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a useful financing function as its cost is still modest compared to domestic borrowing.

A second and related issue has to do with the important role played by the central bank, and of the banking sector in general, in debt accumulation. The CTLDs of the 1970s and the Dresdner Bank accounts (as well as various balance-of-payments loans) of the 1980s have ultimately been the liability of the central bank. The advantage of these kinds of borrowing is that they provide a degree of latitude in their use which project credits do not allow. But this may also be a disadvantage to the extent that they allow a disjuncture between decisions on debt accumulation on the one hand, and decisions on resource allocation and investment patterns on the other. Whether this is dangerous or not depends on how finely tuned the central bank is to the investment possibilities in the public and private sectors. These arrangements have an additional consequence: they tend to bias the debt-servicing process toward money creation rather than public sector budget adjustments.

9.5 Concluding Remarks

This chapter has focused on Turkey's external financial relations in the aftermath of the crisis of 1977. The importance of the support provided during this period by the international financial community (mostly OECD governments and eventually the IMF and World Bank) cannot be underestimated. No other country has been the beneficiary of comparable amounts of financial assistance. We have argued here that the West's concern with the Turkish economy was at heart strategic; as one foreign banker colorfully put it, "supranational agencies such as the IMF, as well as Western governments, showed little interest in Ankara's financial difficulties until Turkish real estate suddenly became more valuable to NATO."[17]

In this key respect, Turkey's adjustment experience is likely to prove nontransferable. Of course, this qualification does not reduce the importance of the domestic policies undertaken since January 1980, nor does it diminish their relative success. But it puts the experience into a proper perspective.

10 Conclusions and Prospects

In many ways, the Turkish encounter with foreign debt has combined the best and worst in the debt-management experience of the developing world. During the 1970s, Turkish policymakers got the country into a debt crisis by relying on an intrinsically destabilizing form of foreign borrowing, and ensured that the adjustment to the crisis would be extremely painful by following policies that consistently discouraged exports. The tail end of the decade witnessed a typical pattern of import compression and inflation, spurred by the authorities' unwillingness to undertake serious adjustment measures. The 1980s, on the other hand, have been a period of recovery and regained creditworthiness. At the policymaking level, the gains made since 1980 can be credited in large part to Turgut Özal, who as deputy prime minister pushed for the radical adjustment package of 1980 and who as prime minister consolidated the outward orientation of the economy after 1983. In this, he was assisted both by the special freedom provided to the technocrats under the military rule of 1980–83 and by the exceptionally generous official capital inflows stimulated by Turkey's important geopolitical role. Without these two enabling circumstances, we doubt that Özal's program could have been carried out to its fruition. This is an important cautionary note for those who believe that Turkey's experience can be easily transplanted in other contexts.

A convenient way to summarize some of our arguments in previous chapters is via the perspective provided by key debt indicators. Table 10.1 displays the trends in debt/GNP, debt/exports, and debt-service ratios over the 1973–86 period. A quick glance at the numbers for the mid-1970s shows what was wrong with the debt strategy at the time. By 1977 the debt/GNP ratio had almost doubled to 27 percent from 15 percent in 1973. But this in itself was a rather undramatic rise, given the small initial base. What proved

Table 10.1 **Principal Debt Indicators, 1973–86 (in percentages)**

Year	Debt/GNP Ratio[a]	Debt/Exports Ratio[b]	Debt-service ratio[c]
1973	14.9	207.2	26.0
1974	11.7	178.4	23.1
1975	13.9	234.0	69.1
1976	19.0	286.5	133.3
1977	27.4	491.9	289.0
1978	32.7	507.2	275.3
1979	31.2	479.1	154.5
1980	27.8	441.5	101.7
1981	28.6	280.2	66.0
1982	32.8	222.2	52.7
1983	36.1	231.4	60.4
1984	43.4	218.2	60.2
1985	47.8	223.3	73.4
1986	53.1	278.8	103.3

Sources: Central bank. SPO.

[a]Debt is converted into national currency by using period-average exchange rates: black market rates for 1974–79, and official rates for 1973 and 1980–86.

[b]Exports refer to exports of goods and services.

[c]Ratio of interest payments, short-term debt (with less than one-year maturity), and amortization payments on medium- and long-term debt to exports of goods and services.

disastrous in the end was a sharp deterioration between 1975 and 1977 in the ability to *service* the new liabilities: the debt-service ratio quadrupled in two years from 70 percent to an incredible 290 percent. This was partly the consequence of the anti-export bias of the growth policies of the period. But more importantly, it was the result of a debt strategy which, by providing a blanket guarantee against exchange losses, encouraged the private sector to incur as many short-term liabilities as possible, as quickly as possible.

During the two-and-a-half years of muddling through which followed the crisis, the economy came crashing down, inflation accelerated, and income distribution worsened considerably as unprotected sectors became the casualty of the rise in prices. Yet as table 10.1 shows, the debt-service ratio started to descend quite rapidly from its peak in 1977–78. Before the January 1980 reform package was announced, this ratio had already come down to 155 percent, and fell further to 102 percent in 1980 *before* the export boom had gotten under way. This drastic improvement in the economy's ability to service its debt was of course not the consequence of adjustment policies, which were quite lacking prior to 1980. The trick was performed by a series of debt reschedulings, which reduced amortization payments substantially, and by the conversion of short-term liabilities into long-term debt. The export boom starting in 1981 took another 40–50 percent off the debt-service ratio, but this reduction looks rather unimpressive in comparison with the one accomplished by debt renegotiations.

To be sure, these debt renegotiations served only to postpone the servicing of the existing debt. Together with the new borrowing of the early 1980s, the reschedulings have now come back to haunt the Turkish economy, requiring ever-improving export performance just to maintain the debt-service ratio level. In fact, as table 10.1 shows, the principal debt ratios have witnessed a marked worsening since 1982. The debt/GDP ratio now stands at an all-time high, and the debt-service ratio has inched its way up to around 100 percent. Both the debt/GDP and debt/exports ratios are currently higher in Turkey than they were in the heavily indebted Latin American countries just prior to their debt crisis (the Turkish debt-service ratio looks better, however).[1] This renders the balancing of exports, creditworthiness, and sustained growth a very delicate high-wire act.

In a way, the statistics overstate Turkey's external debt. A considerable share—amounting to 16 percent at the end of 1986—of the "foreign" debt actually constitutes a liability to Turkish workers who reside abroad.[2] But, accounting conventions aside, we do not think that this fact makes much of a difference in practice. It would be a mistake to consider these liabilities as "safer" and more reliable than conventional forms of external indebtedness. As remittance behavior over the last two decades has shown, Turkish migrant workers are quite sensitive to overall macroeconomic conditions in Turkey. Hence, they are unlikely to keep rolling over their deposits if confidence wanes. And any difficulty in servicing these foreign currency liabilities would likely send a disastrous signal to Turkey's genuinely foreign creditors.

How will Turkey manage the debt-service hump? Its debt burden could be eased substantially by another round of reschedulings or by refinancing existing liabilities and converting short-term debt into longer term debt. However, the current global environment is not particularly encouraging about the prospects for this. Few other countries have traveled as far down the adjustment path as has Turkey, and hence are as deserving of favorable treatment. Ironically, this very fact makes it more difficult for Turkey to openly seek relief: hard-earned creditworthiness is at stake. Nonetheless, it is to the advantage of all concerned—including foreign creditors and multilateral institutions—that Turkey's model prove a viable one in the longer run. For this reason, common interest may well dictate that some workable arrangements be devised for reducing Turkey's debt-service burden. It is scarcely fair that a "successful" country should be servicing its rescheduled debt at several points above LIBOR while problem debtor countries are rescheduling theirs at a margin less than 1 percent over LIBOR.

Irrespective of any rescheduling or refinancing, how Turkey comes out in the short to medium run will depend overwhelmingly on two aspects of economic performance: exports and fiscal balance. The continued servicing of the debt will require both generating sufficient foreign exchange and improving resource mobilization in the public sector, whose liability foreign debt primarily is. The dilemma is that many of the current policies appear to be working at cross purposes with respect to these two goals.

10.1 Export Performance

So far, Turkey's export performance has confounded the export pessimists. The question that remains is the extent to which the export boom represents a genuine structural transformation and a permanent increase in the economy's capacity to generate foreign exchange. Questioning the permanence of a boom which has now been going on for more than six years (with a temporary—it appears—setback in 1986) may seem ungracious, yet we have pointed out at several junctures some unsettling aspects of the export performance to date. We reiterate two of these here. First, maintaining the export boom has required a continuous process of real depreciation of the Turkish currency and alongside it an explicit and generous program of export subsidization. Neither of these two, continuous, real depreciations and subsidies is a policy option that can continue to be exercised without damaging consequences elsewhere. The subsidies themselves, even leaving aside the rather large overinvoicing to which they have given rise, are in clear contradiction of Turkey's obligations under the GATT and will quite evidently attract restrictions on market access by the leading importers as Turkey's exports become more important. Subsidies are also costly to the budget; they therefore render public sector resource mobilization, the second desideratum alongside export performance, more problematic.

As to the policy of real exchange rate depreciations, it is an impractical solution for the longer run. By building a real interest rate premium on Turkish assets, a continuous and expected real depreciation raises the cost of capital and ultimately defeats the purpose of export expansion by choking private investment in tradables. In addition, just like export subsidies, it increases the burden of debt servicing on the public sector budget: everything else being equal, a decrease in the real value of the Turkish lira increases the debt-service/GNP ratio and requires a correspondingly smaller public sector deficit (as a share of GNP) to finance it. Finally, real depreciations are ultimately deleterious to distributional goals. While in theory the link between the real exchange rate and real (consumption) wages is ambiguous, the Turkish experience suggests that in practice it is likely that currency depreciations have to be validated by real wage cuts in order to yield the desired effect on competitiveness. From the social viewpoint, this is an undesirable policy given the magnitude of real wage cuts that have already taken place.

The second aspect of export performance we want to highlight is the evident absence of private investment in tradables that underlies it. So far, the export boom has come from existing capacity; there was considerable room for output expansion given the low rates of capacity utilization in 1980. The continuation of the export drive clearly requires new investment in tradables. The government has pinned its hopes on the private sector's ability and willingness to provide the necessary capital accumulation. While private investment in manufactures has recovered somewhat from its trough in 1980–82, it is still well below its level in 1976–77. Disconcertingly (for exports), much of the recent increase in private investment has been geared toward housing. The overall sluggishness in investment performances is at least partly related to the excessively high real rates of interest currently prevailing. The latter in turn is the consequence of the fact that the fiscal balance is still out of control (see below).[3]

In sum, policy geared toward export promotion will have to start relying less on exchange rate and subsidy policies, and more on increases in private capital formation. A critical prerequisite, then, is to reduce the real cost of credit to the private sector, an outcome that can be achieved only if the demands of the public sector on the economy's resources can be moderated.

10.2 Fiscal Balance

As our argument above indicates, maintaining an appropriate fiscal stance is not only important for generating sufficient resources with which to service the public sector's debt, but is also crucial for avoiding the crowding out of private investment in export-oriented sectors. So far, the Turkish adjustment experience has been characterized by an undistinguished performance in terms of public sector resource mobilization. While some of the reforms undertaken since 1980 have been long needed—e.g., the rationalization of public sector prices, adjustment of tax brackets against inflation, introduction of the VAT—the overall retrenchment in the public sector deficit has not been large, a fact which finds its counterpart in the continuing need for moderate amounts of foreign borrowing. In many ways, the public sector balance remains the Achilles' heel of the Turkish economy.

A given public sector deficit can be financed in a noninflationary manner in only one of two ways: domestic or foreign borrowing. As we have pointed out in previous chapters, both of these forms of borrowing are now extremely costly. Despite its newfound creditworthiness, the amount of voluntary lending flowing into Turkey is not substantial, and the Dresdner Bank accounts used to draw in Turkish workers' savings from abroad pay substantial premia over Euromarket rates. Domestic borrowing, in which the government liberally indulges, is even more costly, at real rates of interest far exceeding the growth rate of the public sector's revenue base. This last aspect, in particular, raises serious questions about the sustainability of the current strategy.

By all indications, then, reducing the public sector deficit is going to be the main challenge to policymakers in the years ahead. Not all of the adjustment here need be borne by public expenditures. A successful outcome would involve both decreased expenditures and expanded tax revenues. The experience in the early 1980s has shown the difficulty of resource mobilization via taxation, but we suspect that a broader based tax effort aiming at, among other things, the enlarged profit margins in many services sectors has considerable promise.

10.3 Income Distribution

Improving the fiscal balance is likely to clash head on with an issue that we expect to become increasingly important over the next few years. As we have highlighted throughout our account, the Turkish experience with income distribution has been singularly disappointing ever since the onset of the debt crisis in mid-1977. What makes this experience even more striking is that it took place after a period during the 1970s in which real wages and rural incomes had more than amply shared in the spoils of economic growth. As the political system opens up, a process which by and large was consolidated with the referendum of September 1987, we expect that distributional issues are going to become increasingly important in the political agenda.

An unavoidable question is the nature of the link between the adjustment policies of the 1980s and the adverse trends in distribution. The first point to be made in this connection is that, despite a widespread impression to the contrary, the deterioration in income distribution started in 1978 and had already become seriously entrenched by the time the 1980 reforms were taking effect. As we analyzed above, this initial sharp deterioration was a consequence of the *lack* of adjustment policies. Inflation triggered by the external constraint and the shortages wiped out the real incomes of the least-protected sectors of the economy. The sad irony was that the half-hearted nature of the pre-1980 reforms was the result of a concern that doing more might have jeopardized the distributional gains of previous years.

It is true nonetheless that the post-1980 policies did not exactly have salutary effects on distribution either. Some of the distributional trends at that time can be linked to the military's role in freezing the factor shares inherited in late 1980. It is also clear that distributional issues were of secondary importance to Özal compared to economic recovery and regaining creditworthiness. In general, theory makes no predictions about the distributional consequences of adjustment policies. But as we have stressed, the very nature of the policies followed in this period, relying on sharp changes in economywide relative prices, ensured that the outcome would not be distributionally neutral.

Take, for example, real wages. The reduction in real wages served a number of important purposes in the adjustment process. First, it allowed an increase in competitiveness of the traded sector. Secondly, it eased the cost pressures brought on by the high cost of credit in an already highly indebted private manufacturing sector. Third, it contributed to the improvement in public sector finances by reducing the wage bill of state enterprises. The deterioration in agriculture's term of trade served many of the same purposes. The reduction in farm price supports and the phasing out of input subsidies enhanced public sector savings. The emphasis on the subsidization of manufactured exports, on the other hand, denied agriculture most of the gains that conventional analysis had posited would follow from outward orientation.[4]

Was there an alternative? We suspect that policies geared directly toward improving the distribution of income would have complicated tremendously the recovery effort in the chaotic conditions of 1980. Yet some of the post-1980 trends could perhaps have been avoided if the emphasis in the program had been less on relative prices and more on policies that reduced expenditures directly. In practice, what this means of course is that the scale of public sector expenditures, both current and investment, ought to have been more tightly controlled. As we argued in chapter 8, this would have been somewhat costly in terms of growth, as public investment played an important stimulating role in the absence of private investment. In addition, we know very little about the distributional implications of direct cuts in government expenditures. Nonetheless, it is quite likely that such a change in the overall thrust of the program would have eased the requirement of turning the terms of trade of workers and farmers sharply against them in order to generate savings for the public sector.

In addition, it is possible that the real interest rate consequences of the post-1980 reforms could have been moderated had policymakers been less dogmatically attached to financial and capital account liberalization. The latter reforms have not only necessitated a reorganization of factor shares at the level of firms, but they have also complicated macroeconomic management by engendering currency substitution. The relative openness of the capital account has rendered speculative attacks and capital flight a dangerous possibility, emphasizing all the more the need for a careful balance on the fiscal front.

Appendixes

A. Political Chronology, 1970–87

1970	Süleyman Demirel's Justice Party (JP) government under increasing strain as political violence grows.
March 1971	The military present the president with a memorandum threatening a takeover. Demirel's cabinet resigns. Nihat Erim (Republican People's Party, RPP) forms new government.
April 1971	Martial law proclaimed in eleven provinces.
April 1972	Erim resigns.
May 1972	Ferit Melen forms a coalition government. Bülent Ecevit takes over from Ismet Inönü as leader of the RPP.
March 1973	President Cevdet Sunay's term expires.
April 1973	Fahri Korütürk is elected president by the Grand National Assembly, after repeated ballots fail to generate enough support for the military's favored candidate, Faruk Gürler. Melen's cabinet is succeeded by one formed by Naim Talu, an independent senator.
September 1973	Martial law comes to an end, as the military greatly reduce their interventionism of the past two years.
October 1973	General elections fail to produce a majority government, but Ecevit's RPP emerges with a plurality of seats.
January 1974	RPP forms a coalition government with the Islamist National Salvation Party (NSP) led by Necmettin Erbakan. Ecevit becomes prime minister.