



**BOĞAZIÇI ÜNİVERSİTESİ**

**ISS/EC-2001-14**

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C.Emre Alper

Ziya Onis

**ARAŞTIRMA RAPORU**

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# Financial Globalization, the Democratic Deficit and Recurrent Crises in Emerging Markets: The Turkish Experience in the Aftermath of Capital Account Liberalization

C. Emre Alper\* and Ziya Onis\*\*

First Draft: May 2001

Revised Draft: July 2001

## Abstract

Financial globalization offers both risks and benefits for countries of the semi-periphery or the so-called "emerging markets". Politics within the national space matters, yet acquires a new meaning, in the age of financial globalization. "Weak democracies" are characterized by limited accountability and transparency of the state and other key political institutions. Such democracies tend to suffer from populist cycles, which result in low capacity to carry out economic reform. Financial globalization, in turn, magnifies populist cycles and renders their consequences more severe. Hence "weak democracies" are confronted with the predominantly negative side of financial globalization which includes over-dependence on short-term capital flows, speculative attacks and recurrent financial crises leading to slow growth and a more regressive income distributional profile. The relevance of these set of propositions are illustrated with reference to the case of Turkey which, indeed, experienced recurrent financial crises in the post-capital account liberalization era with costly consequences for the real economy. Two general conclusions follow. Firstly, there is a need to strengthen democracy in the developing world. Secondly, since this is hard to accomplish over a short space of time serious question marks are raised concerning the desirability of early exposure to financial globalization given the current state of the world.

**Keywords:** populist cycles, neo-liberal democracy, capital flows, speculative attacks

**JEL Codes:** O19, H6, F01

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\* Associate Professor, Department of Economics, Bogazici University, Pk 2 Bebek 80815 Istanbul Turkey. E-mail: [alper@boun.edu.tr](mailto:alper@boun.edu.tr)

\*\* Corresponding author. Professor, Department of International Relations, Koc University, Rumeli Feneri Yolu, Sariyer 80910, Istanbul, Turkey. E-mail: [zonis@ku.edu.tr](mailto:zonis@ku.edu.tr)

## Introduction

The recent wave of financial globalization constitutes a striking development of the late twentieth century. Yet, financial globalization has been extremely uneven in terms of its impact. The major beneficiaries of this process have been developed countries and a limited number of the advanced middle-income economies or the so-called emerging markets.<sup>1</sup> Even within the emerging market category, we observe a differentiation with a limited subset of countries claiming a disproportionate share of capital flows.<sup>2</sup> The process of financial globalization is a double-edged phenomenon; it carries significant risks and as well as offering major benefits for the capital receiving countries. The risk element is clearly evident from the highly volatile nature of these flows and the series of financial crises primarily, if not exclusively, in the semi-periphery of the world economy during the last decade.<sup>3</sup> At the same time however, there is a major potential benefit embodied by the process of financial globalization, in the sense that access to cheaper capital facilitates a higher rate of economic growth than otherwise would be the case.<sup>4</sup>

The ability to benefit from financial globalization differs significantly from one country to another and hence, it is an endogenously determined process. Domestic "institutional and political capacities" of individual states perform a critical role in their ability to reap the benefits from financial flows. An interesting question in this context concerns the link between the "nature" or "quality" of democracy, on the one hand, and the question of "institutional and political capacity", on the other. The interaction between financial

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<sup>1</sup> For evidence on the uneven distribution of the capital flows in the global economy with developed countries and emerging market economies, emerging markets being the major beneficiaries from this process, see UNCTAD (1999).

<sup>2</sup> For evidence in terms of the uneven distribution of the capital flows among the emerging market economies themselves, see UNCTAD (1999).

<sup>3</sup> For detailed evidence on the general characteristics and individual instances of crises in emerging market economies, see Kahler (1998).

<sup>4</sup> On benefits of financial globalization, in terms of access to external resources at lower interest rates and hence the ability to achieve higher rates of economic growth see World Bank (1997).

globalization and political regimes in general and "democracy" in particular has attracted significant attention in recent years.<sup>5</sup> It is fair to argue, however, that the primary emphasis in the literature has been on the issue of how financial globalization itself has shaped the democratization process in countries undergoing a transition from authoritarian rule and created new political openings. In the present context, our emphasis will be not on the causal link running from financial globalization to democracy but the reverse. Our objective is to demonstrate in a case study framework that a regime of "imperfect democracy" or a country's "democratic deficits" may significantly undermine its political and institutional capacity, which in turn prevents it from fully capitalizing on the benefits of the financial globalization.

Within this broad framework, our primary focus will be on the Turkish experience. The origins of Turkey's neo-liberal experiment may be traced back to 1980. However, the critical turning point came in August 1989, which marked the date of full capital account liberalization.<sup>6</sup> From that point onwards, Turkey has been exposed to the vagaries of financial globalization, which has produced two major crises in the post 1990 era, a development, which makes a sharp contrast with the crisis free era of the initial phase of reforms in the 1980s. Indeed, the combined effect of these successive crises has been to reduce the average growth rate of the Turkish economy in the 1990s relative to the previous decade.<sup>7</sup> If August 1989 represented the key turning point of the Turkish economy, the referendum of September 1987 marked a return to "full democracy". The return to democracy and the nature of democratic politics, which emerged in the context of 1990s, had far reaching implications for Turkey's ability to sustain fiscal equilibrium and governmental accountability. In retrospect,

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<sup>5</sup> For a useful study, which focuses on the causal link running from financial globalization to democratization itself, see Armijo (1999)

<sup>6</sup> For a detailed documentation of Turkey's neo-liberal experiment, see Aricanli and Rodrik (1990), Onis (1998), Cizre-Sakallioglu and Yeldan (2000), and Ertugrul and Selcuk (2001).

<sup>7</sup> For evidence on the differential performance of the Turkish economy during the two decades of the Neo-liberal reforms with inferior growth performance recorded during the 1990s, see Ertugrul and Selcuk (2001).

Turkey's inherent democratic deficits closely contributed to the emergence of successive crises and helped to create a lopsided structure of heavy dependence on short-term and volatile capital flows. This created a highly fragile balance of payments structure in which large current account deficits have been disguised by inflows of short-term capital. Lack of democratic accountability was also at the hearth of the process of perverse functioning of the financial sector in the post liberalization era. In fact, this has been another striking element in the creation of financial crises in the recent era. One could go even further and argue that it has been the primary influence in the outbreak of the most recent crises in 2000 and 2001. Hence politics matters in the era of financial globalization and our principal objective is to demonstrate the precise links or mechanisms whereby politics contributes to the economic consequences of financial globalization.

Turning our attention to the specifics of the political sphere, Turkey may be classified as a case of a fragile or weak "second wave" democracy.<sup>8</sup> Multi-party democracy in Turkey effectively dates back to 1950. The democratic regime in Turkey, in spite of its considerable longevity however, has been characterized by periodic breakdowns followed by periods of military rule.<sup>9</sup> In broad terms, the Turkish democracy tends to exhibit some of the characteristics associated with the term "delegative democracy", a term coined by Guillermo O'Donnell (1994) to highlight some of the salient characteristics of the Latin American democracies. The components of delegative democracy, which seems to apply best to Turkish case, include the presence of political parties dominated by an "all-powerful" leader, significant continuity of leadership, the relative absence of intra-party democracy and electoral support based on clientelistic ties and populist redistributive politics. Indeed the

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<sup>8</sup> On different waves of democratization and the characteristics of second and third wave democracies, see Huntington (1991). Representative democracy in Turkey effectively dates back to 1950.

primary motivation of political parties in Turkey seems to be to distribute public rents to their own supporters. This observation also draws attention to a paradoxical aspect of party leadership in the Turkish context. Whilst the party leaders tend to be strong and their power relatively unchallenged, their survival, nonetheless, depends critically on their ability to practice patronage politics and to maintain a certain base of electoral support.

What tends to differentiate Turkish democracy from its Latin American variants is the dominance of parliamentary traditions in the former case and the prevalence of presidential styles of governments in the latter. However, elements, which are common to both cases include polities characterized by leader domination, the absence of checks and balances, pervasive lack of accountability and a lack of emphasis on the rule of law.<sup>10</sup> The deficits of delegative democracies in turn have far reaching repercussions especially in an environment of financial openness. Excessive uncertainty, short horizons for policy makers, and inherent vulnerability to mis-utilization of public funds and periodic crises constitute the typical consequences of such deficits. Furthermore, in spite of their populist claims, these types of democracies tend to be associated with persistently high and indeed increasing rates of income inequality. Judged by the standards of advanced democracies of the West, Latin American style imperfect democracies tend to be typically associated with a distorted pattern of market based development with the two phenomena reinforcing one another. These distortions in turn prevent these economies from fully capitalising on the benefits of financial globalization.

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<sup>9</sup> Periodic breakdowns of the democratic regime in Turkey occurred in 1960, 1970 and 1980. The military interludes have been relatively brief; but nevertheless, have far reaching repercussions on the Turkish political system. For detailed elaboration and evidence, see Ozbudun (2000).

<sup>10</sup> On the combination of imperfect democracy and imperfect market-based democracy in Latin America, see Oxhorn and Starr (1999).

Our broad argument linking the underlying democratic deficit to economic performance in the era of financial globalization requires a serious qualification, however, particularly in the recent Latin American context. Indeed, certain sub-components of the democratic deficit such as leader domination in political parties have been quite common in Latin American settings. Concentrated decision making, in turn, has been instrumental in bypassing populist pressures for redistribution and, hence, has contributed towards controlling government spending. The capacity to reduce budget deficits and inflation by a substantial margin in the Argentinean, Mexican and Peruvian cases during the late 1980s and the 1990s clearly testify the validity of this proposition. The conversion of "neo-populist" leaders such as Carlos Menem in Argentina or Alberto Fujimoro in Peru to "neo-liberal" reformers constitutes one of the striking and paradoxical tendencies in Latin American political economies in recent decades.<sup>11</sup> Without wishing to probe into the complex dynamics underlying this phenomenon, we wish to emphasize that "leader domination" and lack of intra-party democracy may be compatible with far-reaching economic reforms.

## **1. Fragile Democratic Politics and Origins of Premature Capital Account**

### **Liberalization in Turkey**

Considering the drastic ramifications and the *ex-ante* risks involved, an interesting question for interpretation concerns the timing of the capital account liberalization in Turkey in August 1989. Many commentators have argued that the decision to open up the capital account was premature given the prevailing macroeconomic and political instability in Turkey.<sup>12</sup> In retrospect, one can recognize a certain political logic underlying this decision,

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<sup>11</sup> For a detailed elaboration of this issue, see Roberts (1995).

<sup>12</sup> On the premature nature of the capital account liberalization, see Rodrik (1990) and Cizre-Sakallioglu and Yeldan (2000). Discontinuity in Turkish politics clearly manifests itself during the local elections of March 1999, with the ruling party ANAP experiencing a striking decline in its share of the vote from 36% to 21%.

which may help to resolve the apparent paradox. The local elections of March 1989 represented a critical turning point in Turkey's political trajectory. The ruling Motherland Party (ANAP), which, under the leadership of Turgut Ozal, had emerged as an outright winner in the general elections of both November 1983 and November 1987, experienced a drastic decline in its popularity in the municipal elections of March 1999.<sup>13</sup> The process of early capital account liberalization, in turn, may be regarded as a reaction on the part of Ozal to regain popularity and electoral support. In more concrete terms, the decision to open up the capital account may be explained in the following terms. Fundamental to the project of recovering the electoral fortunes of the party was an accelerated process of economic growth, improvement in employment prospects and drastic decline in inflation. Capital account liberalization in line with trade liberalization, at least in the short run, helped to achieve these objectives by attracting additional external capital generating an internal consumer boom through higher imports financed by these flows. Also part of this virtuous cycle was a domestic investment boom again facilitated by large inflows of external capital. Inflation control was aimed at through a mix of import discipline and real appreciation of Turkish Lira. Given the almost costless increase in the availability of international reserves, the unique emphasis on exports, which seemed to characterize the early stages of the neo-liberal program in the first half of the 1980s, was effectively discontinued.

Attention ought to be drawn also to a possible economic logic underlying the premature capital account liberalization in 1989.<sup>14</sup> Starting in 1986, fiscal deficit displayed an expansionary course financed through domestic borrowing with a crowding out effect on private investment. Also relevant in this context is the growing financial autonomy granted to state owned enterprises (SOEs) and local administrations. In the absence of automatic

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<sup>13</sup> The increase in inflation in the late 1980s was a key factor underlying Ozal's loss of popularity. For evidence, see Onis and Webb (1994).



budgetary transfers to these institutions and the monetization of these transfers, the establishments concerned had to borrow from the domestic markets. This in turn raised the domestic interest rates and contributed to the crowding out of private investment. Both of these processes naturally created a need for additional funds to accelerate the pace of private investment. Hence capital account liberalization provided an obvious avenue to achieve this goal.

## **2. The Perverse Outcome of the Capital Account Liberalization in a Fragile Democratic Polity: The Crisis of the 1994**

"Populist cycles" are not novel phenomenon in the Turkish economy.<sup>15</sup> A typical populist cycle is initiated by a period of fiscal expansionism designed to generate political support. Given the underlying electoral logic the emphasis is generally on the current expenditures, which have immediate positive repercussions on the current generation of voters. This process, which appears to offer tangible benefits in the short run, however, creates the seeds of its own destruction and embodies negative implications for medium-term economic performance. Fiscal expansionism in an environment of appreciating real exchange rates result in large current account deficits leading to a balance of payments or debt crisis and an inevitable encounter with the IMF. The IMF programs, in turn, are designed to restore fiscal and current account balance but tend to be costly in the short run in terms of their effects on output growth, employment and income distribution.

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<sup>14</sup> On the timing and economic logic of capital account liberalization in Turkey, see Ersel (1996)

<sup>15</sup> For evidence on the initial two waves of populist cycles during the pre-neo-liberal era in the Turkish economy, see Onis and Riedel (1993)

The first two populist cycles that Turkey experienced in the late 1950s and the late 1970s occurred largely in an environment of fixed exchange rates and capital account controls. Hence current account was the dominant element of the balance of payments and capital flows were of marginal significance.

The third populist cycle the Turkish economy experienced during the period 1987-1993 leading to the crisis of 1994 embodied additional features, which made it fundamentally different from the two previous cycles. The third wave of fiscal expansionism occurred in an environment of capital account openness and managed or controlled flexibility of exchange rates. Rather paradoxically, short-term capital flows, which accompanied the process of capital account liberalization, contributed towards and helped to augment the dimensions of the populist cycle. Hence a highly fragile and unstable pattern emerged whereby the pace of fiscal expansionism became heavily dependent on highly volatile and reversible short-term capital inflows. The perverse outcome of capital account liberalization manifested itself in a striking fashion with the outbreak of the 1994 crisis reflecting the inability of policy makers to adjust themselves to the new environment.<sup>16</sup> The policy makers still continued to operate within the parameters of a closed economy model and tended to neglect the current account as an important source of disequilibrium on the assumption that capital flows would be irreversible and sustained on a steady course.

In fact, the origins of the third populist cycle, or the very first cycle of the neo-liberal era, can be traced back to 1987. The early phase of stabilization and export orientation during the post-1980 era had negative consequences for two distinct groups in Turkish society, namely, wage earners and agricultural producers. These two important categories of "losers" were

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<sup>16</sup> For a characterization of the 1994 financial crisis, as a crisis of mismanagement, see Ozatay (1997).

progressively empowered as part of the political opening process in the 1983-1987 era and were in a position to recover the early losses that they had incurred.<sup>17</sup> Hence, an important component of the populist cycle, which manifested itself in the post-1987 era, reflected the growing influence of these two "numerically important" groups. Indeed the coalition government, formed in 1991, involving the right-of-centre True-Path Party (DYP) and the left-of-centre Social Democratic Populist Party (SHP) could be considered as predominantly a representative of these two important segments of the Turkish society. It would be misleading to equate the emergence of populist cycles of the neo-liberal era purely with the distributional pressures from below. In fact, governments tried to distribute rents to both winners and losers of neo-liberal reforms in order to build broad-based electoral coalitions.<sup>18</sup>

A key characteristic of the political environment, which emerged after the local government elections of March 1999, is a highly fragmented political system with successive weak coalition governments. Coalition governments and non-concurrent elections do not necessarily imply instability in established democracies characterized by a high degree of accountability, a strong system of checks and balances and a political culture based on compromise and consensus. Hence, they should not be considered a component of the democratic deficit itself. In the Turkish context, however, given the underlying democratic deficits, these influences have tended to magnify instability even further. The fragmented nature of the party system tended to reduce the time horizon of governments and helped to intensify the populist cycle. The timing of elections in Turkey, with local government elections typically scheduled in between two general elections (at least up until 1999), could be considered as another disequilibrating influence.

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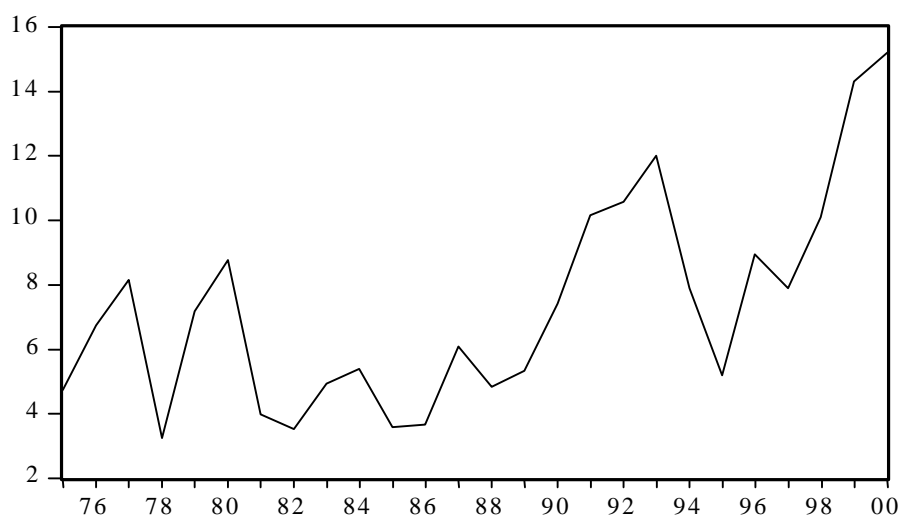
<sup>17</sup> Opening up of the political system involved the removal of restrictions over the bargaining rights of labor unions. See Onis and Webb (1994).

The dynamics of the post-1987 populist cycle are clearly evident from the dramatic increase in the share of public expenditures in GNP (Table 1).

<b>Table 1: Consolidated Budget Deficit and Its Components (% of GNP)</b>					
	Current	Investments	Transfers	Primary	Budget Balance
1981-1985	7.6	3.4	7.0	-1.4	-2.6
1986-90	6.7	3.1	7.2	0.1	-3.2
1991	9.5	2.7	8.3	-1.5	-5.3
1992	10.3	2.6	7.1	-0.6	-4.3
1993	10.3	2.7	11.4	-0.9	-6.7
1994	8.9	1.9	12.3	3.8	-3.9
1995	8.2	1.2	12.4	3.3	-4.0
1996	8.6	1.6	16.2	1.7	-8.3
1997	9.5	2.0	15.7	0.1	-7.6
1998	9.7	1.9	17.6	4.6	-6.9
1999	11.7	2.0	22.1	2.1	-11.6
2000	10.8	2.0	24.2	6.0	-10.2
Average	8.4	2.7	10.6	0.4	-4.7

Source: Central Bank of the Republic of Turkey

Figure 1: Public Sector Borrowing Requirement (% of GNP)



Source: State Planning Organization

<sup>18</sup> Several instruments were used to compensate the winners including low-tax discipline, low-cost imported inputs due to the real appreciation of the exchange rate, and preferential access to credits extended by public

Within the public expenditures, the rise in current expenditures is striking, reflecting the impact of public sector wage booms, notably in 1989-1991. Yet another striking feature is the record PSBR/GNP figure established in 1993 just prior to the crisis (Figure 1).

The perverse outcome of capital account liberalization in an environment characterized by a fragmented party system and populist cycles were distorted capital account structure. Turkey has been able to attract predominantly short-term capital flows, which are highly volatile in nature. In spite of the institution of a liberal foreign investment regime, the inflows of foreign direct investment (FDI) have remained marginal both with respect to other types of capital that Turkey itself has attracted and relative to the levels of FDI attracted by other emerging markets (Table 2).<sup>19</sup>

	in Million USD			% of Total Flows	
	Capital Account	NET FDI	GROSS FDI	Net FDI	Gross FDI
1992	3648	779	844	21.4	23.1
1993	8963	622	636	6.9	7.1
1994	-4194	559	608	NA	NA
1995	4643	772	885	16.6	19.1
1996	5555	612	722	11.0	13.0
1997	7053	554	805	7.9	11.4
1998	-755	573	940	NA	NA
1999	4671	138	783	3.0	16.8
2000	9445	112	982	1.2	10.4
Total	39029	4721	7205	12.1	18.5
Average	4337	525	801	12.1	18.5

Source: Central Bank of the Republic of Turkey

banks.

<sup>19</sup> For evidence on the distribution of FDI flows, see UNCTAD (1999).

The crisis of 1994 was triggered by two proximate causes, namely, the government's attempt to control the interest rates as well as the level of the exchange rate in a high inflation environment and the lowering of Turkey's credit rating. Both of these causes would have been of marginal significance in a controlled capital account environment. The end result was a steady decline of the foreign exchange reserves of the Central Bank, ultimately leading to a successful speculative attack on Turkish Lira, generating a large devaluation necessitating yet another encounter with the IMF.

### **3. The Repercussions of the 1994 Crisis: Longer-term Deterioration for the Sake of Short-Term Recovery**

The IMF program, introduced in April 1994, embodied many standard features associated with Fund programs. A mixture of expenditure reducing and expenditure switching policies were implemented during the course of the year.<sup>20</sup> As a consequence of these policies, there was a significant contraction of output and employment with GNP growth rate emerging negative in 1994. Exports recovered swiftly and the import boom was reversed with a consequent improvement in the current account balance. In retrospect, the Turkish economy managed to accomplish a smooth recovery from the crisis. By the beginning of 1995, the growth process was resumed (Table 3) with a consequent increase in short-term capital inflows (Table 2).

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<sup>20</sup> Expenditure reducing policies included monetary contraction, expenditure cuts particularly in the forms of transfers to SOEs, as well as current expenditures. Expenditure switching policies included devaluation as well as additional incentives to exporters in the form of Eximbank credits.

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**Table 3: Main Economic Indicators of Macroeconomic Performance**

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	Real Growth	Per Capita Real Growth	Inflation	Debt/GNP
1981-1985	4.7	2.1	40.0	36.3
1986-90	5.8	3.5	54.4	49.1
1991	0.3	-1.6	59.2	38.8
1992	6.4	4.4	63.5	38.9
1993	8.1	6.2	67.4	38.8
1994	-6.1	-7.8	107.3	51.2
1995	8.0	6.1	87.2	44.1
1996	7.1	5.3	78.0	47.1
1997	8.3	8.7	81.2	46.6
1998	3.9	2.3	75.3	47.9
1999	-6.1	-7.4	55.8	58.7
2000	6.1	1.4	51.6	59.9
Average	4.4	2.3	59.9	44.9

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Source: Central Bank of the Republic of Turkey and the Treasury

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Part of the swift recovery process may be accounted by labour market flexibility and significant redistribution of income away from wage earners<sup>21</sup>. We should also emphasize however that certain measures undertaken by the government have also contributed to the recovery process, yet this proved to be a distorted recovery, which effectively created the bases of the subsequent and the latest round of crises in the Turkish economy. Stated somewhat differently, short-term responses designed to achieve relatively costless recovery embodied negative repercussions from a longer- term perspective. Two specific ingredients of government policy deserve emphasis in this context. Firstly, the policy of keeping domestic interests high to encourage inflows of short-term capital and discourage outflows have resulted in a rapid build-up of domestic debt with devastating consequences in the late 1990s. Secondly, banking sector regulations, notably full insurance coverage for deposit accounts, to provide breathing space for banks in the aftermath of the crisis have created

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<sup>21</sup> For evidence on labor market flexibility in Turkey and the decline of the wage share, see Senses (1994) and Ozmucur (1996) respectively.

moral hazard problems. Indeed, these banking regulations have constituted a considerable source of instability and have emerged as a key contributor to the latest wave of crises at the turn of a new century.

The Turkish economy appeared to recover quite smoothly from the crisis of 1994. By the beginning of 1995, the growth process was resumed accompanied by a surge in exports, which in turn was facilitated by the depreciation of the exchange rate. The underlying confidence in the economy in general and in financial institutions in particular was also restored. As a consequence, the massive outflow of capital characterizing 1994 was reversed (Table 2). Turkey in the mid-1990s benefited from the broadly favorable financial environment, which was translated to a sustained movement in capital flows to emerging markets as a whole up until the Asian crisis of 1997. A closer inspection reveals however the superficial and fragile nature of the recovery in the immediate aftermath of the 1994 crisis. Fiscal disequilibrium continued to manifest itself as a fundamental source of instability, although in a modified form. Even though some reduction was achieved in the PSBR/GNP ratio in the immediate aftermath of the 1994 crisis -largely due to the reduction in the SEE deficits-, this did not prove to be a sustainable process (Figure 1). The overall budgetary deficit once again reached record levels by the end of the decade. The only difference was a change in the underlying components of the fiscal disequilibrium. A close inspection of the data reveals a steady increase in the share of transfer payments in budgetary expenditures in the latter half of the decade. This in turn is a reflection of the major increase in the interest burden on domestic public debt. The only element of continuity with the earlier era concerned the marginalization of public investment with potentially negative consequences



for future growth prospects. Indeed, one needs to recognize that official figures substantially underestimate the size of the budgetary deficit.<sup>22</sup>

Once again, a crucial link can be formulated between Turkey's democratic deficits and the resilience of fiscal disequilibrium. As in the earlier part of the decade, a fragmented party system and weak coalition governments continued to aggravate Turkey's democratic deficits. Successive governments in office continued to be motivated by myopic electoral concerns and in the absence of appropriate checks and balances, which are part and parcel of established democracies, failed to recognize the importance of fiscal discipline as a means of a sustainable debt burden. The result was magnifying the disequilibrium already built through the years.

Governments in Turkey progressively resorted to extra budgetary means of financing government expenditures, a phenomenon, which can be considered a legacy of the Ozal era of the 1980s<sup>23</sup>. The dimensions of fiscal disequilibrium in Turkey were amplified by the ability of the governments to disguise the true size of public expenditures and the scale of rent distribution. One can recognize here two key elements of the democratic deficit in Turkey namely, a pervasive lack of accountability and lack of transparency.

The underlying lack of accountability and transparency also manifested itself in the form of deteriorating performance of the banking sector and the financial system. Public banks distributed credits often on non-economic criteria with the consequence that they incurred significant losses in real terms, which were concealed for a long time due to non-transparent

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<sup>22</sup> For evidence involving a severe underestimation of the size of the budget deficit in Turkey, see the report of Audit Court, Sayistay (2000) and Akcay et al. (2001).

<sup>23</sup> For a detailed analysis involving the origins of the extra budgetary funds in Turkey, see Oyan and Aydin (1987)

accounting procedures<sup>24</sup>. Indeed the weakness of the banking sector in Turkey and endemic fiscal disequilibrium constituted interrelated phenomena. Public banks in general and notably the largest bank of the Turkish financial system as a whole, the State Agricultural Bank (Ziraat Bank), contributed to fiscal deficit<sup>25</sup>. Indeed these two phenomena were at the hearth of the two consecutive sets of crises, which affected the Turkish economy at the turn of the new century.

Bribery and corruption have been endemic features of the Turkish economy in the recent era. International evidence clearly places Turkey among the set of countries where the practice of corruption is perceived to be a significant phenomenon.<sup>26</sup> Finally, military expenditures constitute yet another sphere where accounting and transparency have been strikingly absent. The official estimate of the military expenditure GNP ratio is around 4.5 percent. This figure is high by international standards, yet many investigators consider this estimate to be a true understatement.<sup>27</sup> In fact, a close correspondence may be detected between the underestimation of the military expenditures and the unaccounted budget deficits in the Turkish context.

#### **4. The Financial Crises of 2000 and 2001: Inevitable and Endogenously Generated Phenomena?**

The IMF remained very much in the sidelines in the early years following the 1994 crisis. IMF continued to publish critical reports on the Turkish macroeconomic performance but its

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<sup>24</sup> For evidence on this issue see IMF (1998). On the disinflation program and its impact on the Turkish banking sector, see Alper et al (2001).

<sup>25</sup> On the mechanics of this process involving the linkages between *Ziraat* and public deficits, see Sayistay (2000).

<sup>26</sup> The corruption Perceptions Index 2001 (by Transparency International, 2001) ranked Turkey fifty-seventh out of ninety-one countries, the rank value increasing with the level of corruption. It is interesting that key emerging markets such as Argentina and Mexico are ranked broadly at the same level, emerging as the fifty-seventh and fifty-first respectively.

<sup>27</sup> See Gunluk-Senesen (2000).

influence was confined to an advisory role as long as there was no imminent danger of a financial crisis. By 1999, however, it became increasingly evident that Turkey was on an unsustainable course. The IMF had an obvious interest in pressurizing the Turkish government to adopt a radical anti-inflationary program based on fiscal austerity and related set of structural reforms. There was increasing recognition among the public at large within Turkey that populist redistribution was proving to be increasingly costly and inherently unsustainable. This was evidently clear from the unusually high and increasing share of interest payments on public debt within budgetary expenditures, leaving very limited resources for either populist redistribution or for growth oriented public investment. (Tables 1 and 4)

**Table 4: Transfer Expenditures (% of GNP)**

	Interest Payments	Transfers to SOEs	Other Transfers	Total
1981-1985	1.4	1.7	3.6	6.7
1986-90	3.3	0.5	3.4	7.2
1991	3.8	1.9	2.6	8.3
1992	3.7	0.7	2.7	7.1
1993	5.8	1.3	4.3	11.4
1994	7.7	0.5	4.1	12.3
1995	7.3	0.6	4.5	12.4
1996	10.0	0.3	5.8	16.2
1997	7.7	0.4	7.6	15.7
1998	11.5	0.3	5.7	17.6
1999	13.7	0.5	7.9	22.1
2000	16.2	0.7	7.3	24.2
Average	5.6	0.9	4.4	10.6

Source: Central Bank of the Republic of Turkey

The year 1999 also marked a turning point in Turkey's political trajectory. Up to 1999, coalition politics in Turkey had invariably signified instability and conflict. This appeared to be the case in both the late 1970s and the early and the mid-1990s. Following the combined

general and local elections of April 1999 however, the coalition government, which emerged, embodied certain features, which made it rather distinct from the earlier experiences. The three political parties, which formed the new coalition government, had very different ideological orientations. The dominant partners of the coalition were the left of centre "The Democratic Left Party" (*DSP*), and the radical nationalist "National Action Party" (*MHP*) with the right of centre "Motherland Party" (*ANAP*) entering the coalition as a minor partner. In spite of the obvious ideological differences, the coalition government seemed to display a high degree of cohesion, which in turn generated considerable optimism both among the domestic and external actors regarding the prospects of implementing the far-reaching stabilization program of December 1999. A closer inspection revealed however that the two dominant parties, which made up the coalition, were essentially parties representing losers from the reform process with *MHP* drawing its electoral base predominantly from rural areas and *DSP* from the urban poor<sup>28</sup>. Hence, in spite of the apparent cohesion among the coalition partners and commitment to reform, the parties concerned were reluctant to give up the old instruments of clientelistic politics and populist redistribution. Two striking examples of this tendency concern the resistance to the sale of Turkish Telekom and the reduction of agricultural support prices, both of which were integral to the success of the program. In both cases, *MHP* was the primary actor in resisting pressures for reform. While the consideration of whether these policies are desirable is beyond the scope of our present analysis, the key issue of concern for our purposes is that the government in question failed to maintain commitment to its initial promises. Hence its credibility was undermined leading to negative signals to both domestic and external actors, jeopardizing the very fortunes of the stabilization program. These observations point towards the resilience and inertial

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<sup>28</sup> For evidence on the electoral base of different political parties, see Carkoglu (2000).

characteristics of Turkey's democratic deficits, which have been at the hearth of the two consecutive crises at the turn of the century.

In retrospect, it would be misleading to classify the 1999 program as a total failure. In fact, significant steps have been taken towards implementing certain key components of the program. Strong implementation was evident in the spheres of public sector wage and salaries, control over monetary aggregates, and measures to improve the structure of the consolidated budget as well as the performances of the SOEs. A closer investigation reveals, however, the reluctance of the policy makers to tackle the potentially more difficult and politically costly issues particularly in the area of banking sector regulation notably in the context of public banks. A striking example in this context concerns the failure to deal with the perennial problem of "duty losses" of SOEs in general public banks in particular. Indeed, the policy makers tackled the issue only after the collapse of the program in February 2001 with costly consequences. The Treasury assumed responsibility for the duty losses of the public banks, amounting to US\$ 20 billion, only after the crisis had materialized. This profound delay, in turn, led to a massive outflow of capital. The result was a sharp increase in interest rates due to a contraction of liquidity.<sup>29</sup> Given the fragile nature of the banking system<sup>30</sup> and its inability to shoulder the burden of high interest rates, the Central Bank had to give up its commitment to a fixed exchange rate regime, allowing the float of the currency which in effect meant a large devaluation of the Turkish Lira. Moving beyond these immediate consequences, the medium-term ramifications were also quite profound. The devaluation led to a jump in the inflation rate, reversing perhaps the principal success (at least

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<sup>29</sup> For a comprehensive analysis of the 2000 liquidity crisis in Turkey, see Alper (2001). Interbank overnight interest rates skyrocketed to a maximum of 6,200% on February 21, 2001 from the previous week's level of 45%. This resulted in a massive devaluation on the following day. During 19-21 February 2001, the Central Bank had to sell USD 5 billion. For evidence see Central Bank (2001).

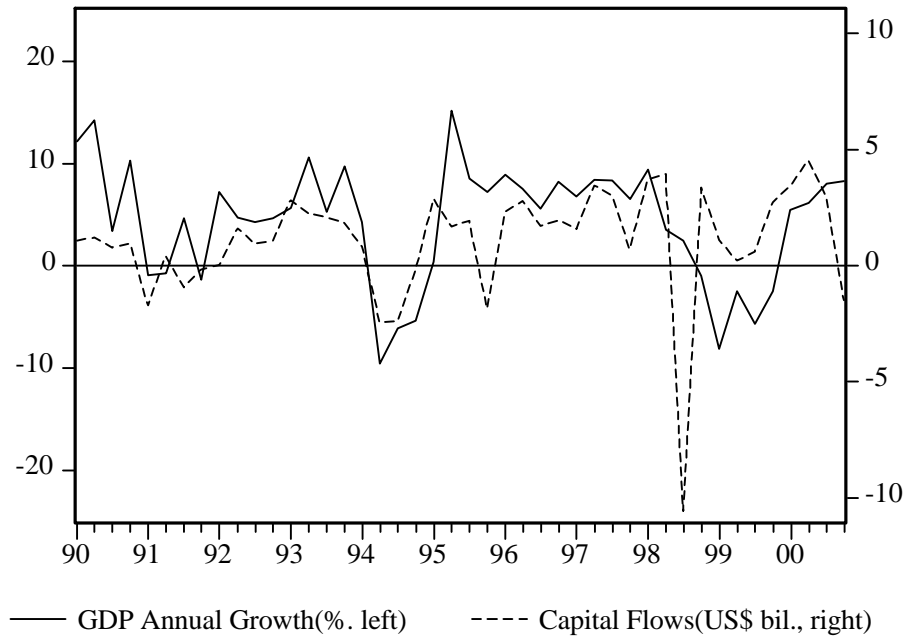
on a temporary basis), which nevertheless had been achieved in a rather costly manner. The heavy losses of the banking sector incurred during the crises, a natural outcome of the sharp increase in the interest rates, generated a credit crunch. Hence the increase in the interest rates was associated with negative consequences for the real economy in terms of contraction in output and rise in unemployment. This process also exercised a negative influence over budgetary balance. Contraction of output restricted the capacity to generate public revenues whereas high post-crisis interest rates aggravated the cost of financing the budget deficit. As a result, the issue of debt sustainability became a fundamental cause of concern in the design of the ensuing stabilization program of May 2001.

Looking back to the latter half of the 1990s, Turkish economy's fortunes were negatively affected by external developments. Both the Asian Crisis of 1997 and the ensuing Russian Crisis of 1998 were significant for the growth trajectory of the Turkish economy. Given the growing significance of Russia as a trading partner, the Russian Crisis, through trade links embodied negative ramifications for Turkey's real economy. Perhaps more significantly, an environment characterized by successive financial crises, which were inherently contagious, and dominated by private capital flows rendered capital flows even more volatile and fragile. One has to recognize therefore that not only the task of stabilization, predicated on the availability of large private capital inflows, was rendered more difficult, but also the system was exposed to greater risks of speculative attacks and ensuing financial crisis. The implications of these policies for the performance of the real economy are quite profound as indicated by the close association, which seems to exist between ups and downs of growth and capital flows in the Turkish context during the post-capital account liberalization era (Figure 2).

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<sup>30</sup> Banks in Turkey had been accustomed to living in a high inflation environment, which is clearly a consequent of the democratic deficit. Yet the sudden drop in inflation, engineered by the 1999 program exposed the fragility

Figure 2: Growth and Capital Flows in Turkey (1989-2000)



Source: Central Bank of the Republic of Turkey

This brings us to our initial conjecture concerning the importance of politics in the era of financial globalization. Indeed, politics matters in a rather specific way to the process of sustainable capital inflows. It is increasingly recognized that sustainability of capital inflows is conditional upon the provision of a stream of good news emanating from politicians and policy makers. The logical corollary is that provision of bad news is costly. A clear example of this phenomenon is the conflict between President Necdet Sezer and the Prime Minister Bulent Ecevit, which helped to trigger off the Crisis of 2001 with costly consequences. Whilst it would be misleading to attribute the crisis to this particular "incident", it nevertheless displays the sensitivity of markets to political phenomena. This, in turn, highlights the importance of the causal relationship, postulated in this study, running from the

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of the sector even further. For documentation, see Alper et al (2001).

nature of the political system or "democracy" to the ability to benefit from or hurt by financial globalization and capital flows.

## **6 Overcoming the Democratic Deficit and the Resulting Cycles of Economic Populism**

Our analysis suggests that the benefits of financial globalization are crucially dependent on overcoming the democratic deficit and the resulting cycles of economic populism. This in turn raises the question of how a stalemate of this nature could be overcome. To provide an answer to this question and explore prospects for change, one needs to investigate three sets of actors in the Turkish context. These include political parties, civil initiatives originating from non-governmental organizations and external actors such as the European Union, or international financial institutions.

Political parties constitute the least likely avenue for change in the Turkish setting. Recent research on political parties in Turkey demonstrates quite conclusively that these organizations tend to be leader dominated clientelistic networks. They tend to be organized in a highly hierarchical manner, a structure, which offers a disproportionate influence to the leader with little or no room for intra-party opposition.<sup>31</sup> The exceptional durability of party leadership and the clear absence of intra-party democracy tend to block any kind of change in the direction of greater transparency and accountability. Not surprisingly, political parties, in such an environment, are primarily concerned with the distribution of public resources among their own supporters. Their narrowly based short-term electoral focus prevents them from adopting a longer-term perspective and concentrating their attention on policies, which pay dividends only over a certain period of time.

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<sup>31</sup> On the nature of political parties in Turkey, see Heper and Landau (1991) and Kalaycioglu (2001), Turan (1995).



Whilst political parties are unlikely to assume a leadership role in the process of establishing a more accountable and transparent state, they are increasingly pressurized both from "above and below" by other actors such as supranational or international agencies and civil society organizations. A powerful "external anchor" often provides a major impetus for change in societies, where the practice of economic populism is highly entrenched. The experience of Mexico under NAFTA constitutes a clear testimony in favor of this observation.<sup>32</sup> Mexico was able to undertake difficult policy reforms and overcome domestic political resistance to reforms by utilizing the prospects of NAFTA membership and its associated benefits in the form of trade expansion and large inflows of foreign capital. Similar observations can be made in the case of the first wave of Mediterranean enlargement involving Greece, Portugal and Spain during the 1980's and the latest wave of "eastern enlargement" of the European Union, particularly in the cases of Hungary, Poland and the Czech Republic.<sup>33</sup> The transformation of Greece during the 1990s under the pressure of conforming to Maastricht criteria and the complying with requirements of entry into the European Monetary Union is particularly striking.<sup>34</sup> In the Turkish context, the EU anchor<sup>34</sup> has been only partially effective. During the 1990s, Turkey has been integrated into the European Space through the Customs Union arrangement, which arguably forms a limited avenue for integration falling considerably short of full membership.<sup>35</sup> The implementation of the Customs Union agreement, since the beginning of 1996, exercised a powerful influence in terms of accelerating trade liberalization and regulatory reforms in Turkey. However, the positive impact of Customs Union was far more limited in comparison with the impetus provided to

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<sup>32</sup> For an analysis of Mexico under NAFTA, see Aspe (1993).

<sup>33</sup> For evidence on EU's southern and eastern enlargements and the positive consequences on the countries involved, see Preston (1997).

<sup>34</sup> On the transformation of Greece under the impact of EU pressures, though with a time lag of a decade, during the course of the 1990s, see Preston (1997) and OECD (1998).

<sup>35</sup> For evidence on the Customs Union agreement and its immediate impact, see Balkir (1998).

the Mediterranean trio in the 1980s and the post-communist Eastern Europe in the 1990s. The mix of conditions and incentives facing Turkey under the Customs Union agreement can be considered rather unfavorable.<sup>36</sup> Turkey faced rather tough political conditions in terms of qualifying for EU financial assistance, which has been missing during the period under consideration in sharp contrast to the experiences of other actual and potential late entrants.

The recent decision of the European council to include Turkey as a candidate country for EU membership constitutes a critical turning point in this context. Indeed, the Helsinki decision provided a favorable environment for the December 1999 Stabilization program. The impetus coming from EU will be of key importance for the prospects of overcoming democratic deficit and the resulting cycles of economic populism in Turkey during the course of the next decade. Arguably however, the unfavorable mix of conditions and incentives, which applied to the Customs Union in the first place, continues to characterize relations with the EU in the post-Helsinki era. This, in turn, strengthens the hand of the anti-reform coalition in Turkey, slowing down the momentum of change, instigated by the EU.

The second powerful arm of the external anchor operating in the Turkish case involves the international financial community, as represented by its key institutions such as the IMF and the World Bank. Such institutions have every incentive to engineer an improvement in an economy like Turkey for three main reasons. First, they have a short-term incentive to recover the loans extended previously. Second, as a typical emerging market, Turkey constitutes a favorable market from a global trade and investment perspective. Finally, in a global financial environment characterized by "herd-behavior" and the resulting contagion, disciplining relatively poor performance becomes an over-riding objective. Similar incentives

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<sup>36</sup> On the inappropriate mix of conditions and incentives facing Turkey in its relations with EU, see Onis (2001).

exist in the case of EU as well since the EU will naturally benefit from the improved performance, both economic and political, of a potential member.

Turning our attention to pressures from below, we witness significant growth in civil initiatives notably originating from the business community in recent years. In fact, external influences and domestically based civil initiatives are inherently interlinked. The increasing interest in and pressure for reform in the direction of greater transparency and accountability on the part of the business community, at large, and big business, in particular, has been heavily influenced by the need to conform to both the EU and the broader global norms.<sup>37</sup>

The Turkish Industrialists and Businessmen's Association (*TUSIAD*) has been particularly vocal in recent years in its plea for "democratization" with an explicit focus on the creation of an accountable and transparent state.<sup>38</sup> Whilst *TUSIAD* has been the primary actor in this context, other key business associations have followed its lead.<sup>39</sup> The collective long-term interests of the business community and especially the component of the business community integrated in to the world markets favor reform along the lines suggested. Yet a major qualification is called for in the sense that large number of individual businesses continue to be embedded in traditional clientelistic networks benefiting from particularistic access to state patronage. This in turn constitutes a counter force, limiting the momentum of change originating from the business community in the Turkish context.

Civil initiatives in Turkey, in recent years, are not confined to the business community. Indeed, a series of recurrent civil initiatives can be identified in the latter half of the 1990s.

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<sup>37</sup> On the relationship between business and democracy in Turkey, in the recent era from a critical perspective, see Onis and Turem (2001).

<sup>38</sup> *TUSIAD* has published a number of reports in this context, among which *TUSIAD* (1995) and *TUSIAD* (1997) have been among the most influential.

The most striking examples of such initiatives include the plea for more open and transparent society initiated as a reaction to the *Susurluk* incident<sup>40</sup> and the civil initiatives flourished following the Earthquake of August 1999. Both of these initiatives represented a reaction to the undemocratic nature of the state and the inadequacy of state response to popular demands. More recently, civil initiatives against corruption have been particularly pronounced with some results in the direction of greater accountability.

In spite of these favorable developments, however, one needs to recognize that the development of the civil society is in its infancy. Added to this, one also ought to acknowledge that civil society in Turkey tends to be highly fragmented and characterized by weak horizontal links, resulting in incoherence and limiting the impact of pressures from below. The business associations, in particular, tend to be quite elitist in their approach and refrain themselves from entering into broader alliance with other segments of civil society. This is perhaps not a paradox in a society, which is characterized by wide asymmetries in the distribution of power resources and pervasive relative income inequality. Hence, one should not overestimate the magnitude and speed of change originating from civil society, given the existing nature of the civil society itself and the highly entrenched interests, which continue to block reforms in the direction of greater accountability and transparency.

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<sup>39</sup> A number of other business associations in Turkey have also been pushing for a more transparent and accountable state, as part of a broader program of democratization in recent years. Among the business organizations, active in this respect, are *MUSIAD*, *TIM*, *TOBB* and *TUGIAD*.

## 7 Conclusions: Broader Lessons and the Ramifications of the Turkish Experience

Variations in economic performance, in the era of financial globalization, are increasingly dictated by differential domestic capacity to adjust to global norms. Countries with low domestic capacity for adjustment are typically states, which display significant democratic deficits. Weak democracies tend to experience recurrent populist cycles in the neo-liberal era and hence fail to benefit from the process of financial globalization. In fact, financial globalization tends to magnify the populist cycles and at the same time, renders these cycles increasingly more asymmetric in nature. Relatively mild up turns of the populist boom may be followed by severe downturn of the cycle, reflecting the impact of the crisis itself as well as the deflationary impact of the stabilization program, which follows. Each severe downturn of the populist cycles is in turn characterized by an increasingly more regressive income distributional profile. Such economies face the inherent danger of entering into and subsequently not being able to break away from "low-level equilibrium trap" involving low growth-high inequality. These broad observations have considerable relevance for explaining the behavior and performance of the Turkish economy during the post 1989 capital account liberalization era.

Three key elements are highlighted in the present study. Firstly, contrary to the emphasis in the literature, our approach involves endogenizing the impact of the capital flows, with the nature of the political system or democracy, considered as the determining influence. Secondly, what on the surface appear to be short-term crises of liquidity, are diagnosed as resulting from the existence of deeper structural influences brought about by the democratic deficit. Finally, it is argued that an escape form the so-called low-level equilibrium trap is

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<sup>40</sup> For a discussion of civil initiatives in Turkey in the late 1990s, as a reaction to the *Susurluk* incident and the August 1999 earthquake, see Kasaba and Bozdogan (2000).

quite possible over time due to a combination of external and domestically induced pressures, which tend to enforce one another. Hence, the existence of democratic deficit should not be viewed as a permanent stalemate since powerful incentives exist on the part of the key domestic and external actors to move in direction of greater compliance with global norms. A key implication of our analysis the speed and magnitude of escape are heavily dependent on the signals provided by external actors as well as the coherence and intensity of the initiatives emanating from the civil society. It is quite clear, for example, that clear and consistent signals in the form of a more balanced mix of conditions and incentives provided by the EU, is likely to perform a catalytic effect in the case of a country like Turkey. Indeed the powerful signals provided by the EU are likely to empower civil initiatives in challenging entrenched clientelistic networks characterizing the operations of the state.

From a broader comparative perspective, our fundamental conclusions are the following. Financial crises during the recent era are typically concentrated in semi-periphery or emerging markets, countries that are typically characterized by weak democracies or democratic deficits. This suggests that there is a serious systemic need to strengthen and deepen democracy in the developing world. Since this objective is not easy to accomplish, serious question marks can be raised concerning the desirability of early exposure to financial globalization considering the current state of the world. Stated somewhat differently, the real benefits of financial openness emerge only after countries reach a certain threshold of democratic development.

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