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Chapter Author: Merih CelÃ¢sun, Dani Rodrik

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25 percent in 1980, bringing the cumulative reduction in three years to 43 percent.

The worsening of income distribution in this period was the consequence of inflationary pressures being reflected in contract prices (such as wages) only with a lag whereas other prices could adjust freely. Ironically, the resulting relative-price structure would be maintained and consolidated in the post-1980 period of adjustment. As will be discussed at greater length in the following two chapters, the inflationary episode of 1977–80 had disturbing effects which outlasted this period.

3.3 Concluding Remarks

Was there an alternative? Given the necessary retrenchment on the current account, it was inevitable after 1977 that real expenditures would have had to be cut somewhat. Instead, the authorities acted as if the crisis might go away if ignored, setting off an inflationary spiral which eroded the real incomes of the poorest segments of Turkish society. A series of bold measures of expenditure reduction and expenditure switching early on in the game might have enabled the economy to avoid some of the worst excesses of adjustment via inflation. In the event, letting inflation do the job of cutting real expenditures proved a very costly method compared to the obvious alternative of reducing nominal spending itself. In any case, the policies of the 1978–79 period did not seriously tackle any of the underlying problems of the economy, and they were incapable of promoting recovery. The latter would have to wait for the 1980s.

4 Stabilization and Adjustment Policies, 1980–85

As described in the earlier chapters, Turkey became the first major developing country debtor to face a deep payments crisis in the post-1973 period. Because of the poorly managed macroeconomic environment and massive short-term borrowing, Turkey's debt rout arrived early in mid-1977 before the second oil shock of the late 1970s. A heavy reliance on import compression in combination with unrestrained nominal expenditures resulted in an inflationary slowdown of growth during 1978–79. The accompanying shortages in commodity supplies produced wide public discontent. The unsuccessful implementation of the IMF standby arrangements also strained

relations with the Fund and the international financial community. Against the background of deteriorating economic performance and increasing social and political tensions, Turkey had parliamentary by-elections in October 1979, which resulted in the resignation of Ecevit's cabinet and the formation of Demirel's minority government.

Faced with a thoroughly destabilized macroeconomic picture. Demirel's minority government introduced a new policy package in January 1980. After the resumption of growth, together with a sizable inflation reduction in 1981, the policymaking process, with the full support of the IMF and World Bank, increasingly focused on export-oriented adjustment issues and liberalization reforms in the economy. Turkey gained an acceptable degree of creditworthiness by 1982–83, just as most of the major LDC debtors were entering a disruptive crisis phase in their development. The Turkish recovery has been accompanied, indeed partly caused by, an export boom which has taken even the most optimistic observers by surprise. The relative success of the Turkish adjustment policies since 1980 has been undeniable.

In the aftermath of the Mexican debt-service moratorium in August 1982, the IMF and World Bank have stressed trade and financial liberalization in their high-conditionality programs for LDCs with debt-servicing difficulties. Together with the well-known cases of the export-oriented East Asian economies, Turkey's recent adjustment experience has been showcased by these multilateral institutions as a successful application of their liberalization-focused approach to the management of the LDC debt crisis.[1]

The current policy debate on the LDC debt crisis is concerned with the efficacy of the official international approach to a number of crucial points. As aptly argued by Sachs (1986) and Dornbusch (1985), fiscal correction problems are very serious in the LDC debtors, as the bulk of external debt is held and serviced by the public sector. The trade-liberalizing measures involving sizable depreciation of the exchange rate often tend to overburden the budget-correction process and destabilize the internal balance. As noted by Sachs (1985), in his comparative analysis of the Latin American and East Asian cases, the political-economy context also matters in the maintenance of realistic exchange rate and commercial policies in the pursuit of export-led growth processes. Nonetheless, in recent years distributional aspects and social costs have invited very little formal concern in launching adjustment programs.

In the context of the contemporary policy debate on the LDCs, a balanced review of the recent Turkish experience, as well as other country-specific case studies, may provide useful points for generalized assessments. Turkey's outward-oriented experiment in the 1980s is still a continuing one and contains imperfections as well as strengths in the way conditions for equitable and sustainable growth in the long run are being established. Hence, Turkey's policymakers may also benefit from expost assessments of the policy and adjustment patterns observed in the post-1980 period.

A number of earlier reports and papers by official agencies and individual authors offer useful accounts of the Turkish economic recovery in the 1980s.[2] While drawing on the data and commentaries of the earlier studies, our analysis strives to focus on the overall pattern of policy sequence and interdependencies, and to bring out the key linkages in the adjustment process. Rather than treating policy elements and actual outturn in one unified chapter, it appears more convenient to discuss the nature of policies in the present chapter (with occasional references to performance data), and analyze the anatomy of the adjustment process in chapter 5.

4.1 Special Factors Affecting Economic Performance

Before proceeding with the discussion of policy aspects, certain special factors that have played a role in Turkey's recent economic recovery should be pointed out. The purpose of this is not to downgrade the domestic policy effort, but to provide a more balanced picture for intercountry comparisons. Among a host of special factors prevailing in the policy setting, the most salient ones are the following.

Domestic Political Context. Although initiated by Demirel's government in January 1980, the implementation of the new stabilization program received not only continuity but also additional political clout under the military rule from September 1980 to November 1983. The military regime retained Turgut Özal, the principal technocrat behind the new program, as deputy prime minister during 1980–82. With the return of Özal as the newly elected prime minister in late 1983, the liberalizing measures were further extended and strengthened. Besides ensuring continuity in the policy process, the interim military arrangements facilitated legislative and administrative changes pertaining to the structural components of the program. Furthermore, the presence of the military in the political arena made it possible to attain downward flexibility in real wages and agricultural prices—which we will stress in the next chapter as a key aspect of the adjustment process—and to avoid open distributional conflicts in policy implementation.

Sizable Debt Relief and New Lending. The post-1980 policy experiment benefited from the debt relief, balance-of-payments assistance, and policy support of the major bilateral creditors (mainly the OECD countries) and multilateral lending institutions. As we will discuss in greater detail in chapter 9, the debt relief granted through the OECD Aid Consortium reached $4.6 billion in 1980–85. Not only the size, but also the timing of the external assistance was beneficial to Turkey's economic recovery. During the difficult stage of 1980–83, the cumulative net resource transfer (excluding the minor items connected with foreign direct investment) was nearly a positive $2 billion, which obviated the need to generate surpluses in the noninterest current account. The effective policy dialogue with the IMF

and World Bank has facilitated debt relief agreements and concessional bilateral lending in the 1980–85 period.

Special Market Conditions in the Middle East. The trading opportunities in the Middle East assumed special political characteristics with the Iran-Iraq military conflict in the Persian Gulf. To offset the cyclically unfavorable export conditions in the OECD region, a comprehensive effort was made by Turkey to penetrate the Middle Eastern and North African markets. The marginal share of the Middle East in the expansion of merchandise exports in 1980–83 (from $2.9 billion in 1980 to $5.7 billion in 1983) was 68 percent. The export drive to this region was complemented by the rapid rise in construction projects, the value of which reached $12 billion in 1981 from $3 billion in 1979. In turn, the incremental contribution of the Middle East has lessened after 1983 with the reemergence of the OECD region (mainly the EEC countries) as the predominant trading area for Turkey, accounting for around 55 percent of both exports and imports in 1985.[3] The econometric work reported in chapter 7 is suggestive of the important role played by Middle Eastern demand in Turkish exports after 1980.

4.2 Latin American Debtors and the Turkish Case: A Digression

To place the policy review for Turkey in a more relevant cross-country context, attention may also be drawn to a basic similarity, as well as to a number of differences, between Turkey and major Latin American debtors in their crisis management in the 1980s.

One basic similarity pertains to the structural nature of external capital in the pre-crisis growth process. At least until the mid-1970s, Turkey and major Latin American debtors (e.g., Mexico, Brazil, and Argentina) pursued a development strategy that centered on a growing home market and used external capital to supplement domestic savings in investment. The prolonged maintenance of heavy protection and the exhaustion of relatively easy import-substitution possibilities eventually yielded a productive structure which rigidly depended on imported inputs almost in fixed proportions.[4] As observed by Dornbusch (1986, 138), these heavily indebted countries have been structural importers of capital, facing a wide range of short-run structural impediments in restoring external balance. Unlike the cases of flexible open economies, the rapid return to external balance from a large deficit position cannot be accomplished just by cutting down overspending, at least not without substantial losses in output.

In coping with structural rigidities in the adjustment process, the Turkish experience in the 1980s differed, however, from the Latin American cases in four key respects. First, Turkey could secure sizable new lending in the early years of the recovery effort, and thus bolstered its foreign exchange position to resume the needed growth of imports in overcoming the structural impediments to a more outward-oriented stance in development policy.

Second, Turkey's public finances were not overburdened by external debt servicing in 1980–83, largely due to the debt relief granted by its major creditors through the OECD Aid Consortium. Third, unlike in major Latin American economies, the Turkish policymakers did not have to deal with indexed contract prices, and therefore could attain a credible price stabilization—through an orthodox shock treatment—in the earlier years of the program. Fourth, the dependence on primary exports was considerably less in Turkey than in the Latin American region, which suffered as a whole substantially from the sharp fall in primary commodity prices in the post-1982 period.[5]

4.3 Broad Strategy and Policy Objectives

In retrospect, it seems clear that the new economic team under Özal by late 1979 had made a thorough assessment of the earlier policy trials, the current situation, and possible future actions.

As discussed in chapter 3, it was evident that immediate corrective actions were needed to regain control over monetary expansion and to relieve commodity shortages. The evaluation of past policies pointed to the adverse consequences of aborting trade-liberalization objectives in the earlier stabilization episodes, and of subsequent appreciation of the real exchange rate which produced an anti-export bias in the growth process. To restore creditworthiness, it was necessary to attain a rapid rise in foreign exchange earnings through domestic efforts. The resumption of growth seemed to be essential in gaining public confidence in the policymaking process. Drawing lessons from past experiences and recognizing the limited scope for further import compression in the country's current stage of industrialization, the economic team persuaded Demirel's government to introduce a bold and comprehensive set of policy measures on 24 January 1980. Apparently, these measures went further than the proposals and requirements of the IMF.[6]

The package of January 1980 was specific on policy measures, but not explicit on the magnitude and sequence of objectives sought in the future performance of the economy. In retrospect, it can be stated that the policy objectives were basically twofold: (1) to attain, as quickly as possible, an acceptable degree of price stability combined with export-led (output) recovery, and (2) to achieve a greater outward-orientation of the economy through a sequential liberalization and structural adjustment.

The new strategy was more of an approach and a style, rather than a blueprint for future actions. Besides featuring a strong commitment to flexible pricing, this approach emphasized gradual changes in institutional mechanisms for the development of a unified market economy. The gradualist character of the overall strategy was stressed by Özal in a 1982 interview as follows:

> Change has to be gradual; we try to have what I call dynamic programming, but, in certain areas, change has to be step by step. For example, on January 24 [1980] we did not free interest rates. Six months later we freed them. But real freedom came at the beginning of last year [1981], when the banks started to fight each other. The same applied with foreign exchange. This year [1982] we hope to change the line protection scheme, which we couldn't change immediately because people were so used to it. (Euromoney 1982)

In the discussion of the broad strategy, a further observation relates to the policymakers' preference for the simultaneous pursuit of macroeconomic stabilization and export-led recovery in Turkey's post-1980 adjustment effort. This point is important for our subsequent discussions, requiring preliminary remarks at this juncture.

Although committed to a rapid disinflation in the early stage, the policymakers were well aware of the potentially adverse consequences of a prolonged recession in the Turkish economy. Too rapid a squeeze in the real sector could have discouraged the manufacturing-based export initiative, which required complementary actions in a wide range of sectors. An early success in export promotion was perceived to be essential to restore creditworthiness, establish the credibility of liberalization measures, and extend penetration in foreign markets for a sustained export drive in the future.

After attaining a reduction in the annual rate of inflation from over 100 percent in mid-1980 to around 30 percent in mid-1981, the policymakers began to emphasize export-led output expansion also to avoid higher unemployment in the urban sector, which had experienced a sharp fall in real wages in 1979 and 1980. In fact, to reinforce the growth process, public investment was increased (about 9 percent) in real terms in 1981, partly to offset the continuing decline in private investment, despite the advice to the contrary by the international financial agencies.

Against the background of continual upward adjustments in the exchange rate and SEE prices, domestic inflation settled around a 30 to 35 percent core rate in the post-1981 period, which saw a fairly steady expansion of output through 1986 (as will be discussed in chapter 5). In turn, the persistence of inflation around this rate (with a substantial amount of variability) reduced the information content of relative price changes, possibly retarding deeper allocational restructuring in the economy.

4.4 Policy Mix and Sequence

After this discussion of the initial conditions and overall policy trends, we now take a closer look at the pattern and content of policy measures introduced in early 1980 and extended thereafter. The time frame for our

present analysis is the 1980–85 period. For convenience in presentation, the entire set of measures is loosely referred to as the post-1980 program. The time horizon is extended to 1986 in chapter 8, in which we deal with public sector finances.

While benefiting from hindsight, an ex post classification of the wide range of measures taken in 1980–85 involves three sets of methodological problems. First, the policy measures had mutually interdependent effects on the observed economic performance. Second, their effects spilled over time in a non-uniform fashion. Third, some of the more important measures were qualitative in character, the effects of which were expected to be seen in the longer run. Thus, a precise mapping of policy instruments onto policy objectives, on the basis of a well-defined set of criteria, is neither possible nor critically necessary in the context of our principal concern with the basic pattern of Turkish policies in this period.

Having stated these caveats, in this section we present a crude policy taxonomy which is shown in table 4.1. As can be seen from the table, the main policy measures implemented from 1980 to 1985 can be classified in three main categories: (1) measures basically aiming at stabilization and export-led recovery, (2) liberalization measures, and (3) supportive fiscal and institutional actions. Four successive policy stages are identified within the 1980–85 period, which roughly take place in 1980, 1981–82, 1983, and 1984–85. In the table, the implementation subperiods for specific policy measures are marked by the sign (x), where the occasionally used sign (?) indicates the doubtful nature or weak application of the corresponding measure.

Although a further breakdown of the policy measures and subperiods is possible, the level of disaggregation adopted in table 4.1 appears to be sufficient to identify the seven main characteristics of the policy mix and sequencing as follows.

(1) Because of the severity of internal and external imbalances, the program emphasized macroeconomic stabilization in the first year with a heavy reliance on price shocks (mainly exchange rate devaluations and increases in the price of public enterprise products), which complemented monetary and budget restraint. The brunt of adjustment in the budget was on the SEE subsidies and social expenditures.

(2) With an early emphasis on export promotion, a clear signal was given to producers that output recovery would be induced by export expansion. The maxi-devaluation of January 1980 was followed by frequent mini-devaluations through May 1981. From May 1981 onward (to the end of 1983), the exchange rate was adjusted daily against a currency basket. Besides devaluations, export incentives included tax rebates, credit subsidies, an exchange retention scheme, and duty-free imports for the production of exportables.

Table 4.1 **Mix and Sequence of Policy Measures, 1980–85**

	1980 (1)	1981–82 (2)	1983 (3)	1984–85 (4)
A. *Stabilization and export-led recovery*				
1. Price shocks				
a. Maxi-devaluation	x			
b. Interest rate shock	x			
c. SEE Price hikes	x	x		x
2. Flexible pricing of exchange rate, interest rates (partial), and industrial products (partial)	x	x	x	x
3. Supportive incomes policy for downward flexibility of real wages and agricultural prices	x	x	x	?
4. Tight monetary stance	x	x		
5. Budgetary restraint	x	x	?	
6. Export incentives (exceeding 20% total subsidy on eligible manufactures)	x	x	x	
7. Debt relief and net new lending	x	x	x	
B. *Liberalization measures*				
1. Flexible pricing (same as A.2): deregulation of product markets (partial), decontrol of interest rates (partial)	x	x	x	x
2. Import liberalization				
a. Removal of quotas, retention of licensing		x		
b. Introduction of a Prohibited List				x
c. Major reductions in licensing				x
d. Realignment of tariffs				x
3. Partial decontrol of external financial flows				x
4. SEE reform legislation			x	x
5. Financial development				
a. Capital Market Board		x		
b. Framework for stock exchange			x	
c. Bank supervision system				x
6. Encouragement of foreign direct investment	x	x	x	x
C. *Supportive fiscal actions and institutional changes*				
1. Restructuring public investment	x	x		
2. Tax incentives for financial intermediation	x	x	x	
3. Income tax reform	x	x	x	
4. Introduction of VAT system				x
5. External debt management (improved debt reporting system)			x	x
6. Sector-specific actions (planning and pricing schemes for energy and agriculture)		x	x	x
7. Extrabudgetary funds				x

Source: The authors' ex post classification of major policy measures.

(3) The initial stabilization effort was strengthened by two additional factors: namely, a supportive incomes policy, and sizable debt relief and new borrowing. The incomes policy worked in implicit ways through restrictions on labor union activity, delays in wage adjustments, real reductions in the salaries of government employees, and restrained nominal increases in agricultural support prices.[7] The increased foreign exchange availability

contributed to the elimination of hoarding of essential commodities, enhancing the workability of the new program.

(4) The overall liberalization process proceeded in four distinguishable steps. The sequence was as follows: First, industrial product markets were deregulated (with the initial exceptions of fertilizers, coal, electricity, sugar, and certain oil products). Second, interest rates were to a large extent deregulated in mid-1980. This step consisted of decontrol of bank deposit rates and free setting of nonpreferential lending rates. Third, a preliminary step in import liberalization came in mid-1981 in the form of the removal of the quota list from the import regime. With the elimination of quotas, the import policy relied on licensing and prohibited imports as restrictive devices until 1984. Fourth, the import regime was further liberalized and a partial decontrol of external financial flows was undertaken in one unified major step at the end of 1983 and early 1984.

(5) Financial sector reforms, SEE reorganization, and encouragement of foreign direct investment (FDI) constituted other supplementary measures with varying degrees of strength and success. Besides the deregulation of interest rates in mid-1980, the major policy initiatives for the financial sector included the establishment of the Capital Market Board (1981), introduction of a new framework for the stock exchange (1983), legislation of a new banking law and regulatory system (1983–85), and creation of an interbank money market (1986).

(6) On the SEE front, the main emphasis was on price flexibility, a hiring freeze, and real wage reductions. The reform legislation for the SEEs came rather late (1983). The new legislation delineated the particular SEEs that would function on the basis of market criteria. Privatization studies for the SEEs were initiated in 1985–86. Policy measures related to FDI were mainly directed toward a more flexible and simplified application of the existing legislation on FDI, which contained highly liberal provisions.[8]

(7) Finally, the remainder of the policy measures shown in table 4.1 are classified as supportive fiscal actions and institutional changes. This category includes rationalization of public investment, tax incentives for exports and financial intermediation, income tax reform, adoption of the value-added tax (VAT) system, and sector-specific actions for energy and agriculture (mainly involving improved planning and pricing schemes). Income tax reform was helpful in creating more realistic tax brackets and reducing marginal rates for wage and salary earners. After showing an initial rise (to about 20 percent) in 1981, the tax/GNP ratio dropped (to 16.6 percent) in 1984. Because of the lagging tax performance, the overall budget correction was achieved instead through the SEE price hikes and restrained current expenditures.

As summarized above, Turkey's liberalization drive proceeded in successive stages. In its basic outline, it followed the general pattern suggested in the literature, which argues in favor of the following sequence: fiscal correction, deregulation of product and financial markets, liberalization

of the current account, and decontrol of the external financial flows in the balance of payments.[9]

Turkey's liberalization effort should not be viewed, however, as a completed process. As of late 1987, it still contained a number of incomplete aspects such as: a complicated system of preferential credits, fragmented financial markets, political interference in SEEs, and arbitrarily handled import permissions and levies. Despite the remaining imperfections, these reforms constitute in their entirety a credible policy package, which broadened the role of market forces in determining the direction of the Turkish economy. Some of the key aspects of policy pertaining to relative prices are reviewed in sections 4.6 and 4.7, following some remarks on the role of the IMF and World Bank in the next section.

4.5 IMF and World Bank Conditionality

The implementation of the 1980–85 policy measures outlined in section 4.4 benefited from the balance-of-payments assistance and policy support of the major creditors and international financial organizations. A three-year standby arrangement concluded in June 1980 with the IMF (SDR 1,200 million, 625 percent of quota) was followed by a one-year standby in June 1983 (SDR 225 million), which was later cancelled and replaced by a final one-year arrangement with the Özal government in April 1984. In turn, as shown in table 4.2, the World Bank provided five structural adjustment loans (SALs) totaling about $1.6 billion in support for liberalization reforms and rationalization programs in the energy, agricultural, and financial sectors in addition to regular project lending. The smooth and effective policy cooperation with the IMF and World Bank facilitated multilateral debt relief agreements and concessional bilateral lending in the 1980–85 period.

In their work with Turkey, the IMF and World Bank collaborated closely, with their conditionalities determining, to an important extent, the contents and modalities of the policy frame sketched in table 4.1. The overall concern of the IMF with the management of aggregate demand, the payments

Table 4.2 World Bank Structural Adjustment Loans (SALs) for Turkey

Loan	Date of Approval	Amount (million $)	Disbursements to 31 December 1984
SAL 1	3/25/80	200.00	200.00
Supplement	11/18/80	75.00	75.00
SAL 2	5/12/81	300.00	300.00
SAL 3	5/27/82	304.50	304.50
SAL 4	5/23/83	300.80	300.80
SAL 5	6/14/84	376.00	250.00

Source: Yagci et al. (1985).

regime, and the exchange rate was complemented by the efforts of the World Bank focusing on trade liberalization, resource mobilization, financial development, public investment planning, SEE reorganization, and sector-specific issues. The IMF relied on the standard performance criteria, emphasizing interest rate reform, ceilings on net domestic assets of the central bank, subceilings on central bank credits to the SEEs, limits on contracting new external debt, and currency depreciation in a unified framework. The World Bank was particularly effective in its public investment review and trade policy conditionalities, which are listed in table 4.3. The policy actions envisaged in five successive SALs for the gradual liberalization of the import regime, as disclosed in table 4.3, illustrate how deeply the World Bank was involved in the policy process. We will return to the role of these Bretton Woods institutions in chapter 9.

4.6 SEE Price Hikes and Agricultural Support Prices

As indicated in the policy overview above, a key aspect of the reform package in 1980 was a restructuring of key relative prices within the

Table 4.3 World Bank SAL Conditionality for Import Liberalization

Issues and Objectives
Issues
1. Exchange rate policy
2. Elimination of quotas
3. Rationalization of tariffs
Objectives
Improved efficiency of production and support exports by reduction in anti-export bias

Policy Measures Envisaged
SAL 1 (1980) and SAL 2 (1981)
Flexible exchange rate policy after January 1980 (SAL 1), daily adjustment after May 1981 (SAL 2)
Initiation of a protection study (SAL 1)
Abolishment of the quota list in the 1981 import regime and reduced licensing of imports (SAL 2)
SAL 3 (1982)
Further reductions in licensing and simplified procedures; continual expansion of the liberalization list
Commitment to rationalize the tariff system over the next five years
Preparation of a list of prohibited items
SAL 4 (1983)
Introduction of a rational tariff structure, adoption of a timetable by September 1983 for shifting from licensing system to one relying on tariffs
SAL 5 (1984)
Reduce remaining licensing for imports to a negligible level during the fifth plan period (1985–89), drawing on the recommendations of the completed protection study

Source: Yagci et al. (1985) and World Bank.

economy. We start our discussion here by looking more closely at SEE prices and agricultural support prices. Table 4.4 documents price changes for selected SEE and agricultural support items from 1979 to 1983. It also gives the official estimates for percentage annual changes in the wholesale price index (WPI), SEE revenue, and real GDP over the same period.

The data in table 4.4 reveal that, relative to the WPI, SEE prices moved sharply upward and agricultural support prices moved generally downward. In interpreting the agricultural price movements, we should also note that prices of agricultural inputs (such as fertilizers and *motorin*) shifted sharply upward in real terms, as subsidies were reduced. Thus, the impact of new policy measures was more pronounced on the net rather than gross prices of agricultural products.[10] Moreover, delays in payments for agricultural support purchases also served as a mechanism to restrain farmers' real incomes.

The SEE sales revenue showed a substantial rise in real terms in 1980–82, especially in the first year of the program. In the context of a falling real GDP in 1980, we may infer that the SEE sales revenue increased almost entirely due to price hikes, which were introduced in one major step in early 1980. Hence, the sharp rise in the inflation rate in 1980:I and 1980:II (see table 4.5 below) reflected to a substantial extent the cumulative impact of the maxi-devaluation, SEE price corrections, and deregulation of private industrial prices.

Table 4.4 **Changes in Selected SEE and Agricultural Support Prices**

	Percentage Annual Increase				
	1979	1980	1981	1982	1983
A. SEE items					
Electricity	38	153	49	61	10
Lignite	72	131	101	18	40
Fertilizer (TSP)	0	824	52	10	0
Cement	62	177	39	30	27
Sugar	62	171	82	12	19
Motorin	72	225	64	32	28
Paper	21	231	39	40	14
Pig iron	89	121	46	66	21
B. Agricultural suppport items					
Wheat	57	103	83	22	29
Cotton	82	100	26	24	22
Tobacco	22	83	24	53	34
Tea	21	91	48	34	32
Sugar beet	58	118	48	28	16
Hazelnuts	74	193	14	20	17
Memo items:					
WPI[a]	64	107	37	25	31
SEE sales revenue[b]	69	163	53	51	35
GDP (real)	−0.6	−1.0	4.7	4.3	4.1

[a]Treasury wholesale price index.

[b]Excluding budget transfers that cover duty losses.

Impressionistic evidence on SEE sales revenues and real GDP growth rates (as shown in table 4.4) suggests that the demand curves for most SEE products were largely inelastic in the short run. In the absence of sufficient competition from imports (before 1984), the emphasis on SEE price hikes to augment public revenue resulted in significant departures from competitive pricing in domestic product markets. Moreover, the available data on private industry suggest that the profit markups have not changed significantly in the post-1980 period.[11] These observations suggest that the deregulation of industrial prices has not produced by the mid-1980s a highly competitive market structure in the Turkish economy.

4.7 Interest Rates, the Exchange Rate, and the Monetary Stance

Aside from SEE prices and agricultural support payments, two other key prices directly controlled by the government were the interest rate and the exchange rate. The sharp change in the policy attitude toward the latter two macroeconomic prices was perhaps the most noteworthy aspect of the post-1980 program.

Table 4.5 provides quarterly data from 1979:I to 1985:IV on inflation rates, real interest rates, and real exchange rate changes. The inflation rates are measured as percentage changes in the WPI over the previous year; the real interest rates are after-tax returns on one-year bank deposits deflated by the WPI; and the exchange rate depreciations are the percentage changes over the previous year in an export-weighted index of the real exchange rate (increases correspond to depreciations).

A scrutiny of the data shown in table 4.5, especially from 1980:II to 1981:II, points to the brisk realization of a 30 percent exchange rate depreciation and a nearly 45 percent rise in the real deposit rate at the outset of the program. These produced a ratchet effect in the overall price level, and in combination with the SEE price hikes led to an unprecedented price shock in the economy. In the absence of full monetary accommodation, the resulting squeeze on real money balances produced a temporary recession, but also served to cut the annual rate of inflation from 115 to 35 percent in a relatively short span of time.

The effect of these relative-price shocks on the macroeconomic balance can be observed in the trend for real money balances. Figures 4.1 and 4.2 show the quarterly movements in the levels and annualized rates of change of the real monetary base (MB) and of real broad money (M2), from 1979:I to 1985:IV. As pointed out in chapter 1, M2 is a reasonable overall indicator for the scale of the Turkish financial sector, which is dominated by the banking system. From 1979:I to 1980:II, the cumulative real decline in M2 was nearly 40 percent, with most of the reduction taking place in the first two quarters of 1980. This gave rise to a heavy squeeze on the banking system and correspondingly to a rapid expansion of the unorganized credit market.

Table 4.5 Inflation, Interest Rate, and the Exchange Rate

	% Change from Previous Year's Same Quarter		
	Inflation Rate (WPI)[a]	REER[b] Depreciation Rate	Real (Net) Interest Rate (1-yr deposits)
1979:I	50.2	−10.3	−25.2
II	62.7	−20.2	−29.6
III	66.6	−2.7	−31.5
IV	72.1	−8.6	−35.9
1980:I	112.2	27.2	−43.5
II	115.6	38.6	−42.0
III	101.5	25.1	−32.3
IV	98.6	30.5	−32.5
1981:I	60.2	−0.6	−11.3
II	35.1	−2.4	2.8
III	37.2	−0.7	0.7
IV	27.5	13.1	8.7
1982:I	26.2	17.1	8.1
II	30.0	14.8	4.5
III	24.7	16.3	8.7
IV	22.4	10.9	11.5
1983:I	24.6	7.6	7.4
II	25.8	7.4	7.8
III	31.2	1.7	2.3
IV	39.0	0.3	1.9
1984:I	44.1	6.8	9.3
II	54.6	4.4	2.0
III	54.7	3.1	1.9
IV	52.2	1.0	2.7
1985:I	49.2	−6.4	3.3
II	40.2	0.3	10.3
III	35.8	4.6	9.7
IV	37.7	4.3	8.5

Source: Central bank of Turkey for the WPI and real (net) interest rates; own calculations for the real effective exchange rate.

[a]The WPI denotes the Treasury wholesale price index.

[b]The REER is the real effective exchange rate (export weighted, using WPI).

In such a context, where the rate of decrease in real M2 had reached 30 percent (in annual terms) in 1980:II, the government deregulated deposit rates in July 1980 and freed nonpreferential lending rates. The deregulation of deposit rates was at first followed by a "gentlemen's agreement" among major banks, which put a ceiling on the nominal rates. But eventually collusion collapsed under the impetus of the smaller, more aggressive banks, as well as the pressure from the unorganized money market. The real net interest rate on decontrolled deposits went from an average of −32 percent in 1980 to 9 percent by 1981:IV, and to an average of 8 percent in 1982. Following the decontrol of deposit rates and the introduction of certificates of deposit (CDs), real balances for M2 increased at much faster rates than the real MB from 1980:II to 1982:IV, indicating a substitution of interest-bearing accounts for cash and an upward drift in the monetary

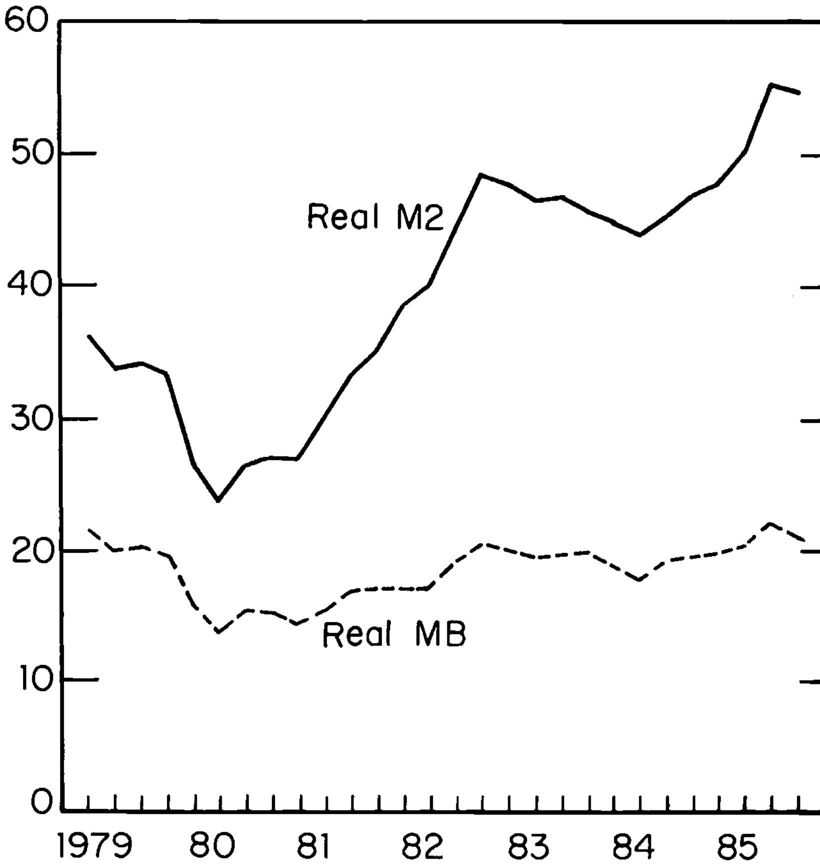

Fig. 4.1 Real money balances (in constant 1963 prices)

multiplier (M2/MB). Hence the high interest rates contributed to the monetization of the economy as it recovered from the recession.

While broad money responded favorably to the rise in deposit rates, a consequence of financial reform was that the lending rates for nonpreferential credits soared. They reached unsustainable levels of 25–30 percent in real terms in 1981–82. A significant part (guesstimates running around 40 to 60 percent) of the nominal credit expansion in this subperiod was directed toward refinancing the interest payments connected with nonperforming loans. The illiquidity problems of the private corporate sector stimulated the activities of the so-called bankers (brokerage houses) that traded bank CDs and corporate bonds and provided loans at rates higher than nonpreferential bank lending rates. The unregulated activities of the unorganized credit market eventually produced a financial crisis in mid-1982 after the collapse

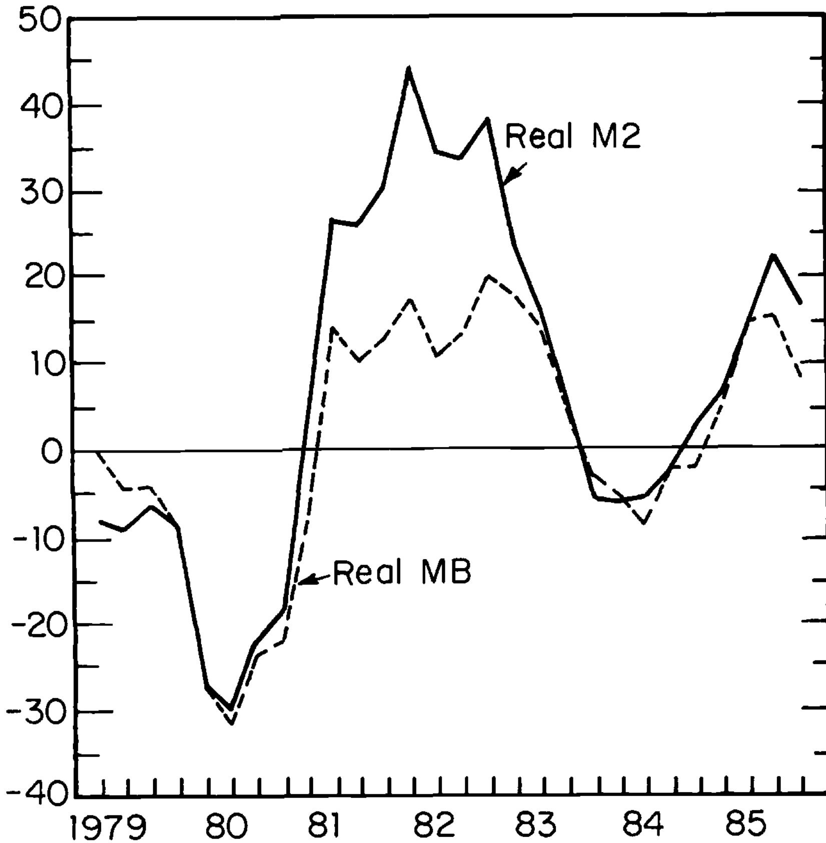

Fig. 4.2 Percentage change in real money balances (from the previous year's same quarter)

of the largest broker (Banker Kastelli).[12] The response to this crisis included, besides the replacement of key cabinet ministers, a relaxation of monetary policy, which had been quite tight at first, and the introduction of new guidelines for the financial system. At the end of 1982, the central bank was reauthorized to fix ceilings on deposit rates.

As shown in table 4.5, real deposit rates in 1983–84 were lower than in 1981–82. However, they exhibited a large degree of variability during 1983–84. What was the cause of this variability, and why has it apparently lessened from 1985:II onward?

The fluctuations in real deposit rates in 1983–84 reflected to a large extent the attempt of policymakers to realign the real rates according to the official inflation targets, which were, however, persistently exceeded by the realized

inflation rates. This caused an instability in expected rates, resulting in the stagnation of demand for broad money (see fig. 4.1).

From 1985:II on, real deposit rates were stabilized at a higher level, partly as a response to the introduction of foreign exchange deposit accounts with Turkish commercial banks at competitive interest rates. The new interest rate policy began to take into account the arbitrage equilibrium conditions to contain currency substitution within reasonable limits. Hence, from early 1985 onward, domestic real deposit rates tended to match the world rates (about 4 to 5 percent) adjusted by a margin corresponding to the rate of real depreciation of the exchange rate plus a perceived risk premium. We may conclude that the prior experience with domestic financial liberalization was helpful in handling the new situation brought about by the partial decontrol of the capital account at a later stage. But the latter policy has also implied higher real interest rates domestically, under the joint influence of financial openness and sustained real exchange rate depreciations.

4.8 A Missing Element: Political Participation and Contestation

By postponing the analysis of the actual outturn to chapter 5, in the present chapter we attempted to provide an overall review of the 1980–85 policy measures. Our discussion emphasized the supportive factors, sequencing patterns, and selected technical characteristics pertaining to the pricing aspects. Our policy review leads us to conclude that the policy mix in this period as a whole was one of the most comprehensive country adjustment programs applied in recent years with the full support of the multilateral lending agencies. Notwithstanding the social costs involved, the initial strength and sustained implementation of the program were quite impressive in technical terms, especially in the light of the ineffective policy trials of the earlier periods.

In concluding this chapter, we may question whether the 1980–85 policy episode had any missing element in an important sense. Our answer is an affirmative one, and we suggest that broad political participation and contestation were crucial elements missing in this important national experience.

The bulk of the 1980–85 program coincided with transitional military rule in Turkey, such rule having been instigated essentially on noneconomic grounds. The program did not sufficiently benefit from critical evaluations and possibly constructive proposals of the various groups of participants in the political and economic life of the country. The lack of political participation also undermined the medium-term policy planning process, which could have reduced the social costs of the program (to be reviewed at the end of the next chapter). On the other hand, the prevailing restrictions on political participation and contestation were clearly instrumental in providing the technocrats with the requisite autonomy to introduce a wide range of

radical reforms and the ability to withstand the distributional consequences. It is to be hoped that this missing element has not deeply hampered the foundations of a long-term social commitment to a more viable development strategy.

5 Performance and Adjustment Patterns in the 1980s

After the review of the policy measures in chapter 4, in the present chapter we aim to analyze the performance and adjustment patterns of the Turkish economy in the post-1980 period. Following a brief look at the actual outcome in section 5.1, in the remainder of the chapter we seek to explicate the major macrolevel mechanisms and linkages in Turkey's recent adjustment experience. While leaving the quantitative treatment of selected topics to subsequent chapters, we focus here on the anatomy of the overall adjustment process, including the distributional aspects.

The main argument in the present analysis is that changes in macroeconomic prices have played a determining role in Turkey's overall adjustment effort. In this context, we consider the following as macroeconomic prices: the exchange rate, interest rates, SEE prices, real (urban) wages, and net prices (or domestic terms of trade) for major sectors. In the Turkish setting, real wages and sectoral net prices were determined by and large as residual variables, while the exchange rate, interest rate, and SEE prices served more directly as policy instruments.

On the subject of relative prices and distortions, the economic literature has been mainly concerned with microlevel efficiency and welfare issues. As aptly analyzed by Balassa (1987) recently, and Krueger (1974b) and Bhagwati (1971) earlier, policy-induced market distortions tend to have adverse effects on resource allocation and employment. The permanent removal of these distortions would involve transitional costs, but could bring a continuous stream of future benefits, as emphasized by Fischer (1986). The post-1980 Turkish policies did make a genuine effort to remove a wide range of distortions that prevailed in the pre-1980 period, but market imperfections and related inefficiencies continue to exist, as discussed in the context of SEE prices in section 4.6. The investigation of remaining microeconomic distortions and their allocational effects is an important item in the agenda of future empirical research on Turkey.[1] But our emphasis in the present chapter is on the *macro*economic consequences of a sharply altered relative-price structure, as took place in the Turkish economy.