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THE TURKISH ECONOMY AFTER THE CRISIS

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ABSTRACT

The recent crisis has demonstrated that a financially open economy has many sources of vulnerability. Even when a country does its homework, it remains at the mercy of developments in external financial markets. So, one lesson is that policy needs to guard not just against domestic shocks, but also shocks that emanate from financial instability elsewhere. Complete financial openness is not the best policy. A second lesson is that Turkey's prevailing growth strategy does not generate enough growth and employment. Therefore it would be a mistake for the country to return to the status quo ante and resuscitate a model that fails to make adequate use of domestic resources. Most importantly, Turkey has to learn to live with reduced reliance on external borrowing. The paper discusses the needed realignments in fiscal and exchange-rate policies.

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THE TURKISH ECONOMY AFTER THE CRISIS

Dani Rodrik
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Turkey is coming out of yet another financial crisis. This one may not have been its own doing, but that has not reduced the pain. In fact Turkey was hit worse in many ways by the present crisis than in any of the previous instances of sudden stop in capital inflows. And this despite the admirable resilience of domestic banks and the dramatic cuts in interest rates that the central bank undertook. Unemployment reached historic heights and the drops in GDP and industrial output were exceptionally severe.

Macroeconomic instability has long been the bane of Turkey's economy. In the past the culprits were easy to identify. You could blame irresponsible monetary policies, unsustainable fiscal expenditures, poor financial regulation, or inconsistent exchange-rate policies. It is to the country's credit that as it came out of the 2001 crisis Turkey succeeded to fix these traditional sources of fragility. Monetary policy is governed by an inflation targeting framework and an independent central bank. Fiscal policy has been generally restrained and the public debt-to-GDP ratio stable or declining. Banks have strong balance sheets, and regulation and supervision are much tighter than before. The currency is afloat. When it comes to macroeconomic management, Turkey has adopted all the best practices.

The crisis has demonstrated that a financially open economy has many sources of vulnerability. Even when a country does its homework, it remains at the mercy of developments in external financial markets. Crises and contagion are endemic to financial globalization. The world of finance does not always operate in a benign fashion. So lesson number one is that policy needs to guard not just against domestic shocks, but also shocks that emanate from

financial instability elsewhere. This has important implications for the optimal degree of financial integration for middle-income countries like Turkey. In particular, it suggests that complete financial openness may not be the best policy. A counter-cyclical approach to the capital account—encouraging inflows when finance is scarce but discouraging them when finance is plentiful—deserves serious consideration.

A second lesson has to do with Turkey's growth strategy. The Turkish economy grew at quite rapid rates in the years before the most recent crisis. This can be interpreted as the reward for the solid macro policies pursued since 2001. At the same time, there were too many disconcerting elements in this growth experience. In particular, domestic saving fell (instead of rising, as it should have done in an environment of increased macro stability and confidence) and unemployment remained stubbornly high. The external deficit kept on widening. Investment remained lower than required. All of these put the sustainability of the economic boom into question. Even if the sub-prime mortgage crisis had never taken place, Turkey's prevailing pattern of growth would have run into problems. Therefore it would be a mistake for the country to return to the status quo ante and resuscitate a model that fails to make adequate use of domestic resources. Most importantly, Turkey has to learn to live with reduced reliance on external borrowing.

I begin the paper by comparing the present crisis to the two previous ones Turkey went through since having become financially globalized (in 1994 and 2001). By juxtaposing the trends in the major economic indicators during these three crises we can discern common elements as well as important differences. The main point that comes out of this comparison is that Turkey is emerging from the present crisis with a significantly higher level of unemployment and a much more appreciated real exchange rate.

Next I present two growth narratives which differ with respect to the nature of binding constraints faced by the Turkish economy and have conflicting implications for policy. The first narrative views financing as the key constraint while the second narrative emphasizes a profit squeeze in tradables. Depending on which of these one views as the dominant narrative, the approach to the external accounts and exchange-rate policy would take very different forms. Unfortunately, a quick overview of the evidence does not allow a very clear-cut conclusion to be reached. The Turkish economy presents elements of both types of constraints. Nevertheless, it is possible to draw some broad policy conclusions, and I will close the paper with those.

How does the present crisis compare to previous ones?

Financial crises in emerging markets may be sparked by different causes, but they tend to follow similar scripts. They begin with a sharp turnaround in financial flows—what Guillermo Calvo has memorably called a "sudden stop." The drying up of credit in turn sets off a chain of events. The value of the domestic currency collapses. Domestic banks are starved of liquidity so they begin to call in their loans. Firms need to retrench and lay off workers. The economy needs to generate an external surplus in short order, which requires a sharp fall in domestic demand. This now adds a demand shock to the initial supply shock, and further aggravates the cost to output. Eventually the depreciated currency helps revive demand for domestic tradables, the panic subsides, and capital begins to move in again.

Turkey has gone through three of these crises since it opened up its capital account in 1989. The first instance was 1994, when a misguided attempt to keep domestic interest rates low led to a sudden capital outflow. The second was in 2001 when a minor political crisis threw the sustainability of an exchange-rate based stabilization program into question and led to a massive

withdrawal of funds. And the third happened in 2008 as a result of the global flight to safety that the U.S. sub-prime mortgage crisis produced.[1]

Since the turnaround in capital flows is the instigator of the crisis, it is useful to look at how each one of these episodes unfolded as the events in financial markets played out. In the charts that follow, I juxtapose the time series for the three crises by plotting them against a time scale where each quarter stands in the same relation to the quarter with the peak amount of inflows.[2] Financial inflows reached their peak in 1993:I, 2000:II, and 2008:II, respectively, so these quarters are taken as t=0 for the three crises.

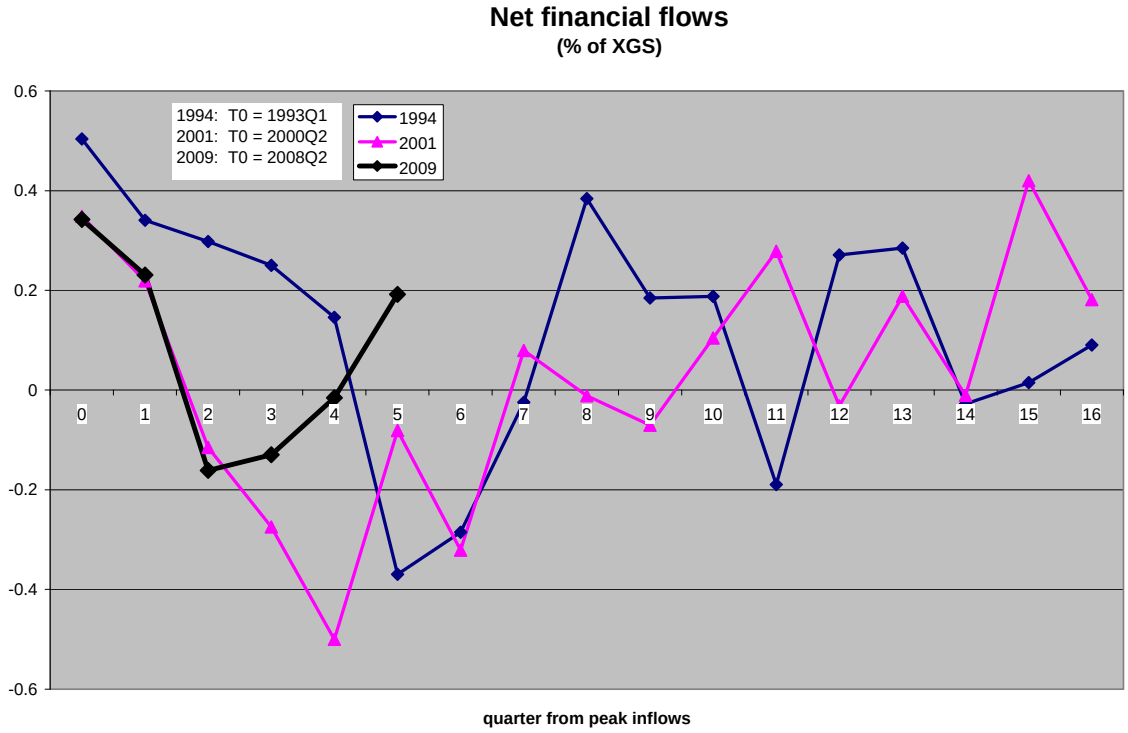

Figure 1

[1] See Uygur (2009) for a detailed discussion of Turkey's performance during the recent crisis, along with an evaluation of the policies followed.

[2] Unless specified otherwise, all data come from the Central Bank's online data retrieval facility.

Figure 1 compares the patterns of financial flows during these three crises. It makes clear that Turkey was a large net recipient of financial inflows at the onset of each crisis. At their peak *net* inflows amounted to somewhere between 35-50 percent of the gross volume of exports of goods and services. The figure also shows the rapidity of the turnaround. In 2001 and 2008, these large inflows not only quickly evaporated, but within two quarters they had been replaced by sizable net outflows. The first three quarters of the 2001 and 2008 crises bear in fact an uncanny resemblance. But thereafter an interesting divergence sets in. In the 2001 crises, it took roughly two years for financial inflows to turn positive once again. In the current crisis, the resumption of capital inflows happened much more quickly and by t=5 (2009:III, the latest quarter for which we have data) Turkey had become a sizable recipient of inflows once again. What happened was that the stabilization of global financial market conditions produced a resurgence in capital flows to emerging markets. Turkey was among the beneficiaries. As we shall see, however, this may well turn out to be a mixed blessing.

When foreign finance dries up, the current account deficit has to be quickly reduced and eliminated. As Figure 2 shows, the Turkish economy entered all three crises with a large current account deficit. And in all three cases, there was a significant adjustment in the current account over a period of 5-6 quarters. The current account balance turns positive typically within a year-and-a-half of peak inflows. But the evidence from the older crises (1994 and 2001) also shows that this adjustment tends to be temporary. Three years after these crises, Turkey was again running large current account deficits.

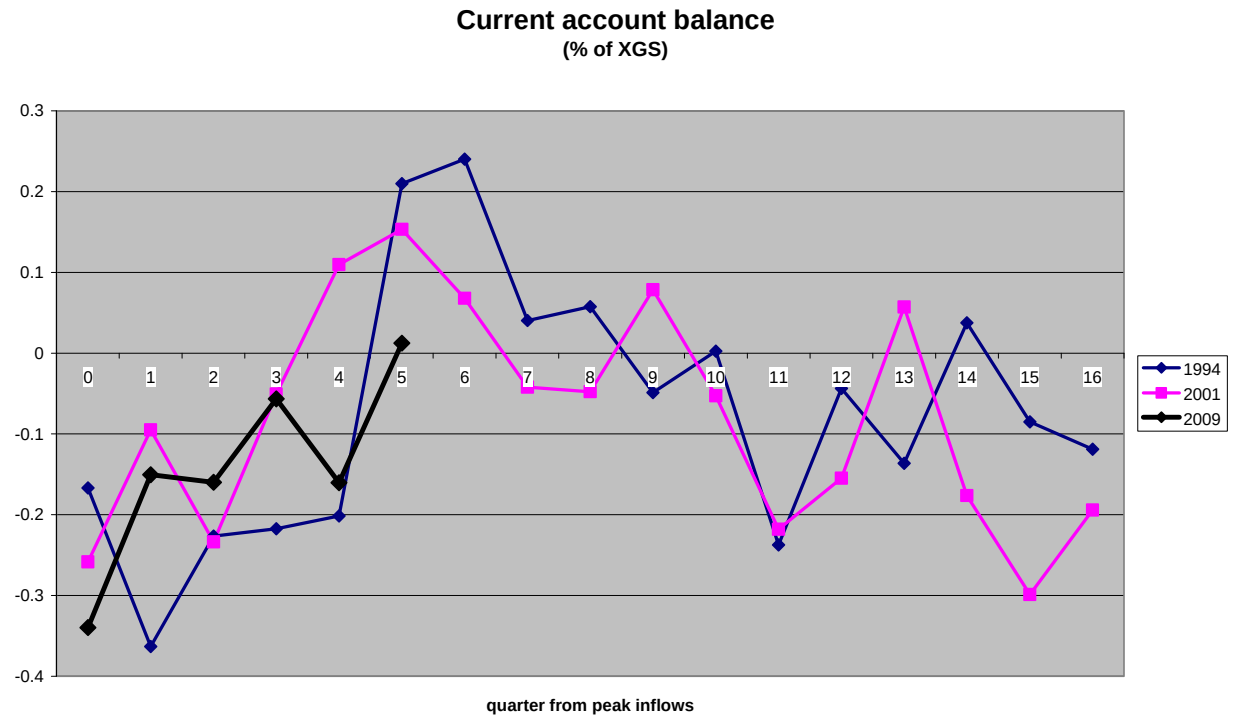

Figure 2

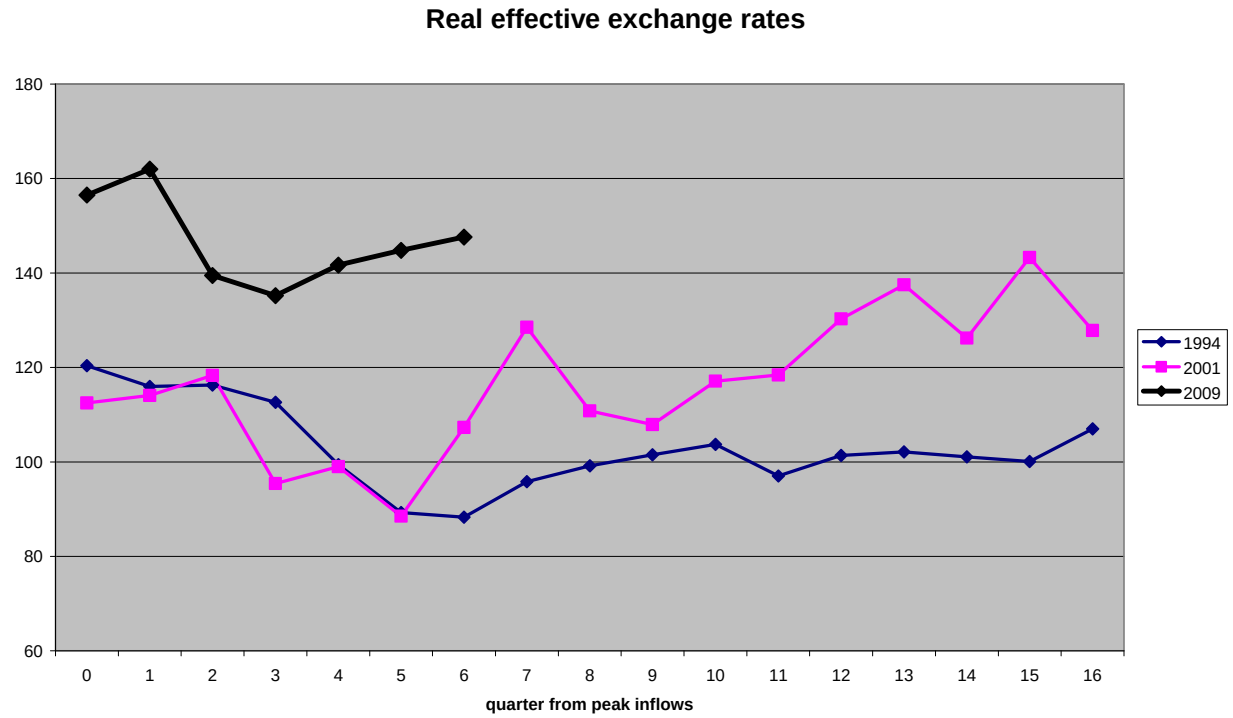

Figure 3

The adjustment in the external balance is achieved in part through a significant realignment of the real exchange rate. In the crises of 1994 and 2001, the real exchange rate depreciated on the order of 30-40 percent. A similar depreciation took place in 2009 as well, but as Figure 3 shows, the depreciation was much more short-lived in the latest crisis. By the second quarter of 2009, the Turkish lira had already begun to appreciate. This is clearly linked to the more rapid resumption in capital inflows in the current crisis. What Figure 3 also revels is that Turkey entered this latest crisis with a more appreciated real exchange rate than it had entered either of the previous two crises. So the quick appreciation is doubly problematic. I will return to the competitiveness issue below.

Another distinguishing feature of the latest crisis is that the adverse effects on the real economy were deeper and felt much more quickly than in previous crises. Figures 4, 5, and 6 depict the comparative outcomes in industrial production, real GDP, and unemployment. Both real GDP and industrial production took a severe tumble as soon as financial flows turned around, and their fall was more pronounced than anything seen to date. The decline in real GDP during the first quarter of 2009 was the worst on record since 1945. But the recovery in economic activity has also been comparatively rapid. By the end of 2009, even though the Turkish economy stood considerably below its previous growth path, the worst was clearly behind.

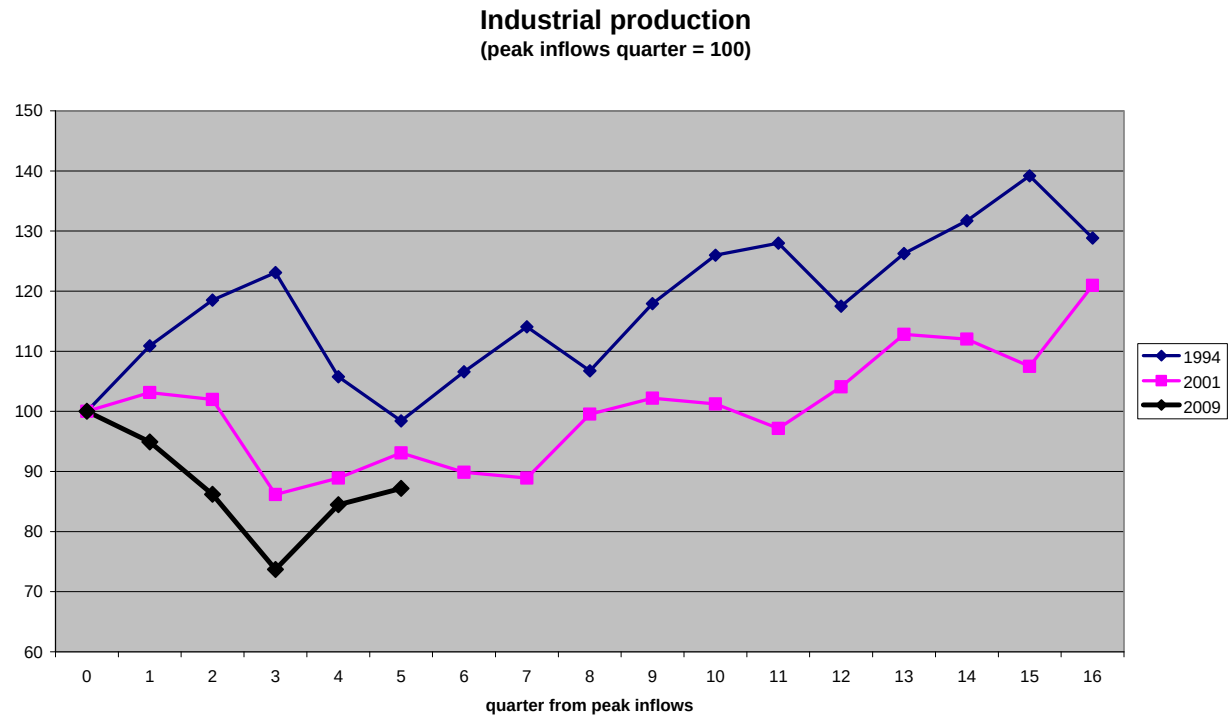

Figure 4

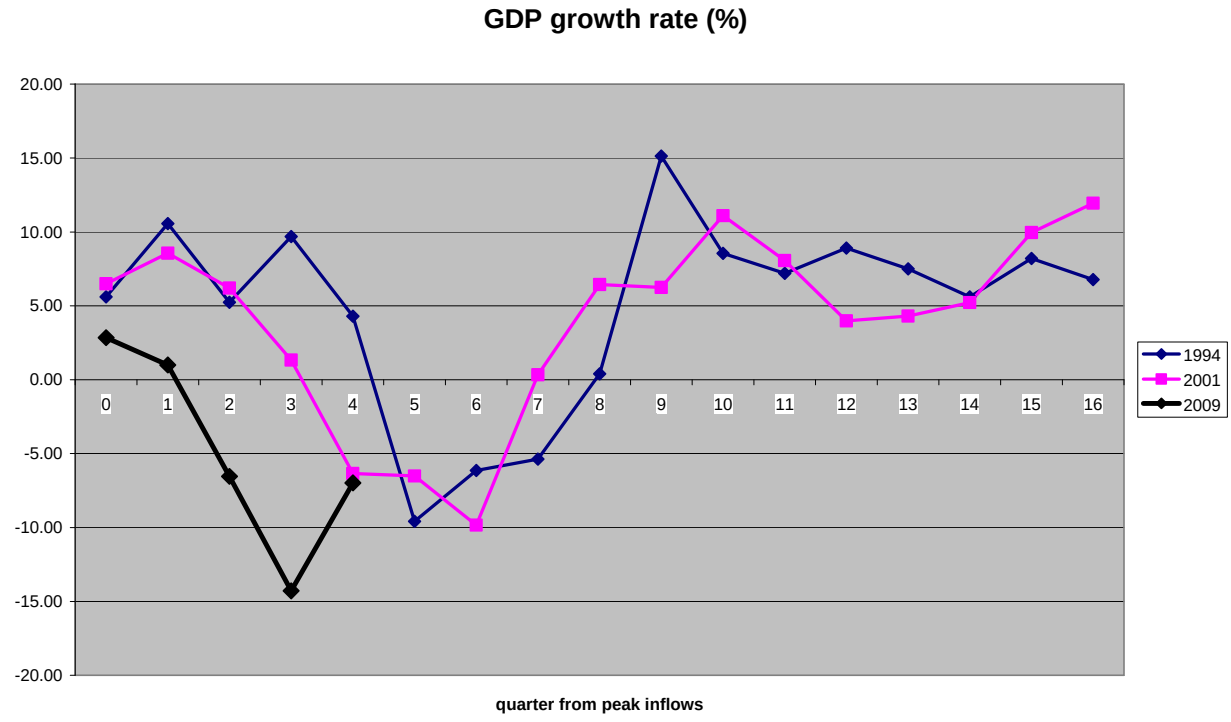

Figure 5

However, it is more difficult to feel optimistic on the unemployment front (Figure 6). The rate of unemployment has come down somewhat since having reached a record-breaking level approaching 16 percent in 2009:1. But unemployment already stood at much higher levels at the onset of the 2008-09 crisis than in any of the previous crises, and is unlikely to fall much further. The unemployment rate has remained stubbornly high despite rapid growth since 2001, and this remains one of the blemishes of Turkey's recent performance. Going forward, any sensible growth strategy will have to focus on employment creation as a central plank.

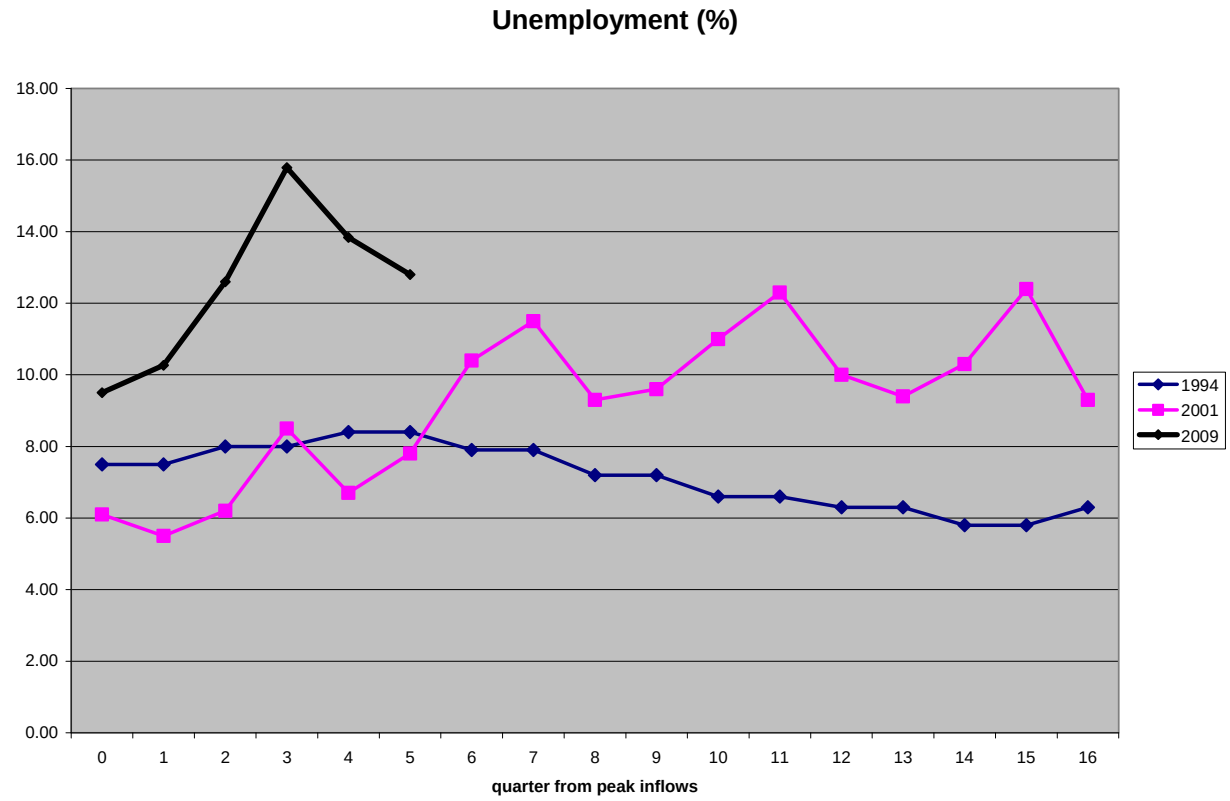

Figure 6

A final difference in the recent crisis relates to export performance (Figure 7). In previous crises, an important mechanism driving the recovery was a rapid increase in exports, driven in large part by a competitive currency. As Figure 7 shows, exports have taken a very different path during the 2008-09 crisis. Export volume fell until early 2009, and has remained stable subsequently. There has not been a strong export response at all. The difference is due, in the first instance, to the fall in global demand, which resulted in a worldwide collapse in trade. This prevented external demand from operating as an adjustment mechanism in Turkey and other emerging markets. But the short-lived real depreciation of the Turkish Lira must also be a factor. As the Lira began to appreciate again in 2009, it undercut the incentives of firms to export. For both sets of reasons, exports are not contributing much momentum to economic activity in the present crisis.

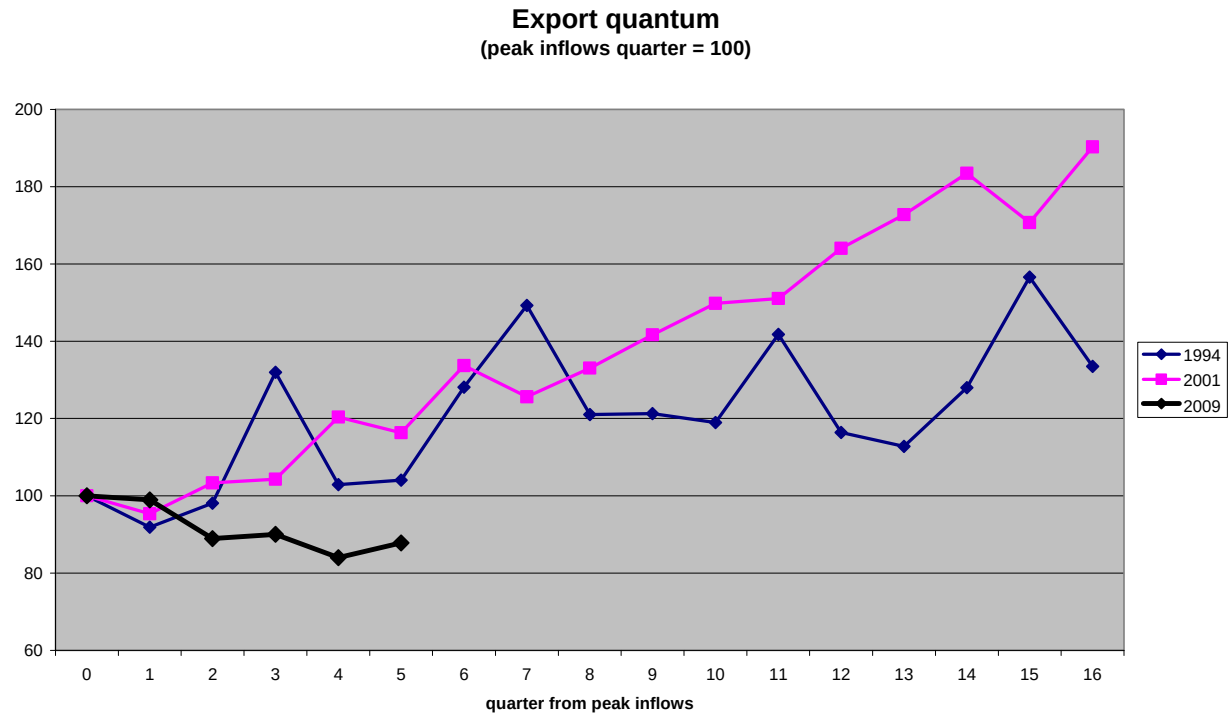

Figure 7

These comparisons and quick overview reveal that despite many strengths the Turkish economy is emerging from the current crisis with some important weaknesses. The resumption of capital inflows is indicative of a renewed vote of confidence on the part of financial markets in the underlying health of the Turkish economy. The quick rebound in economic activity suggests the worst of the crisis is over. Yet unemployment is extremely high by Turkish standards and the real exchange rate remains very appreciated. How alarming are these features of the current recovery? The answer depends in large part on what we think is an appropriate growth model for Turkey.

Two contending growth narratives

In developing countries growth is produced by structural change. It requires moving their resources—predominantly labor—from low productivity activities such as traditional agriculture and informality to high-productivity modern and mostly tradable activities such as manufacturing. The more rapid this movement, the higher the growth rate of the economy. The facts that so many countries remain poor and the rate of convergence is rarely positive are indicative of the magnitude of the inherent market and institutional failures that block this transformation. Weak market systems, externalities, and poor governance exert a disproportionate tax on the modern parts of the economy, preventing rapid structural change in the absence of corrective government policies. This is why growth is never an automatic process, and requires proactive policies in addition to sound macroeconomic fundamentals.

Among the various constraints that prevent the take-off of modern tradable activities, two are particularly important. First, modern industrial activities may be too slow to expand because of problems of access to credit and a shortage of finance. Second, these activities may be

hampered by low private returns, despite the presence of high *social* returns, due to a range of learning spillovers or institutional shortcomings. Of course under-developed countries suffer not from a single malady but from a whole host of problems. In reality developing countries may be plagued both by poor finance and by poor returns. But as desirable as it may be to try to remove all these problems at the same time, this is neither practical nor necessary. As the experience of successful countries demonstrates, what is required is strategic prioritization. If we can develop a sense of where the most important bottlenecks lie, we can address the problems sequentially. So it is of great practical importance to know whether it is poor finance or poor returns that acts as the most binding constraint (Hausmann, Rodrik, and Velasco, 2008).

Until recently, the mental model that dominated thinking about economic growth was based on the presumption of capital shortage. This model held that low savings and weak financial markets at home were first-order constraints on economic growth and development. Thus greater access to investible funds from abroad and improved financial intermediation would provide a powerful boost to domestic investment and growth along with better consumption smoothing. As some of the downsides of financial globalization became more evident, proponents of this view began to recognize the potential financial instability and crises. But the conclusion that they drew was that sufficiently vigilant prudential regulation and supervision would ameliorate the attendant risks. Given the presumed importance of access to international finance, the model required that policy makers give very high priority to the implementation of appropriate regulatory structures in finance.

We can restate this argument in the form of a three-pronged syllogism: (1) Developing nations are constrained by finance and therefore need foreign capital to grow. (2) But foreign capital can be risky if they do not pursue prudent macroeconomic policies and appropriate

prudential regulation. (3) So developing countries must become ever more vigilant as they open themselves up to capital flows. This syllogism remains at the core of the case for financial globalization (Rodrik and Subramanian 2009).

Recent evidence has thrown some cold water on the premise of this syllogism. The cross-country evidence on the growth benefits of capital-account openness turns out to be inconclusive. Even more damaging, it appears that countries that have grown most rapidly in recent decades are those that have relied less (not more) on foreign capital. In addition, financially globalized developing countries have experienced less, not more, consumption smoothing. These results are at variance with the presupposition that poorer nations need foreign finance in order to develop. To make sense of what is going on, we need a different mental model.

The alternative narrative goes as follows. While some nations may be severely constrained by inadequate access to finance, others—and perhaps a majority—are constrained primarily by poor returns. The essential problem here lies with inadequate investment demand due either to low social returns or to low private appropriability of social returns. The problem is particularly acute in tradables, which are the essential source of growth. In such settings capital inflows exacerbate the investment constraint through their effect on the real exchange rate. The real appreciation of the home currency which accompanies capital inflows reduces the profitability of investment in tradables and depresses the private sector's willingness to invest. It thereby reduces economic growth. So openness to foreign finance ends up being a handicap rather than an advantage.

These two syndromes—poor finance and poor returns—can be differentiated by posing the following hypothetical question to would-be entrepreneurs and investors in an economy: if

you were to receive an unexpected inheritance of $25 million, where would you invest it? In an economy where the binding constraint is lack of finance, this sudden windfall serves to relax the constraint and therefore permits the undertaking of investment projects that would not have been possible otherwise. Entrepreneurs in such an economy are therefore likely to respond to the question with a long list of sectors: agribusiness, tourism, call centers, auto parts, pharmaceuticals, and so on. These are all instances of profitable investments that could be undertaken if finance were available at reasonable cost.

On the other hand, when the binding constraint is low returns the windfall provides no additional inducement to invest—at least not in the home economy. In this alternative economy, the respondent is most likely to fall into a long silence, scratch his head, and then say something like: "can I take the money to Switzerland instead?"

As real-world counterparts to these two prototype economies, think of Brazil and Argentina. In Brazil, private entrepreneurs have no shortage of investment ideas, and even with real interest rates at double-digit levels until recently, the investment rate stood relatively high. When the finance constraint is relaxed in Brazil, either because interest rates fall or foreign finance becomes more plentiful, domestic investment rises. Argentina is somewhat different. In that country, there is much greater uncertainty about the credibility of government policies and the stability of the rules of the game, so the tendency is for private investment to remain low, even when finance is plentiful and cheap. What fosters private investment in the Argentinean economic environment is a big boost in the relative profitability of tradables, which offsets these other distortions. So when the government actively managed the exchange rate in recent years to maintain an undervalued peso, the private sector responded with an investment boom in

tradables—despite the continued lack of credibility in government policies. The Argentinean economy grew rapidly—more rapidly in fact than Brazil's economy.

As these examples illustrate, identifying desirable economic policies requires taking a stand on the nature of the binding constraint. If the binding constraint is finance, we should look kindly on capital inflows and moderately large current account deficits, even though they are likely to produce currency appreciation and overvaluation. The costs of overvaluation are likely to be more than offset in this instance by the benefits in the form of increased availability of investible funds. For an economy like Brazil, it is more important to stimulate finance than it is to enhance returns. But the same set of policies would be disastrous in Argentina. Capital inflows and currency appreciation would not spur domestic investment (at least not in tradables); they would instead lower domestic saving and boost consumption (as they did indeed in the 1990s).

The question that faces Turkey, then, is essentially this: Is Turkey more like Brazil or more like Argentina? It turns out that this is not an easy question to answer. I will provide a first pass through the evidence here, leaving a more detailed analysis to another occasion (or to others).

Reading the tea leaves of the Turkish economy

As it came out of the 2001 crisis, Turkey came to rely increasingly on foreign borrowing to fuel its growth. The widening of the current account deficit went along with a sizable appreciation of the real exchange rate. What does this most recent experience tell us about the nature of the binding constraint in Turkey?

Consider first some of the evidence that would suggest that Turkey is, like Brazil, a finance-constrained economy. It is telling that real interest rates have been quite high and at double digit levels—at least until the recent crisis. Among emerging markets, Turkey's real interest rates are in fact second only to Brazil's (Kannan 2008). Such high rates render the cost of external finance prohibitive for all but the most profitable investments. Despite the high cost of finance, however, private investment has held its own and has hovered in the 16-18 percent rage (in relation to GDP) prior to the crisis (Figure 8). This is not very high compared to Asian countries, but it must be considered a decent performance, and indicative of the presence of high returns in general given the cost of capital. The high level of external borrowing in recent years has clearly helped sustain domestic investment and counteract somewhat the adverse effects of high interest rates.

What is perhaps even more striking is that the composition of investment has been moving in the direction of tradables, and manufacturing in particular (Figure 9). In 2000, manufacturing made up a quarter of total investment; by 2008, this ratio had increased to almost 50 percent! This is a remarkable transformation, rendered all the more striking by the fact that the real exchange rate has appreciated by around 20 percent in the interval. A somewhat similar picture can be seen when we turn to exports, where significant gains in terms of expansion and diversification have been recorded in recent years (see World Bank 2008, chap. 2). The strength of manufacturing investment and exports, despite the appreciation, is another piece of evidence suggesting private returns are high.

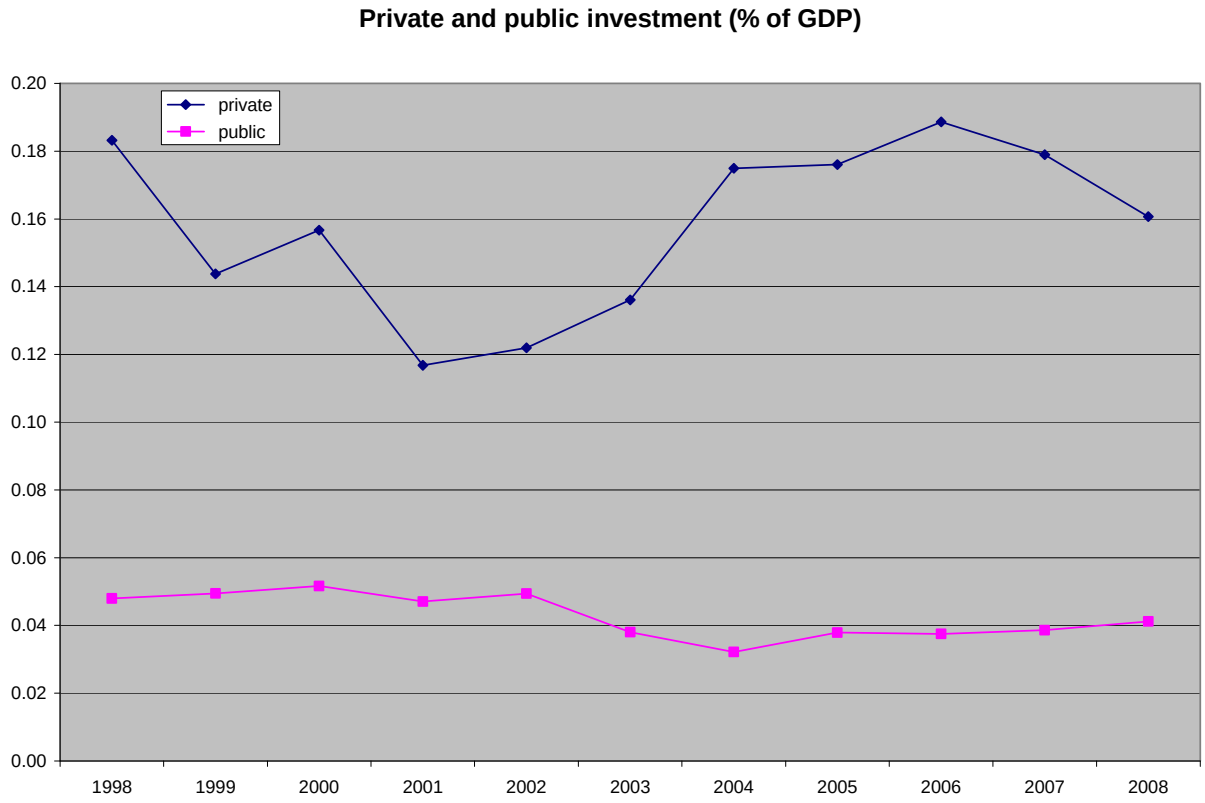

Figure 8

Source: State Planning Organization (SPO)

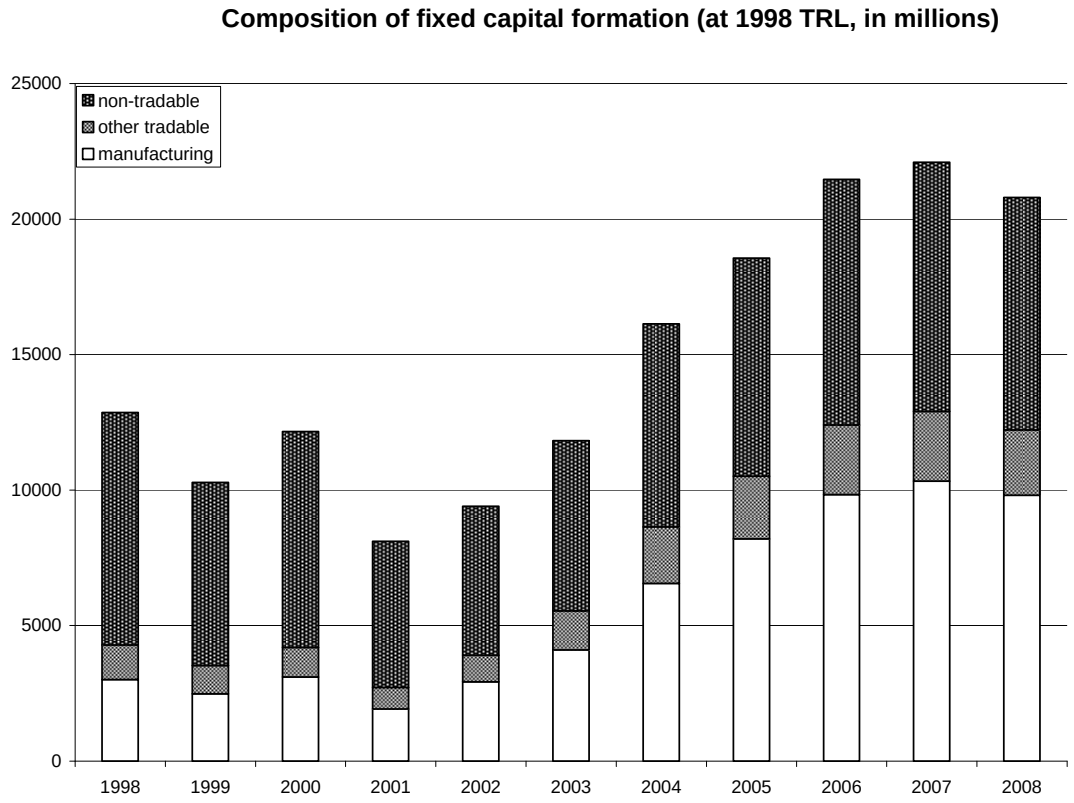

Figure 9

Source: SPO

Third, recent experience with foreign-borrowing led growth has produced a rather good performance in terms of growth and productivity. Figure 10 summarizes economic outcomes during three different periods of Turkey's recent history: the 1980s, the 1990s, and 2000-2008. For each period, the figure provides the growth rates of three different measures of productivity: GDP per capita, GDP per worker, and manufacturing value added per worker. The post-2000 period looks uniformly good, irrespective of which measure of productivity growth we focus on. With the exception of the growth in MVA per worker, post-2000 performance dominates the experience in all previous periods.

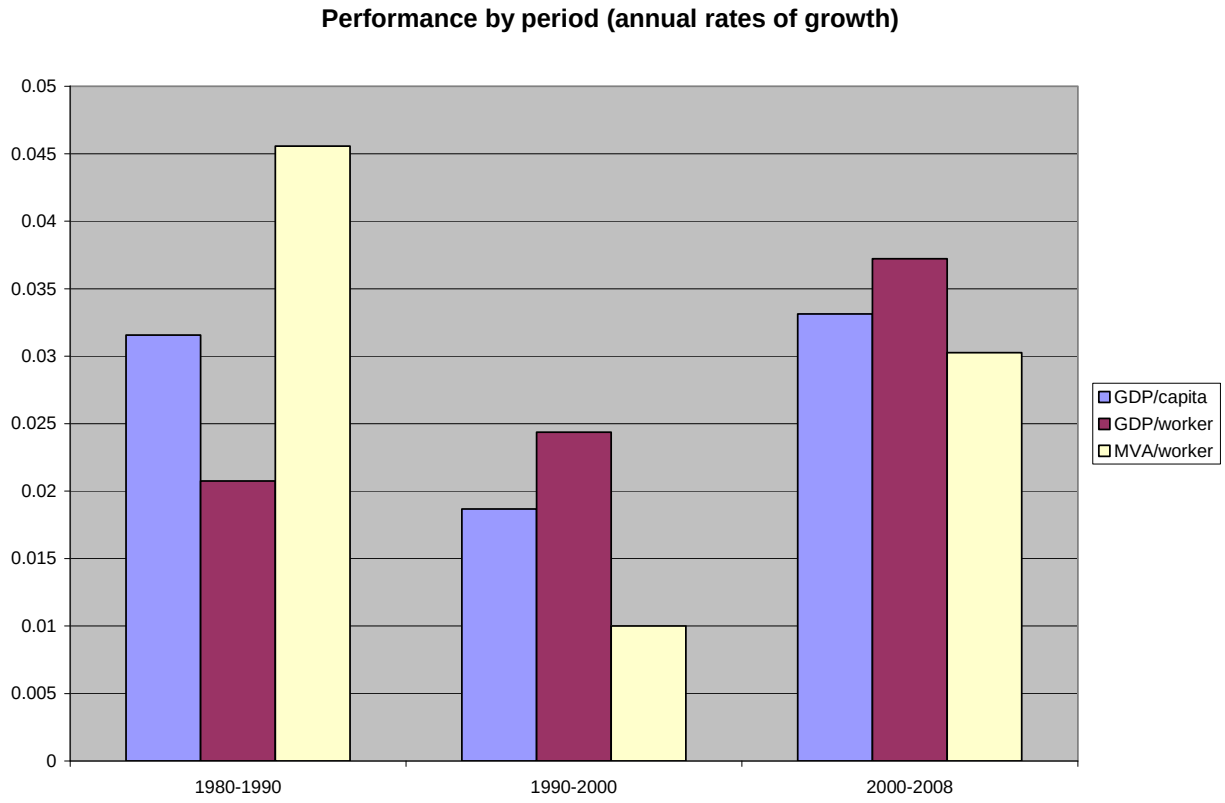

Figure 10

Source: World Bank, World Development Indicators and SPO.

It is clear that recent economic growth has come at the expense of growing current account deficits and an appreciation of the real exchange rate. But the indicators reviewed above suggest that this growth has been quite healthy in a number of respects: it has come through higher investment in tradables, especially in manufacturing which exhibits strong performance despite some degree of overvaluation of the currency. So far, the picture suggests an economy that is constrained more by finance than by low returns.

Now consider the other side of the story. First, it is worth reiterating that aggregate investment remains low in Turkey, despite the support it receives from foreign savings. At its peak, gross capital formation amounted to 23 percent of GDP in 2006 (Figure 11), which is

considerably lower than the rates we observe in high-performing Asian economies. It may be true that Turkey invests more than would be expected for a country where real interests are so high, but it is equally true that there is considerable upside room for increasing the investment effort in the economy. There is no reason why the Turkish economy cannot grow even more rapidly (and indeed it will certainly have to if the excess supply of labor is to be absorbed in coming years).

Figure 11 shows why investment remains low even at high levels of current account deficits: the domestic saving rate has fallen during the 2000s and remains quite depressed. So in 2006, a substantial resource transfer from abroad in the amount of 6 percent (of GDP) could barely lift the domestic investment effort up to 23 percent. A desirable investment rate for Turkey would be closer to 28 percent. As long as Turkey remains outside the Eurozone, a sustainable and "safe" level of current account deficits will not surpass 6 percent—and indeed may even lie below that number. Anything higher will leave the country in risk of periodic sudden stops. In other words, with domestic saving so low, there are inherent limits to how much the current account can help finance domestic investment, even if we accept that the binding constraint lies on the financing side. Regardless of the nature of the binding constraint, raising growth in the future will necessitate a significant increase in the domestic saving effort.

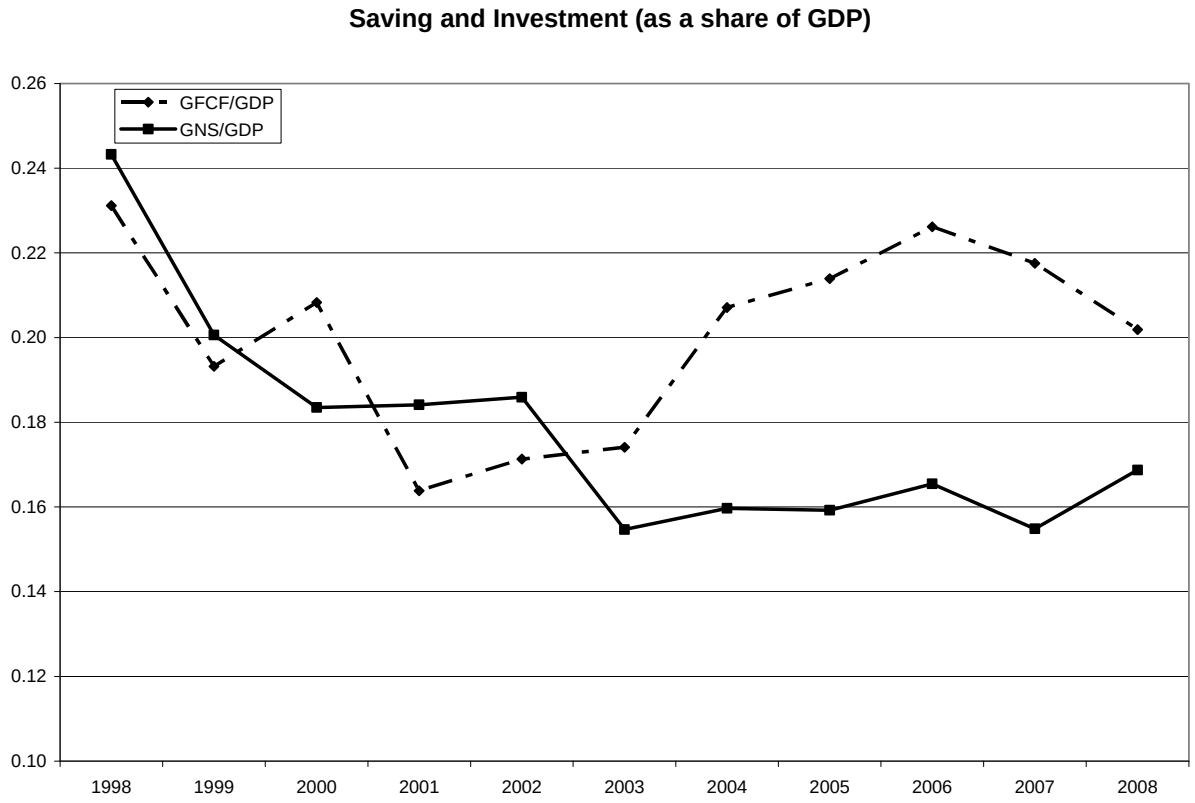

Figure 11

Source: SPO

Perhaps the strongest bit of evidence that suggests Turkey needs a different growth strategy is the dismal record on employment creation and on unemployment. As Figure 12 shows, Turkey's unemployment rate jumped from a range of 6-8 percent during the 1990s to a new plateau of 9-12 percent following the 2001 crisis. In the aftermath of the current crisis, unemployment may well get stuck at even higher levels still. This is both an economic and social problem. On the economic front, it means that there is gross underutilization of domestic resources. On the social front, it is the harbinger of political difficulties and tensions that may become difficult to overcome if left unresolved. For both sets of reasons, a healthy growth strategy will need to focus explicitly on job creation. That means both a higher growth rate and

greater expansion of high productivity sectors with good employment potential.

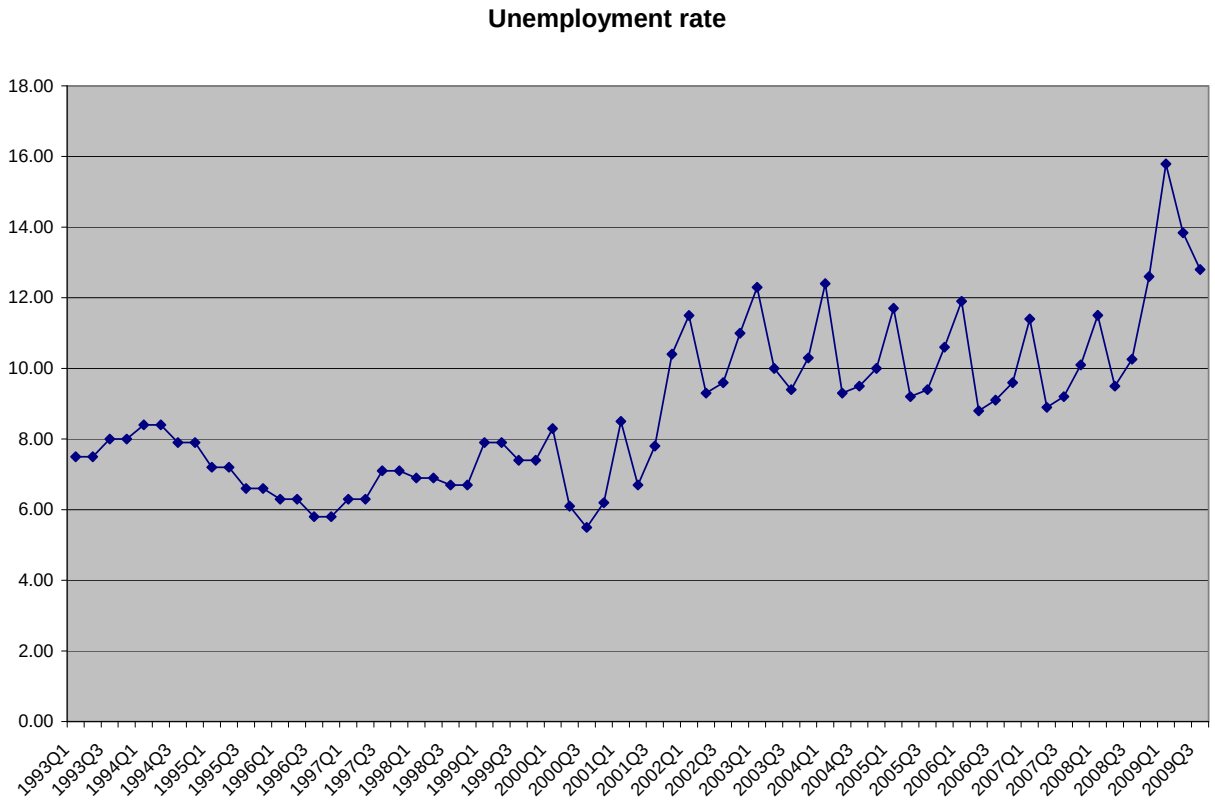

Figure 12

The bottom line is this. Foreign borrowing does boost growth in Turkey, because private returns in tradables are relatively high and current account deficits permit greater investment than would be possible otherwise (despite the associated reduction in competitiveness). However, this model of growth places too low a ceiling on growth and does not permit a rapid enough generation of jobs to prevent unemployment from rising. Faster growth would require, under the prevailing strategy, an unsustainably large external deficit. The only alternative is to move to a model of growth that breaks the link between growth and the current account deficit.

This alternative strategy would require a substantial effort in terms of domestic saving mobilization, in addition to maintaining high private returns in tradables.

Concluding remarks

We can summarize the story outlined here as follows. Turkey *needs* to grow more rapidly; and it *can* also grow more rapidly. Turkey has a growth potential that recent performance, successful as it may be, has not fully exploited.

A growth model that relies on foreign savings and large current account deficits can generate respectable growth, but it runs into inherent problems. For one thing, given the present level of domestic saving, a substantial rise in domestic investment would push the external deficits to heights that would clearly be unsustainable and dangerous. And second, even moderate reliance on foreign savings, as we have seen during the recent crisis, leaves the domestic economy vulnerable to sudden stops and confidence reversals that originate from external sources. A comparison with Brazil is again instructive here. Brazil entered the 2008-09 crisis with a much smaller external imbalance than Turkey, and as a result has experienced a much more shallow recession.

If growth is going to be financed domestically, Turkey will need a permanently higher saving rate. Fiscal policy has a critical role here. The most direct way in which domestic saving can be increased is to increase the structural surplus of the public sector. The medium-term programs of the government must target a large enough fiscal surplus to leave room for the Central Bank to move interest rates to a permanently lower plateau. An increase in public saving will reduce capital inflows, prevent the current account deficit from rising, and help sustain a

more competitive currency. This step is a critical element in moving Turkey to a new growth path.

But more will need to happen for all the pieces to fall into place. A few numbers can help quantify the nature of the challenge facing Turkey in moving to an alternative growth model. A sustainable and safe current account deficit for Turkey would not much exceed 3 percent of GDP, so let's take that number as the upper limit on the resource transfer from abroad. A desirable target for the investment effort would be around 28 percent, to ensure high enough growth keeps unemployment in check. This implies a domestic saving rate of at least 25 percent. This is a whopping 9 percentage points higher than the 16 percent achieved by the Turkish economy in the years just prior to the 2008-09 crisis (see Figure 11). Obviously, such a large increase in saving cannot be achieved through a rebalancing of public sector accounts alone. So is this target at all realistic?

The record of fast-growing countries—not just Asian economies but also Chile since the mid-1980s—suggests a positive answer. All these economies experienced significant saving transitions at the onset of their growth accelerations (Rodrik 2000). A positive growth dynamic is in fact one of the most important factors sustaining a rapid increase in private (and especially corporate) saving. When growth rises in a sustained manner, it also induces higher saving. The prospect of high earnings growth leads firms to increase their retained earnings, which in turn feeds into higher investment and growth. A determined fiscal effort along with a competitive currency, then, has the potential to crowd in the private saving required to close the gap.

If a shift in fiscal policy provides the first plank of the new growth strategy, a second would be the signaling of a new policy attitude towards the exchange rate. Currently, the official line is that the Central Bank intervenes in currency markets only to smooth short-term

fluctuations, without taking a stand on the medium-term level of the exchange rate. This has to be replaced with a clear statement of preference in favor of preventing overvaluation. The Central Bank, the Treasury and the Finance Ministry need to cooperate and coordinate when capital inflows threaten to push the value of the currency up. Policy makers have many policy instruments they can use to stem appreciation. A combination of sterilized intervention, prudential restrictions on inflows, liquidity requirements aimed at stemming foreign borrowing and other fiscal measures can be effective if deployed with sufficient determination. None of this needs to be inconsistent with inflation targeting as long as the performance of tradables features prominently in the Central Bank's evaluation of potential growth of the real economy and fiscal policy allows sufficient room for monetary policy to be counter-cyclical with respect to capital inflows.

The key point is that private sector saving and investment behavior is unlikely be transformed unless there is a credible shift in the policy regime with regard to both the fiscal stance and the exchange rate.

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