DEVALUATION OF THE TURKISH LIRA

by Maxwell J. Fry and Selim İLKİN

A devaluation of the Turkish lira was predicted in an article by one of the present authors on the lira which appeared in the May 1970 issue of the International Currency Review.[1] This devaluation was announced on 10 August. One of the main reasons for believing that such action was imminent was the known exertion of pressure by the OECD, the IMF and the World Bank on the Turkish Government, primarily in the form of delays in disbursing grants and loans until the Government proved that it was prepared to remedy the chronic balance of payments situation. In this article, therefore, some of the general arguments for and against devaluation as the most appropriate remedy for balance of payments problems in underdeveloped countries are discussed. The specific measures taken by the Turkish Government are then examined and an attempt made to predict their probable effects.

Consensus on the most satisfactory exchange rate policy for underdeveloped countries has never been reached but majority opinions have undergone several changes since the War. A liberal, free-market view held sway for a while and was then replaced by prognoses based on more sophisticated theories of foreign trade which suggested that certain controls and a multiple exchange rate system could be particularly advantageous for countries whose main exports were primary products with relatively inelastic supplies. More recently, practical experiences of multiple exchange rate operations have been somewhat disil-

1 Maxwell Y. Fry, "The Turkish Lira", *International Currency Review*, May 1970.

lusioning and the feeling now seems to have emerged that there is no simple or single remedy which is best for all underdeveloped countries.

Three differences might be noted between balance of payments phenomena in countries such as Turkey and those of industrialized countries of the West-the distinction between hard and soft currencies, the difference in the average degree of protection and the different types of exports.

The distinction between hard and soft currencies is relevant in that hard currencies are held as reserves by other countries because of their ensured convertibility. The non-convertibility of soft currencies results in very small quantities of these currencies circulating outside the country concerned and the inability of residents to convert in anticipation of devaluation. Thus, a drain on the reserves is not associated with panic reaction to devaluation rumours. Furthermore, devaluations will not have adverse effects on foreigners' willingness to hold the currency as a reserve currency in the future as it is not a reserve currency. Thus, there would appear to be on the one hand less likelihood of external pressures forcing a devaluation and on the other hand less reason for not devaluing in cases where, on other criteria, such action is deemed appropriate.

In a highly protected economy such as Turkey, foreign trade may well account for less than 10 % of GNP. If the exchange rate is far removed from the equilibrium free market rate and import controls exist to ration foreign exchange a devaluation may have very little impact. In the article referred to above appearing in the May issue of the International Currency Review it was stated that even after the expected devaluation of the Turkish lira "one can confidently predict that the lira will still remain over-valued." In this case, controls will still be maintained, the advantages of an equilibrium market rate are not achieved and if subsidies on exports and tariffs on imports are adjusted when devaluation takes place there will not necessarily be any increased incentive to export or disincentive to import. Thus, no easing of the pressures on the balance of payments need occur.

The distinction between exports of primary products and manufactured goods is important because of the differences in the elasticities of supply normally associated with them. Supplies of primary products are frequently rather inelastic, whilst supplies of manufactured goods tend to exhibit considerably greater elasticity. The relevance of this dictinction lies in the fact that devaluation inevitably results in an increase in demand for domestically produced goods and can thus lead to inflation if the economy is already operating at full capacity. If devaluation is not going to increase the volume of exports (a result of the inelastic supply of primary products) the disadvantages of inflation caused by higher earnings of exporters and substitution of foreign for domestic products are not offset by any improvement in the balance of payments unless the devaluation significantly reduces import demand. Here again, the elasticity of demand for imports in underdeveloped countries is likely to be rather less than that in developed countries as much of this demand will be for capital equipment essential for the development programme.

This brief sketch of some of the differences in balance of payments problems between developed and underdeveloped countries is not meant to have implied that all devaluation efforts by underdeveloped countries are ineffective. However, it has been suggested that devaluations in underdeveloped countries under certain conditions may have either negligible effects or effects whose disadvantages may be relatively large in comparison to their advantages. The alternative solution to balance of payments problems in such cases is either to make radical changes in the direction of establishing a free market exchange rate which must, by definition, eliminate balance of payments deficits or to operate multiple exchange rates. The advantages of the latter over quota restrictions, etc., are fairly well-known, the main one being that profit accrues to the Government rather than to those fortunate enough to obtain import licences.

The Turkish devaluation appears to fall into the category whose effects are likely to be almost negligible in the long-run. In the short-run, however, despite the fact that the international agencies are not altogether satisfied with the Government's devaluation package, Turkey will probably receive additional loans from them.

The devaluation of this August is the third since the establishment of the Turkish Republic; the first took place in September, 1946, the second in August, 1958.[2] The devaluation of 1946 from 1.30 TL. to the dollar to 2.80 TL. to the dollar was primarily a result of rapid inflation (over 340 % between 1938 and 1945) due to vastly increased defence expenditure. Much of this expenditure was financed through increases in the money supply (194 m. TL. in 1938; 937 m. TL. in 1946). Foreign trade underwent a temporary phase of liberalisation after the 1947 devaluation; this was short-lived as post-devaluation stabilisation measures were inadequate and prices continued to rise steeply. The failure of the Government to implement the necessary stabilisation measures can be traced to the liberal atmosphere created internally by the transition to a multi-party system[3] and externally by the efforts to become more identified with the West after Bretton-Woods.[4] Liberalisation resulted in a large increase in imports of luxury consumer goods and a drain on the gold and foreign currency reserves from 733 m. TL. in 1946 to 481m. TL. in 1948.[5]

The 1950's were not years of successful economic development. The average annual real rate of economic growth, as measured by the rise in the real level of Gross National Product, was 4.0 % between 1951 and 1961 and 3.4 % between 1956 and 1961.[6] During the latter period per capita income actually declined.[7] Despite this slow rate of growth the level of aggregate demand continously exceeded supply causing severe inflation. The most serious effect of this was clearly on the balance of payments. Devaluation was strongly resisted by the Government as a solution to the serious imbalance which appeared in the early 1950's. By 1956, however, the situation had reached a point where action had to be taken. The course pursued was to enact a

2 For further information, see, Ernest Struc, "Stabilization Policies: Experience of Some European Countries in the 1950's", *I.M.F. Staff Paper*, July 1968, pp. 204–210.

3 Kemal H. Karpat, *Turkey's Politics: The Transition to a Multy-Party System*, Princeton, 1959, pp. 137–168.

4 Targan H. Çarıklı, *Bretton Woods Anlaşması ve Türkiye*, İstanbul, 1947, pp. 127–212.

5 Erol Zeytinoğlu, "Devalüasyonlar ve Sonuçları: III", *İstanbul Ticaret*, 2 October, 1970.

6 All growth rates used here are continuously compounded unless otherwise specified.

7 U.S. AID, *Social and Economic indicator-Turkey* 1970, Table 4-A.

law[8] empowering the Government to fix any prices, commissions, fees, etc., it deemed desirable. The State Economic Enterprises were forced to sell below cost and losses were made up by credits from the Central Bank. As a limit was also fixed for the expansion of Central Bank credit the private sector suffered from a sharp credit squeeze.

As an immediate solution to the balance of payments problem tariffs on imports were raised and subsidies provided for exports. A tourist rate was introduced which lowered the exchange rate for certain categories of visitors from 2.80 TL. to the dollar to 5.25 TL. to the dollar. Black market rates, however, were reported to lie in the region of 10–12 TL. to the dollar.[9]

The measures taken to stem the tide of rising prices were quite inadequate and, after a brief respite, prices again began to spiral upwards, reaching a rate of inflation of 20 % in 1958. Agricultural productivity had not increased relative to population increases during the 1950's and Turkey was once again an importer of agricultural products. The foreign trade deficit had been increasing and foreign indebtedness rose to nearly $2 billion, a sizable figure when compared to an annual GNP of only $6–7 billion.[10]

The 1950's seem to have been a period of lost opportunity on the foreign trade front. U.S. military and economic aid was flowing in steadily; the recovering European markets were paying remunerative prices for Turkey's main exports; and the Korean boom further helped bolster prices. Yet the increased development effort was concentrated on infrastructure investment and import substitution activities.

Even though high prices for ores, cotton and wheat led to a considerable increase in exports, the need to constrain consumer expenditure on both domestic and imported goods became more and more apparent. Despite this, the Government pursued a policy of maintaining high agricultural prices, thereby providing higher incomes for farmers, without further increases in output being realised: Cultivated land had by now reached its extensive limits.

8 Law number 6731, *Resmi Gazete*, II June 1956.

9 Z. Y. Hershlag, *Turkey-The Challenge of Growth*, (Lewen: Bill, 1968), p. 147.

10 D. J. Simpson, "Development as a Process: the Menderes Phase of Turkey", *Middle East Journal*, 19 (2), Spring 1965, pp. 150–151.

The devaluation of 1958 was again accompanied by increased liberalism. Internal price controls were lifted on most goods, individual licensing was restricted to semi-luxury goods and machinery, whilst global, semi-annual quotas were allocated to raw materials, spare parts and certain consumer goods. The balance of payments situation in 1960, however, was almost the same as it had been in 1958. The continued inflation, further losses of reserves and increased political agitation culminated in the military coup of May, 1960.

With the establishment of the State Planning Organisation in 1961 Turkey entered into a new era of planned economic development. The First Five-Year Development Plan, 1963–1967, was designed to raise the rate of growth in GNP to 7 % per annum, a target which, it was calculated, would require foreign aid amounting to 3.5 % of GNP annually.[11] A Consortium was established under the OECD to provide this aid. In the event, foreign aid disbursements only averaged 1.8 % of GNP over this period;[12] the majority of Consortium members did not provide Turkey with any net financial assistance. In fact, principal and interest payments which some members received from Turkey exceeded their new loans to Turkey. This has led some people to question whether the Consortium did fulfil any useful role during the First Plan.[13]

Despite the relative price stability in Turkey since the inauguration of planned economic development (the rate of inflation averaged 4.4 % between 1962 and 1968, a figure somewhat lower than the average for all OECD countries over this period), balance of payments problems increased. Until 1968 the shortfall in foreign aid was partly offset by the over-realisation of export targets and the unanticipated receipts of foreign currency from remittances returned by Turkish workers in Europe. However, exports fell in 1968 and were only just above their 1967 level in 1969, a factor which accelerated the balance of payments crisis of this year.[14]

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11 State Planning Organisation, *Planning in Turkey No.* 1, (Ankara: 1963), p. 33.

12 OECD, *Turkey*-1968, (Paris, 1968) p. 23.

13 W.W. Snyder, "Turkish Economic Development: The First Five-Year Plan", *Journal of Development Studies*, 6 (1), October 1969, pp. 68-69.

14 S.P.O *Memorandum on Turkish Economy with special Reference to Balance of Payments*. February 1970, (mimiograph).

The Plan envisaged the stimulation of export activities through an export rebate scheme started in 1963 primarily for non-traditional manufactured exports.[15] It was designed to return to exporters the taxes paid at every stage in the production process. This programme was supplemented by new measures which allowed manufacturers to obtain 30 % of the imported raw materials contained in their export products whithout being subject to quota restrictions and to use between 10 % and 15 % of their export proceeds for whatever imports they might need in their production processes. The gains from these provisions have been estimated at between 1–4 TL. to the dollar. Later the Government expanded the rebate programme to include subsidies for certain export commodities. However, Turkish exports still consist primarily of unprocessed agricultural products-tobacco, cotton and hazelnuts alone make up 70–80 % of total exports-which have not found nearly such profitable markets in the 1960's as they did in the 1950's.

During the period of relatively rapid economic development since 1962, the demand for imports in Turkey has far outstripped the additional foreign currency acquisitions. The proportion of investment in GNP has risen and there has been a shift towards industries with higher imported input contents. In an attempt to reduce the pressure of demand for foreign currency an import pre-deposit scheme (see Table 1) was introduced and the stamp tax on imports raised from 5 % in 1966 to 25 % in 1970.

Table 1

Money Supply and Import Pre-Deposits at the Central Bank

(Millions of TL.)

Date	Money Supply	Import Deposits
3 August 1968	9,293	1,461
2 August 1969	10,317	2,508
1 August 1970	11,403	4,647

Source: Balance sheets of the Central Bank of the Republic of Turkey.

15 For further information See, *Institutional Reforms for the Development of Turkish Exports*. AID, June 1968. (mimiograph) pp. 121–132; İstanbul Üniversitesi Maliye Enstitüsü, *İhracatta Vergi İadesi*, İstanbul, Kasım 1969 (teksir).

As can be seen from Table 1, the money supply increased annually by 10–11 % over the past three years, a rate consistent with that experienced during the rest of the 1960's. However, during the past three years a significant proportion of the money supply has been returned to the Central Bank in the form of blocked import deposits where they lay immobilized for up to 50–60 weeks just prior to devaluation. The rapid rise in these deposits had two important effects, the first being an acute shortage of imported raw materials and capital equipment which led to the closure of a number of plants and a cutback in production in many others, the second a serious credit squeeze on the private sector.[16] This large increase in predeposits seems to have been over-looked by the monetary authorities in their estimates of the appropriate expansion in the supply of money during these years.

The pre-deposit scheme did contain the demand for foreign currency such that the realised trade deficit was held within manageable limits. Nevertheless, the rapidly increasing size of the pre-deposits indicated the existence of increasing disequilibrium in Turkey's foreign trade position. A natural result of this has been black market prices for import licences commanding 4–10 per dollar in 1967 rising to 8–35 TL. per dollar in 1970 over their face value.

The worsening imbalance over the past year has led the international organisations to repeat their arguments in favour of devaluation.[17] They indicated that Turkey's aid requests would not be met until a realistic exchange rate was set. The promotion of export industries, the need to take measures to stimulate private foreign investment, etc., wes also strongly recommended.

Similar pressures have probably also been exerted by the EEC of which Turkey became an associate member in 1963; full-membership was foreseen in three stages. In the initial five-year "preparatory stage" the EEC provided Turkey with credits of $ 175m. plus certain tariff exemptions for Turkey's major exports. During this period, the EEC expected Turkey to strengthen her economy and prepare herself for the "reciprocal obliga-

16 Ziya Kayla, "Para Darlığı ve Alınan Tedbirler", *Cumhuriyet*, July 18, 1870.
17 Mükerrem Hiç, "Devalüasyon: Dış Baskı", *Milliyet*, August 19, 1970.

tions" of the next stage which was to start at the end of 1969.[18] Although it was possible to extend the preparatory period, the Turkish Government wanted to enter the "transition stage" immediately so that, on the one hand, the governing Justice Party would have achieved a political success in the face of other adverse political developments and, on the other hand, Turkey would obtain a new inflow of EEC credits.[19]

The liberalisation of the foreign trade regime required for the "transition period" which included reduced tariffs and the gradual abolition of quota restrictions necessitated,[20] in the first instance, the establishment of an exchange rate nearer equilibrium than the 9: 1 rate set in 1958. A demand by the EEC to this effect was probably made during the secret negotiations for entry into the "transition stage".

Despite these external pressures devaluation was resisted for some time due to the political situation. In the last General Election which took place in October, 1969, the Justice Party won 256 out of the 450 seats in the National Assembly. However, Premier Demirel's position was weakened in February of this year when 41 members of his own party opposed him over the Budget thereby bringing the Government down. Demirel eventually managed to form a new government and succeeded in pushing the Budget through the National Assemby. He now has only 234 Justice Party votes, a majority of 9 seats. Other domestic problems with which the Government had to contend over the past twelve months have included demonstrations by producers, trade unionists and students. Martial law was imposed on Istanbul for several months during the summer of this year. Rumours of another military coup were prevalent in May and June. However, the political situation appeared to ease as the summer progressed and by August the Government appeared secure enough to be able to face any adverse criticism which its announcement to devalue the lira by 66 $\frac{3}{2}$ % might provoke.

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18 Stephen Y. Ettinger "The Association of Greece and Turkey with the European Economic Community", *Public and International Affairs*, Vol. III, No. 1, Spring 1965, pp. 130–161.

19 *Cumhuriyet*, August 28, 1970 p. 5.

20 For further information see, Ali Sait Yüksel, *Ortak Pazara Geçiş Dönemi Sorunları*, S.P.O. April 1970 (mimiograph).

The devaluations of 1946 and 1958 were quite evidently associated with inflation in the years preceding them. It is striking that this has not been the case with the 1970 devaluation. As already mentioned prices have been relatively stable since the start of the planning era. Two explanations can be given for the emergence of balance of payments problems in the later part of the 1960's. The first is that the rapid inflation between 1958 and 1961 caused the lira to be seriously over-valued at the onset of the planning period. At some point the maintenance of the over-valued rate became untenable. The second explanation is that the radically improved rate of growth resulted in greater and greater pressures on the balance of payments. Indeed, it has been estimated that a 1 % rise in GNP results in a 1.4 % increase in the demand for imports.[21] In general, the process of development is almost inevitably accompanied by balance of payments problems. This has led to the suggestion that a balance of payments deficit in an underdeveloped country must be regarded primarily as a problem of development rather than as a balance of payments problem per se. In this case, both explanations are probably partially correct.

Independent evidence suggests that the lira has been considerably over-valued for many years. *A priori*, one might hold inflation as the chief culprit for this since it occurred both before and after the first two devaluations. However, a simple arithmetic exercise can be used to show that this is not the case. Comparing the average rates of inflation between 1948 and 1969 of Turkey and the U.S.A. with the exchange rate at the beginning and end of the period between the Turkish lira and the dollar, the result emerges that the Turkish lira has suffered a depreciation of 11 % on the 9:1 exchange rate and of 47 % on the 15:1 rate. Had the lira not been devalued by the extent of the relative price rise in Turkey the results would have produced an appreciation of the lira *vis-à-vis* the dollar on the relative inflation-corrected exchange rate. It might be noted, parenthetically, that currency depreciation based on the same calculation averaged 31 % for all the underdeveloped countries in Europe (Turkey included) between 1948 and 1967 and for all underdeveloped countries suffering from chronic inflation (Turkey included)

21 Melih Celasun, *Milli Ekonominin Uzun Vadeli Gelişme ve Sanayileşme Perspektifleri: Bir Makro Tahlil-Bölüm: I*, S.P.O, Ankara, 1969 (mimiograph).

27% over the same period.[22] One is, therefore, thrown back to the explanation of an over-valued lira resulting from the accelerated pace of economic development with its resultant demands for imported raw materials, capital equipment and luxury goods.

The devaluation of 10 August, 1970, established a new exchange rate of 15 TL. to the dollar.[23] There are, however, some exceptions to this rate: 12 TL. per dollar is the rate for foreign exchange earnings from cotton, tobacco, hazelnuts, raisins, dried figs and olive oil. As already pointed out, these items constitute the bulk of Turkey's exports. Various other transactions are subject to different *de jure* rates, e.g., foreign currency for travel abroad (10 TL. to the dollar) and remittances from Turkish workers abroad (11.25 TL. to the dollar), but taxes and subsidies bring the *de facto* rate to 15 TL. to the dollar. These appear to be just some examples of a number of rather roundabout practices which seem to have entered into the devaluation package as a result of legal constraints.

The first group of exceptions are important and interest a large number of farmers. There may have been two predominant motives behind the Government's decision to establish a multiple rate of this form. In the first place agricultural producers gain from a 33 $\frac{2}{3}$ % devaluation and yet purchasing power is held below the increase which would have resulted from devaluation by the full 66 $\frac{1}{3}$ %. In the second place the Justice Party relies on the rural vote for its majority and may bring the rate on agricultural exports up to 15 TL. to the dollar at a politically opportune moment, meanwhile meeting any presently felt discontent from this group of the electorate with its announcement to raise price floors by 20–25% over the previous year's.

At the same time as the devaluation announcement, the Government announced a series of new stabilization measures designed to make the devaluation effective in the long-run. These can be classified into three groups:[24]

22 M. G. de Vries, "Exchange Depreciation in Developing Countries", *IMF Staft Papers*, 1968, 15, pp. 569–570.

23 *Resmi Gazete*, August 10, 1970.

24 For further information see, *Milliyet*, August 11, 1970.

1) Fiscal Measures: A new law was proposed which introduces certain new taxes and raises existing taxes on a fairly wide range of commodities.

2) Monetary Measures: Interest rates on both deposits in and loans from the banking system have been raised by between 1% and 3%. More funds are to be made available at priority interest rates to those engaged in export activities. The main source of these funds is to be the import pre-deposits at the Central Bank. A significant innovation in the monetary field is the introduction of direct subsidies to borrowers from the banking system engaging in priority activities. These subsidies, which range from 1% to 3%, are to be met from funds set aside from the General Budget for distribution through the Selective Credit Fund. Furthermore, banks which lend at priority interest rates (1% below the normal rate) will receive a subsidy of between 1.3% and 1.7%. Given that all borrowers in such cases receive a Government subsidy as well, it might be observed that a much simpler way of obtaining the same results would have been to have abandoned the priority rate altogether and simply given the entire subsidy to the borrower.

3) Foreign Trade Controls: The rate for import pre-deposits, the subject of many complaints, has been lowered by 50% and the stamp duty on imports has been reduced from 25% to 10%. These measures lower costs of imports slightly and are consistent with the demands of the EEC for liberalisation. Although the tax rebates for manufactured goods are to continue, their rates have been lowered and the system simplified. The Special Export Fund and the fund for supporting foreign exchange earning activities are also to be continued and are to be used in financing export-oriented investment.

Hope of immediate improvement in the balance of payments as a consequence of the devaluation is not great. Prior to devaluation the only significant stocks existing were of tobacco; the only way to meet new demand for Turkish exports is to increase production of most of the traditional export commodities. This will necessitate efforts to stimulate productivity and/or to restrict domestic demand; both involve difficult and time-consuming political decisions. It would also be unwise to expect large increases in manufactured exports, with the exception of cotton textiles and processed food, as most activities in this category consist of light consumer goods production with patent restrictions confining sales within Turkey. Most of these industries have suffered from inefficient management and there has been little concern with up-to-date marketing and packaging techniques, practices which would be necessary in the face of foreign competition. The possible increases in output in one or two commodities are unlikely to make more than a marginal impact on what is still a chronic balance of payments situation.

On the import side problems seem no less intractable. As a significant portion of imports consist of raw materials and investment goods, a reduction in imports is likely to mean a reduced rate of growth in GNP, something the Government would be most loath to accept. However, the receipt of a three-year loan of $1 billion should be of considerable help in tiding Turkey over short-run difficulties.[25]

In the long-run, the success of the recent devaluation will depend on the maintenance of stable prices and increased efforts on the export front, particularly in improving quality and in marketing. The present Government does not seem to give the impression that it can tackle the price stability problem. Already a number of prices have increased by rates considerably above that warranted by the devaluation. Demands for higher wages in the State Economic Enterprises are becoming widespread[26] and civil servants are due for substantial rises under the new Personnel Law. Apart from the increased credit for export activities no plans seem to be afoot for dealing directly with the problem of quality and marketing. However, marketing specialists being trained both in Turkish universities and abroad appear as a small ray of hope in this rather depressing picture. The interest being taken in possibilities for closer relations with the Commu-

25 It has later came out that this figure was misleading because the authorities included already negotiated loans in this sum. The opposition has charged that the actual loan will amount to a much lower figure. See *Milliyet*, September 26, 1970.

26 The prices of goods and services produced by State Economic Enterprises (SEE) are routinly controlled by the government. For this reason these have not kept up with the general inflationary tendency causing losses, thus requiring even greater subsidy for the operation of SEE; Because these subsidies to SEE; have traditionally been obtained through deficit financing, therefore the whole operation leads to grateri nflationary pressure.

nist countries, which has included a $10m. loan offer from Bulgaria, may also be seen as a hopeful sign for increased trading opportunities in the future.

According to the Press, the IMF, the World Bank and the Consortium have found the post-devaluation measures insufficient. They have apparently made it know that "tax increases, cutbacks in expenditure - particularly keeping salary increases proposed in the Personnel Law for civil servants at a minimum-will be necessary."[27] The material presented in this article tends to support this position. Even with these tighter stabilization measures, however, neither short-run nor long-run consequences of this devaluation are likely to be significant in either radically improving the balance of payments or in changing the structure of the economy.

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27 *Akşam*, October 3, 1970.