of 1997. Thus, the borrowing requirement of the public sector (PSBR) rose sharply, and as a ratio to GNP, stood around 10 per cent over 1990–6. This ratio hit 15 per cent in late 2001.

A significant constraint on the state’s capability in financing its gap was its limited options in borrowings from abroad. Given the fragile asset position of the public sector, government net foreign borrowing was minimal, and in most instances was negative. With the advent of fully-fledged financial liberalization after 1989, however, the governments had the opportunity of bypassing much of the liquidity constraints on its operations. Consequently, the financing of the PSBR relied exclusively on issues of government debt instruments (GDIs) to the internal market –especially to the banking sector.

The stock of securitized domestic debt grew rapidly over the 1990s. The stock of GDIs was only 6 per cent of the GNP in 1989, the year when the capital-account liberalization was completed. By the end of 2000 this ratio reached to 29 per cent. Interest costs on domestic debt grew to 10.6 per cent of the GNP in the same year, increasing almost ten-fold in real terms over the decade ([Table 5.2](#)). As a further comparison, interest costs on servicing the debt reached 1,010 per cent of public investments, and 481 per cent of the transfers

accruing to social-security institutions in 1998. In this regard, the central budget in Turkey is observed to lose its instrumental role of social infrastructure development and long-term growth, but rather became a tool of finance capital.

5.2.2 The main elements of the 2000 disinflation programme and the 2001 crisis

Following a series of ill-founded and poorly focused set of stabilization attempts through the decade, the government finally initiated a comprehensive disinflation programme in December 1999 under the guidance of the International Monetary Fund (IMF). It aimed at decreasing the inflation rate to a single digit by the end of 2002. Aided with the supervision and technical support of the IMF, the new programme relied on *exchange-rate based* disinflation and monetary control by setting upper limits to net domestic asset position of the Central Bank (CB). Accordingly the CB committed itself to a policy of *no sterilization*, whereby changes in the monetary base would directly reflect changes in the net foreign assets of its balance sheet. The programme further entailed a series of austerity measures on fiscal expenditures and set specific targets for the balance on the non-interest, primary budget.

Yet, just eleven months after launching the disinflation programme, Turkey experienced a severe financial crisis in November 2000. More than US\$6 billion of short-term capital fled the country, creating a severe liquidity shortage in the domestic commodity and asset markets. The government requested to access the Supplementary Reserve Facility from the IMF. The request was granted with US\$7.5 billion of additional support in 22 December, and the technical limits of the monetary programme have been revised. Only then continued implementation of the programme 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 19 February 2001 badly hit the uneasy markets. The CB 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 per cent. In what followed, the government could not endure the pressures of the markets any further, and declared the surrender of the pegged exchange-rate system on 22 February, thereby letting the exchange rates free float.⁵

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

The macroeconomic performance of the economy under the disinflation programme is shown in [Table 5.3](#). *Disinflation*, being the most important objective of the programme, is observed to be materialized especially in the second half of its implementation. Despite the fact that the annual rate of change in the price level has exceeded the programme’s end-of-year targets by a significant margin, it nevertheless displayed a break in its 30-year trend towards a lower plateau. The monthly rate of change of both the consumer (CPI) and wholesale (WPI) price indexes decelerated especially after May, and hit its lowest rate in June 2000. The core inflation rate, as measured by the change in private manufacturing industry prices, has fluctuated around the aggregate WPI and CPI, and yet has clearly shown a deceleration throughout the whole programme period.

Given the 1999 deflation, the invigoration of the gross domestic product is clearly visible. Rate of growth of GDP accelerated from +5.6 per cent in the first quarter, to a score of +8.3 per cent in the last quarter of 2000. The annual rate of growth averaged 7.2 per cent in 2000, with commerce and trade services registering 11.6 per cent, and industry and

Table 5.3 Macroeconomic developments in Turkey under the 2000 disinflation programme and beyond

construction both growing by 5.6 per cent. The boom in consumption demand was evident, especially with its peak in the third quarter. Investment demand, both public and private, likewise registered a strong upturn over their contraction in 1999. The February crisis is visible over the columns depicting the first two quarters of 2001. As data accumulate one gets a clearer picture of the prolonged deepening of the crisis and the associated impoverishment.

Balance of payments statistics reveal the main source of the growth spurt of 2000 quite succinctly. Over the whole year commodity imports have increased at a rate of 35.9 per cent, while export growth remained at only 7.9 per cent. The deficit on the current account, which was a mere \$1.4 billion in 1999, widened abruptly to \$9.7 billion by the end of 2000. The current-account deficit was initially targeted at \$2.8 billion, and was revised upward to \$5 billion. Thus, the realized current-account deficit has exceeded its *revised* target by 100 per cent over the programme implementation. The deficit on the current account was primarily covered by the capital-account surplus totalling \$9.4 billion. Both short- and long-term capital were instrumental in bringing foreign capital into the domestic asset markets, while the aggregate foreign debt outstanding jumped by 12.3 per cent, from \$103.3 billion to \$116.1 billion within 2000.

The increased inflows of foreign capital have been instrumental not only in financing the current-account deficit, but also in the expansion of domestic liquidity. Given the no-sterilization rule and the constraints on the net domestic asset position of the Central Bank, inflows of foreign capital called for an expansion of the monetary base in line with the increase in net foreign assets. Coupled with the elimination of the currency risk, these developments led to a steep decline in the real rates of interest, especially in the early phases of the programme.

It has to be underlined at this juncture that the Turkish authorities were clearly successful in maintaining the programme targets both in exchange-rate administration and monetary control, as well as attaining the fiscal targets. 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 programme limits. Similarly, the fiscal operations were in line with both the revenue and expenditure targets, and the non-interest primary balance on the consolidated budget succeeded in attaining the end-of-year target by as early as September.⁶ Given the weak financial markets, the underlying cause of the meltdown was ultimately the external fragility generated by the unregulated in- and outflows of financial capital which were excessively mobile, excessively volatile, and subject to herd psychology.

In the context of the Turkish disinflation episode, [Figure 5.1](#) portrays one of the important elements of the culminating process of external fragility: the path of the ratio of short-term foreign debt to the Central

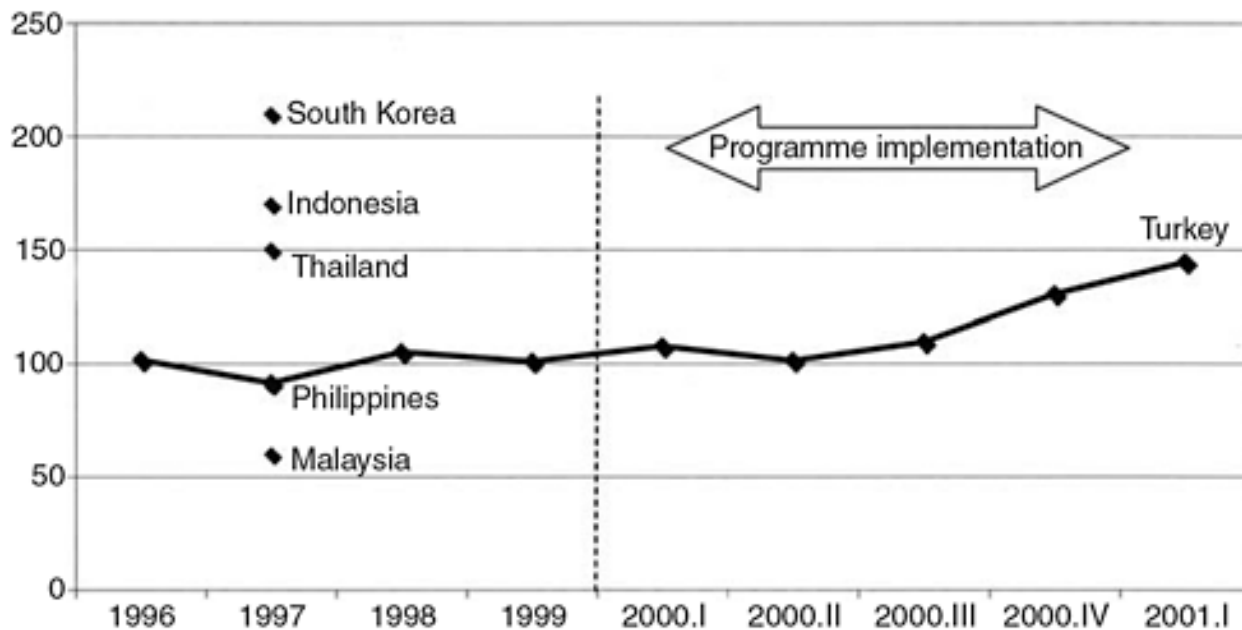


Figure 5.1 Short-term foreign debt/CB reserves (%).

Bank's international reserves. This ratio is regarded as one of the crucial leading indicators of external fragility and has recently been called the "most robust predictor of a currency crisis" in Rodrik and Velasco (1999). Figure 5.1 further contrasts the evolution of this ratio against the background of selected East Asian economies just before the eruption of their respective financial crises in mid-1997. Data at hand disclose that, before the crisis in June 1997, the ratio of short-term foreign debt to the Central Bank international reserves was in the order of 170 per cent in Indonesia, 150 per cent in Thailand, 90 per cent in Philippines and 60 per cent in Malaysia. Thus, it could be argued that the value of 60 per cent for this ratio is regarded as a critical threshold from the point of view of international speculation. It is alarming to note that in Turkey this particular ratio has never fallen below the 100 per cent mark since the opening of the capital account in 1989. Thus, the Turkish financial system had been operating constantly under the "danger zone" for the past 12 years as far as this indicator is concerned.

What is crucial in Figure 5.1 is that the disinflation programme had actually increased the fragility as signalled in this indicator. Let alone turning this path to a favourable trend, the 2000 programme which aimed at disinflation (and stabilization!) caused an increase of external fragility with a rise of this indicator to 112 per cent in June, and to 145 per cent by December of 2000. This level was the highest score since 1993, just before the 1994 financial crisis. 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 \$4.7 billion to reach a total of \$11.1 billion. During this process, total short-term debt stock of the banking sector had increased to \$16.9 billion from its level of \$13.2 billion. The lure of the uncontrolled flows of speculative gains clearly unleashed all its might throughout 2000, when the currency risk was eliminated and the whole liquidity generation mechanism was based on the short-term, hot money inflows.⁷

To summarize, the programme itself has achieved modest gains in disinflation, and as such it should be seen as a programme for maintaining price stability at the expense of destabilization of the Turkish economy along with the worsening of its financial and external balances. The Central Bank was deprived of all its traditional tools of austerity and crisis management and was left defenceless against both the "speculative attacks" and the "sudden stops". Under these conditions it has to be no surprise that the viability of the programme 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.

In the meantime, the distributional conflict underlying the neo-liberal structural adjustments was thereby resolved with the state's strategy to achieve accelerated growth on the basis of short-term inflows of capital. The unsustainable character of this type of growth, however, led to the disguise of the major structural bottlenecks of the Turkish economy, rather than offering viable long term solutions (Özatay, 1999; Türel, 1999; Cizre-Sakallioğlu and Yeldan, 2000; Önis, and Aysan, 2000). We now turn to the destabilizing nature of this episode in the section below.

5.3 Macroeconomic adjustment under post-financial liberalization: overall assessment

The 1989 policy manoeuvre of capital-account liberalization meant a drastic change in the nature of macroeconomic adjustments in Turkey. It paved the way for an injection of liquidity to the domestic economy in terms of short-term foreign capital (flows of "hot money"). Such inflows enabled, on the one hand, financing of the accelerated public-sector expenditures, and also provided relief of the increased pressures of aggregate demand on the domestic markets by way of cheapening costs of imports.

In this setting, the Central Bank lost its overall control over the exchange-rate depreciation and the domestic rate of interest as independent instruments of monetary policy. From the point of view of the domestic financial markets, liberalization of the capital account necessitated a higher rate of return on domestic assets as compared to foreign currency (as given by the rate of nominal depreciation). The rationale of this link can be traced directly to the *threat of* currency substitution (dollarization and/or D-Markization of the domestic liquidity markets). Given this threat, the monetary authority has to assume a passive role against excessively high real rates of interest on domestic assets, coupled with an overvalued exchange rate. Liberalization of the capital account to the short-term capital transactions requires a commitment to high real rates of domestic interest exceeding the rate of currency depreciation. As this commitment stimulates a higher level of speculative capital inflows, domestic currency appreciates, inviting an even higher level of hot money inflows to the domestic economy.

The elements of this process are displayed in [Table 5.4](#). The net return on "hot money" is reported in column 1. This return is calculated as the rate of difference between the highest (nominal) interest offered in the domestic economy and the rate of (nominal) depreciation of the TL. It yields the net return to a unit of foreign portfolio investment which switches into TL, captures the interest income offered in the domestic economy and switches back to the foreign currency at the end-of-period exchange rate. The difference between interest earned and the loss due to currency depreciation is the net earnings appropriated by the investor.

In columns 2 and 3, the gross in- and out-flows of foreign credits acquired by the banking sector are displayed. As one of the major components of "hot money", one can see that such flows show quite high sensitivity to the domestic rate of return calculated in the first column. Except for the 1991 values, the net flows are observed to be of the "expected" sign, and they are observed to have fluctuated widely, especially between 1993 and 1996.

We witness that the gross inflows of foreign credit obtained by the banking sector had been in the order of around US\$10 billion *per month* between 1991 and 1993. The gross annual volume of such inflows reached US\$209 billion in 2000 – exceeding the overall Turkish GNP in that year! Clearly, the domestic financial system is under severe pressure from the international speculative centres and is no longer in a position to generate an independent monetary and foreign-exchange policy. Furthermore, the flows of hot money constituted the major rationale of the short-termism and volatility of the real business cycles, led to increased fragility of the financial and the external position of the domestic economy, and resulted in worsening the distribution of income (Balkan and Yeldan, 1998; Yentürk, 1999).

The last column of [Table 5.4](#) utilizes the composition of the time deposits between foreign and domestic denominated currencies as a measure of the extent of currency substitution. As an indicator of denunciation

of the Lira and the ongoing dollarization of the currency markets, the share of foreign-exchange deposits in total rose at a secular rate over the 1990s and passed the 50 per cent benchmark by 1996.

Thus, the episode of hot money inflows should be interpreted, in the Turkish context, as the long arm of fiscal policy, overcoming the credit restraints and the monetary constraints of the monetary authority. The availability of such funds enabled the fiscal authority to postpone any

Table 5.4 Inflows of short term foreign capital and selected financial indicators (millions US\$)

adjustment in its revenue-enhancing capabilities such as implementation of added taxes on capital earnings and reducing evasions on taxable corporate earnings. Yeldan (1995) and Cizre-Sakallioglu and Yeldan (2000) discuss this stance in terms of a discretionary surplus redistribution strategy on the part of the state via its fiscal policy. Thereby, through the availability of short-term borrowable funds, the fiscal operations of the state became a viable apparatus to generate an economic surplus for the corporate incomes by way of a lax attitude towards tax evasion and the consequent deficits. In so doing, as the Treasury offered market-yields on its instruments, it became the dominant agent in the financial economy, enabling the banking system to make significant returns based on the arbitrage of *open-positions*.

Indeed, throughout the course of these events Turkey's banking sector and financial institutions became disengaged from production to become the dominant faction of the capital manipulating the overall economy. The driving force behind this development was two-fold, one domestic, the other global. On the *domestic* level, it was the collapse of the public disposable income which led to the fever of public-sector borrowing. The consequent high interest rates of government bonds and treasury bills set the course for the dominance of finance over the real economy. As a result, the economy is observed to be trapped in a vicious circle: commitment to high interest rates and cheap foreign currency (overvalued TL) against the threat of capital flight leads to further increase in the real interest rates. When adverse impacts on the current-account balance become excessively destabilizing, real depreciation seems imminent, which, however, needs to be matched by further upward adjustment in the rate of interest if currency substitution or capital flight is to be restrained. This process, as in the case of Mexico in 1994, and the recent crises of East Asia, leads to overvaluation of the domestic currency, cheapening of imports, and thus an acceleration of domestic consumption demand at the expense of exports, and the real productive industries in general.

The *global* dimension of the rising prominence of finance was no less important. As internationalization of the Turkish state intensifies, it also becomes directly accountable to the global asset markets. Complete deregulation of the financial transaction enable the international finance capital to act as the sole arbiter aiming at immediate financial gain, rather than the long-term economic development and sustainable growth. The crisis of 1994, in hindsight, shows the vulnerability of the Turkish economy to the speculative gains of hot money and 'casino capitalism' (Strange, 1986).

Erratic movements in the current account, a rising trade deficit (from 3.5 per cent of GNP in 1985–8 to 6 per cent in 1990–3), and a drastic deterioration of fiscal balances disclose the unsustainable character of the post-1989 populism financed by foreign capital inflows. In Boratav *et al.*'s (1995:34) words:

the post-1990 Turkish experience shows the serious problems confronting a developing economy which decides to move into full external and internal deregulation in the financial system under conditions of high inflation. The specter of capital flight becomes the dominant motive in policy-making and creates commitment to high interest rates and expectations for cheap foreign exchange. The links of these two policy variables with the real sphere of the economy, *i.e.* investment on physical capital and the current account balance of payments, are deeply severed. Instability in the rates of foreign exchange and interest rates creates feedbacks which lead the economy into further instability.

This prolonged instability reached its climax during the fourth quarter of 2000, when the currency appreciation and the consequent current-account deficits rose to unprecedented levels. With the sudden drainage of short-term funds in the beginning of February 2001, production capacity contracted, followed by a continued fall in industrial output throughout that year. Together with this contraction, the post-2001 crisis management gave rise to significant shifts in income distribution, and to an intensification of the ongoing processes of transfer of the economic surplus from wage-labour in particular, and the industrial/real sectors in general, towards the financial sectors. Likewise, dollar-denominated wage costs decreased substantially and enabled export earnings to rise. In this manner, Turkey has, once again, switched back to a mode of surplus extraction whereby export performance of industrial sectors depended on savings on wage costs.

Clearly, the “reform fatigue and exhaustion” of the 1988 crisis, and the unsustainability of the post-1989 growth path which culminated into the 1994 and the 2001 crises have had quite different macro dynamics in operation. Under both episodes, however, one witnesses the presence of the state as an active agent regulating both the paths of accumulation and the patterns of income distribution. It is interesting to note that in spite of the official stance towards privatization and a mandated policy of “reducing the role of the state” in the economic scenery, there is continued use of the state’s frontiers as a regulatory agent, overseeing the distributional conflict over the national product. In this process, its fiscal operations share the major brunt of adjustment in resolution of this conflict in favour of private capital and the banking sector. This is very clearly manifested within the context of the delayed/postponed disinflationary programme. The next section analyses these adjustment dynamics towards disinflation in the context of a game-theoretic model.

5.4 A game-theoretic approach to credible disinflation programme

It has to be clear from our arguments thus far that the current policy environment in the Turkish economy is very much characterized by an impasse between the state and the private actors – the main one being the banking sector. Given the impasse of the state to correct its fiscal balances, it was the commercial banking system which had intermediated between the foreign sector and the Treasury so as to fill the fiscal gap. Given the availability of short-term foreign capital, the banks have played a crucial role in borrowing from abroad at relatively cheap rates of foreign exchange and thereby accumulating short-term foreign debt. The political/economic environment of this mechanism, however, resulted in a standstill with high rates of inflation and domestic debt, which we model as *inertial* equilibrium in a game-theoretic context. In fact, as we documented in [Table 5.1](#), the environment in which Turkey embarks on disinflation has certain characteristics that make reductions in the inflation rate very costly after it had reached a threshold of 60–80 per cent. Formally, we will replicate that feature of the economy in a dynamic general equilibrium model with a sequentially rational government and a banking sector.

There is now a wide consensus in the literature that the optimal inflation rate is at or below zero. The result is robust with respect to the choice of the models which recommend inflation reduction to avoid the deadweight losses associated with inflation. However, comparisons between the steady states with constant inflation rates and the results vary widely as to the optimal disinflation policy, or the optimal speed of disinflation. It is natural to expect that to the extent past inflation rates do not affect the current fundamentals, they should affect the optimal monetary or fiscal policy.

We demonstrate that even when the direct effect of inflation on the fundamentals is short-lived, say, due to the short-term structure of the government’s debt, its indirect effects may last much longer slowing down the optimal disinflation. The stylized facts of our apparatus are as follows: private sector – mainly bankers – voluntarily holds a large part of government debt. As a result of expansionary fiscal policies, the government consistently ran budget deficits in the last 30 years. Since the initiation of the policy of securitizing the deficit, the government debt began to grow and reached a very high level by 2002. Maintenance of the debt is taking a significant portion of the government’s tax revenues. Even though the budget is in primary surplus, debt-servicing requirements bring the government finances into an operational deficit.

Under the above conditions, debt reduction is difficult to achieve politically unless a tax reform is successfully enacted to increase efficiency of tax collection, or a disinflation programme that would increase the efficiency of the overall economy could be implemented. We will not touch upon the causes of repeated delays in tax reform, taking it as a given fact. Instead, we will show that in such an environment, presence of high debt, even mostly short term, results in sustaining an inertia in the existing rate of inflation, making it difficult to be overcome through traditional monetary/deflationary policies. We consider different scenarios of the disinflation programme as perceived by the government and the bankers, a proxy for the government's creditors.

The bankers buy government bonds expecting a high inflation rate π^H . With competitive bankers, the interest rate on these bonds will also be high

$$i^H = (1 + \pi^H - \beta) / \beta$$

where i^L is a time discount rate of the bankers. Suppose the government decides to reduce inflation to $\pi^L < \pi^H$ after the bonds are sold. This means that the government's obligation to the bankers increases in nominal terms by

$$B(i^H - i^L) = B(\pi^H - \pi^L) / \beta$$

where B is the government's debt in real terms at the date of bond maturity. This is the cost the government has to pay to the bankers to conduct the unexpected disinflation programme. Trivially, the cost of unexpected disinflation may be avoided if it credibly pre-announces the programme. In that case the competition among the bankers for the bonds will drive the interest rates down to $i^L = (1 + \pi^L - \beta) / \beta$.

Therefore, the key to a successful reduction of the interest rate on bonds is in the credibility of the disinflation programme itself. We distinguish two types of credibility, conditional and unconditional. An *unconditionally* credible programme is such that the government prefers to disinflate despite its failure to reduce the nominal interest rate. A *conditionally* credible disinflation programme imposes a weaker requirement: the government is expected to disinflate only if the interest rates are reduced. Thus, the success of a conditionally credible disinflation programme depends on market expectations being optimistic. Should the bankers expect the programme to fail, it will fail making bankers' expectations self-fulfilling. Note that in either case the expectations are correct.

Now we will describe the conditions that determine whether the disinflation programme is conditionally or unconditionally credible. Denote the benefit of disinflation in terms of greater private and government income as valued by the government as W^+ ($\pi^L, -\pi^L$). We assume that it depends on the initial inflation rate and the rate of disinflation $-\pi^L$. On the other hand, the cost of disinflation in terms of greater debt service is $W^- (B, i^L)$ which depends on the market expected inflation rate i^L and the stock of government debt B . From the discussion above, it is apparent that W^+ is increasing in π^L and $-\pi^L$, while W^- is increasing in B and i^L . Note that W^+ is known before the programme is started, while W^- will depend on the interest rate on bonds.

The *ex ante* and interim comparison of the benefits and costs of the disinflation programme shapes government's sequentially rational policy. It may apparently involve the following: for relatively high levels of inflation and low debt, the benefits of the disinflation are greater than the costs regardless of the market interest rate. For higher levels of debt, the benefits are greater than the costs only if the interest rate reflects the expectation of lower inflation. Supposing that the market is always pessimistic, the inflation rate will never fall if the government is slightly more impatient than the bankers.

Figure 5.2 demonstrates the equilibrium inflation policy for two different levels of initial debt. This result is obtained under the assumption that the government is more impatient than the bankers. The 45° line

corresponds to the stationary inflation policy, with $\pi_t = \pi_{t+1}$. The distance from the stationary 45° line to the policy function with initial debt B_1 and B_2 reflects the rate of disinflation. The government with high initial debt B_2 does not have an incentive to reduce the inflation as fast the government with lower initial debt B_1 , even though it improves the prospects of future disinflation.

Consequently, we can follow the underlying conditions of the current impasse of the Turkish government towards disinflation from the mechanics of [Figure 5.2](#): the government's disinflation programme is shaped by its expected benefits and costs of the programme, *ex ante*. Given sustained rates of high inflation and an initially high stock of debt with an excessive servicing burden, the inflation is likely to be inertial against reductions as long as the current expectation of interest rates do not reflect the expectations of programmed lower inflation. This bind, however, leads to a stable,

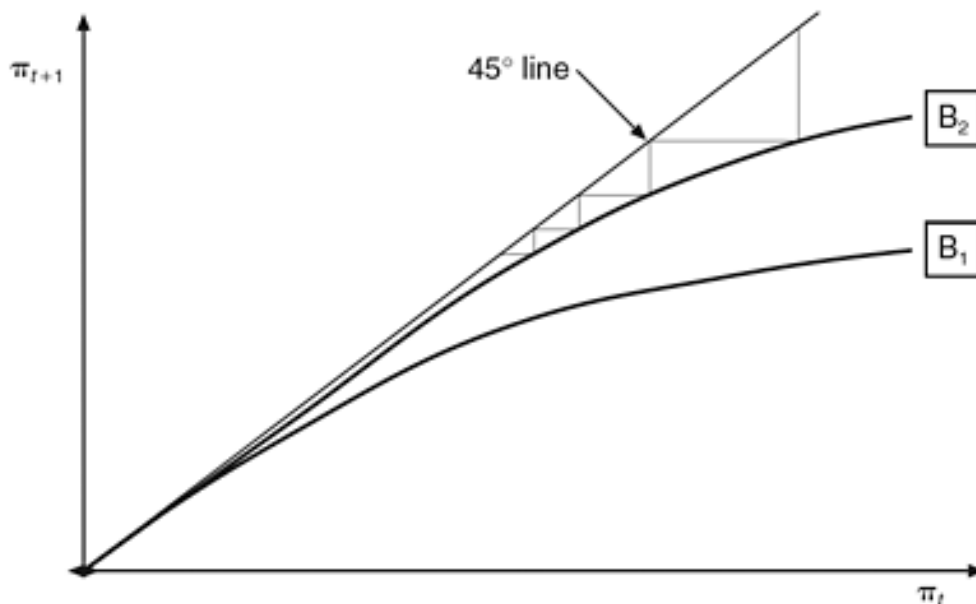


Figure 5.2 Equilibrium inflation policy of a heavily indebted government.

yet vicious circle, which could be broken either with increased confidence and reduced impatience of the government, which itself is a very unlikely outcome given the politics surrounding the programme, or with resort to hyper-inflation, a state which could involve a complete breakdown of the fragile, domestic financial network and disruption of the civilian democracy along with many unforeseen yet unarguably onerous adjustments.

5.5 Concluding comments

In this essay, we have studied the post-1980 episode of trade integration and financial liberalization of the Turkish economy from a political-economy context. We have argued that the state has assumed a regulatory role in the generation and distribution of the economic surplus and its fiscal balances shared the burden of necessary adjustments. We have regarded the macroeconomic balances of the 1990s as a direct outcome of the endogenously driven cycles of growth, stagnation, delayed stabilization, and crisis.

Throughout the adjustment era, there emerged a significant need to reorganize the state apparatus so as to achieve a conformity between the economic rationale of the market forces and the political realities of the policy-making process. Indeed, the post-1980 Turkish macroeconomic development experience scored a leading example of how the stated objectives of the structural adjustment programme towards lesser involvement of the government with the economic affairs may run counter to both the economic/political

realities of the market and the interest of the surplus-extracting groups which command power, especially those of the industrial and financial capital.

In this context, the opening of the capital account and full financial liberalization reforms of 1989 served both as the supplier of liquidity into the domestic economy to sustain the fiscal costs of this manoeuvre, and provided relief of domestic markets through cheapening import costs. The availability of short-term capital flows, however, became a significant source of instability in the domestic financial markets and led the banking sector to be disengaged from intermediation for productive investments to become the leading faction of capital manipulating the whole economy. With the advent of high real interest rates following the collapse of the public disposable income, the banks could have amassed massive returns based on the arbitrage of open positions vis-à-vis foreign financial markets, and the domestic economy drifted towards the vicious circle of high interest rates, current-account deficits, and expectations of devaluation to be matched by ever higher rates of interest.

All of these conditions, generated in the meantime, a high rate of inflation together with an inertia of its own, which is difficult to overcome through traditional monetary/deflationary policies. A break of this inertia seems to involve either the confidence build-up of an intertemporally patient government, or the build-up of hyper-inflationary pressures with their devastating consequences. The hopes are that the system will be able to succeed in generating solutions towards the former.

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Notes

1 See Yeldan (1995 and 2000) for a discussion on the characteristics of the post-1989 Turkish macro adjustments in terms of creation and absorption of the economic surplus. Yeldan (1998) provides, in turn, a quantitative analysis on the strategic role played by the state apparatus. Cizre-Sakallioglu and Yeldan (2000), Boratav *et al.* (1996), Ekinçi (1998), and Boratav *et al.* (2001) report similar analyses based on the effects of international speculative financial capital flows on the Turkish economy.

2 See Boratav and Türel (1993), Celasun and Rodrik (1989), Uygur (1993), and Celasun (1994) for a thorough overview of the post-1980 Turkish structural-adjustment reforms. For a quantitative assessment of the export subsidization programme, see Milanovic (1986) and Togan (1996).

3 According to estimates in Yeldan (1995:50), costs of export subsidies reached 22 per cent of the central government revenues between 1984 and 1988, and in general exceeded the level of corporate taxes paid throughout the decade.

4 This phrase which has repeatedly appeared in the popular press during the 1980s refers to those foreign funds that were transferred to Turkey being registered as earnings from export sales while no shipment of any goods have taken place. The transfer, however, gave entitlements to the “exporter” to claim export subsidies. It is conjectured that the mechanism was used in legalizing the illegal (black-market) foreign-exchange funds accumulated during the crisis of 1977–79.

5 The underlying elements of the disinflation programme and the succeeding crises are discussed in detail in Celasun, 2000; Ersel, 2000; Boratav, 2001; Gencay and Selçuk (2001); Uygur, 1996; Yeldan, 2001, 2001a, 2001b and 2001c; Yentürk, 2001; Boratav and Yeldan (2002); Yeldan (2002); and Ertugrul and Yeldan, 2003. A series of “Round Table Discussions” are also provided in the Turkish literature by *Mülkiyeliler Birliği Dergisi*, January 2000; *Iktisat Isletme ve Finans*, March 2000; *Birikim*, April 2001; *Ileri*, June 2001; and *Iktisat Dergisi*, May 2001.

See also the web site www.bagimsizsosyalbilimciler.org/iktisat.htm of the Association of the Independent Social Scientists – Economists’ Group (Bagimsiz Sosyal Bilimciler-Iktisat Grubu) for a set of critical assessments on the 2000–2001 economic policies. In particular, a detailed evaluation of the so-called “Transition to the Strong Economy Programme” (announced in 15 May 2001) is provided by the Association in July, 2001.

6 The non-interest – primary – budget surplus was targeted at 3.1 per cent of the GDP within the programme. The end-of-year realization reached 6.1 per cent. Clearly, the fiscal austerity objectives were reached under the programme.

7 According to Boratav’s (2001) calculations, before the November 2000 crisis non-residents have brought a total of \$15.2 billion of “hot money” into the Turkish asset markets, while the residents enabled an *outflow* of \$5.3 billion. Thus, during the course of the programme, much of this accumulated short-term debt had financed residents’ capital flight.

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