

AN ASSESSMENT OF IMF POLICIES: THE CASE OF TURKEY

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Abstract: This paper takes issue with the IMF's continued advocacy of liberalization and fiscal and monetary restraint in Turkey, by assessing the impact of the last two stand-by agreements in 1999 and 2000. We investigate the preconditions of the twin crises of 2000 and 2001 and conclude that the initiation of the 1999 Stand-by Agreement should have been conditional on structural reforms in the banking sector. Besides, it is argued that the IMF imposed its policy prescriptions without sufficient consideration of the market imperfections that prevail in Turkey. On the fiscal side we defend targeted spending in key areas, particularly where there is complementarity between efficiency, productivity, relative cost and distributive fairness. We defend the view that the disinflationary, growth and human development agendas should be carried out simultaneously.

Keywords: IMF and Turkey, Stand-By Agreements, Crises of 2000 and 2001.

I. INTRODUCTION

In this paper we will argue that IMF's policy demands in Turkey are ill-suited to the market structures that prevail in that country. As a result of its insensitivity to local factors IMF policies contributed to the conditions that lead up to the twin crises of late 2000 and early 2001 and is frustrating the country's ability to recover from it. The IMF has become a scapegoat for all economic woes across the globe and so our intention is not simply to jump on the bandwagon. Rather we contend that a clear-headed investigation of the structure of the markets in Turkey reveals that the Fund's policy requirements in return for its loans were and continue to be ill-conceived.

Two possible explanations for that failure may be drawn from the critique of the Fund by the hitherto chief economist at the World Bank, Joseph Stiglitz [1]. He argues, firstly, that the Fund's 2000 functionaries are unable to grasp the facts on the ground because they mostly educated in the US and are based in Washington rather than the debtor country. Secondly, it takes a 'one size fits all' approach to its policy prescriptions around the globe in spite of crucial variations between countries. Briefly, what Stiglitz labels as the Washington Consensus

IMF POLİTİKALARININ BİR DEĞERLENDİRMESİ: TÜRKİYE ÖRNEĞİ

Özet: Bu çalışma, IMF'nin iktisat literatüründe tartışılan serbestleşme, mali ve parasal daraltıcı politikalarının Türkiye ekonomisi üzerindeki etkilerini 2000 ve 2001 stand-by düzenlemelerinin etkileri çerçevesinde incelemektedir. Bu bağlamda, 2000 ve 2001 yılı krizlerinin önsel nedenleri incelenmiş ve Bankacılık sektörü reformlarının 1999 Stand-by düzenlemesi öncesinde yapılmış olmasının gerekli olduğu sonucuna varılmıştır. Buna ek olarak, çalışmada IMF'in Türkiye'de var olan piyasa aksaklıklarını yeterince dikkate almadan politika önerilerinde bulunup bulunmadığı tartışılmaktadır. Maliye politikası alanında ise özellikle etkinlik, verimlilik, görelî maliyetler ve adil bölüşümü destekleyen temel alanları hedef alan harcamaların yapılması gerektiği savunulmaktadır. Ayrıca, desenfasyon ile birlikte büyüme ve insani kalkınma amaçlarının eşanlı olarak sürdürülmesi gerekliliği savunulmaktadır.

Anahtar kelimeler: IMF ve Türkiye, Stand-By Düzenlemeleri, 2000 ve 2001 Yılı Krizleri.

demands that in return for the disbursement of a loan the beneficiary government must cut fiscal spending and/ or raises taxes in order to balance the budget (thereby enabling the country to pay back the loan). In order to help reduce the budget deficit and to off load inefficient state institutions (inefficient to the point where state workers are effectively on welfare because their activities do not contribute to the social product) it argues for privatization. In combination with fiscal austerity it argues that the government must maintain a tight monetary policy in the form of high interest rates in order to reign-in inflation. Coupled with this and in keeping with the free market orthodoxy the Fund further requires trade liberalization and the liberalization of capital markets [1] and [2] (Perhaps not unsurprisingly Stiglitz's critique has drawn an almost vitriolic response from Kenneth Rogoff, the chief economist at the IMF [3] and also [4]). We shall not speculate further here as to the institutional reasons behind the Fund's diagnostic failure, but what we argue below is not inconsistent with Stiglitz's critique.

Generally speaking we are strongly persuaded by Amartya Sen's view that policy design must not commit itself to a, [C]ompartmentalized view of the processes of

development (for example, going just for 'liberalization' or some other single overarching process). The search for the single all-purpose remedy (such as "open the markets" or "get the prices right") has had much hold on professional thinking in the past ... Instead an integrated and multifaceted approach is needed, with the object of making *simultaneous* progress on different fronts [5]. (Emphasis added)

Thus, for example,

The need for financial conservatism - important as it is - fits into this diverse and broad picture, and cannot stand on its own - in solitary isolation - as the commitment of the government or of the central bank. The need for scrutiny and comparative assessment of alternative fields of public expenditure is altogether crucial [5].

Indeed the paper argues that simultaneity is further justified given the structural peculiarities of the Turkish markets.

We begin in Part A by outlining the economic conditions that precipitated the 2000 and 2001 crises. We then argue, in Part B, that the primary reason for the crisis was the fact that the increasing public sector borrowing requirement created a fragile structure in the banking sector such that the public banks became vulnerable to interest rate risk and the private banks to the exchange rate risk. In addition to this fragile structure, imperfectly competitive conditions in the banking sector also contributed to the crisis. These problems arose because the December 1999 stand-by agreement was implemented before the required reforms to the banking system had been implemented. In addition the Fund was too slow to realize that the November 2000 crisis was due to the resulting liquidity squeeze. We then move away from the precise causes of the crisis itself and argue in Part C that the IMF's wage led disinflationary strategy cannot hope to achieve its objectives because of the oligopolistic structure of the Turkish goods market.

In Part D we challenge the austere fiscal stance prescribed by the Fund on the grounds that fiscal intervention is required to counteract coordination failure in the Turkish credit markets. In addition government expenditure on social opportunities such as education and health care are comparatively cheap, crucial to personal well-being and essential to the country's ability to foster sustainable growth. A further feature which the IMF failed to identify is the extent of the informal economy in Turkey. Recently growth rates have actually picked up in spite of the twin crises and in spite of ongoing cutbacks in government spending. We argue that recent growth is largely due to the extent of money kept 'under the mattress'. At the same time inflation has started to decrease, thus suggesting - but not, it must be said,

proving - that the level of fiscal austerity prescribed by the IMF is exaggerated.

II. BEFORE THE CRISIS

II.1. A Brief Pre-history: 1980-2000

Turkey followed an import-substitution industrial policy until the end of 1970s. This period were characterized by protectionist trade regime. In the late 1970s Turkey confronted a serious balance of payment difficulties in the face of rapid inflation. As a result, a stabilization program came into force on January 24, 1980 which was aimed at coping with the accelerated price increases and balance of payments deficits in the short run as well as changing the development strategy and pattern of export production in the long run. The stabilization program was followed by the military takeover of September 12.

Macroeconomic developments after 1980 can be divided into two phases: 1981-1988/89 and 1990-2000 [6] and [7]. The first decade of liberalization was characterized by trade liberalization, a relaxation of direct government controls on the prices of some commodities as well as interest rates, devaluation of the Turkish lira and foreign exchange rate liberalization. Trade liberalization reached its final stage with the establishment of Customs Union with the EC in 1996. Another important adjustment during this period was the liberalization of capital markets.

For the two years following the reforms, the macroeconomic balances in Turkey improved. The current account deficit in the balance of payments was reduced by about two-thirds, was supported by rapid export growth, and the overall balance moved into surplus. Between 1980 and 1982, the central government's budget deficit was halved, making it possible to cut the public sector borrowing requirement (PSBR) to 6 percent of GDP in the latter year [8]. The export-led growth strategy was quite successful initially. There was an average annual growth rate of GDP was 5.8% between 1981 and 1988 [7]. Similarly export revenues increased at an annual rate of 10.8 percent between 1983-87 [6].

However the initial success of the program reached its limits at the end of the 80's. First of all, due to political developments it was no longer practical to use wage suppression to ensure export-led growth. Secondly, export-led growth was reliant on export subsidies and the devaluation of the national currency. In effect growth was overly dependent on the productive capacities established during the 70's [6].

Capital account liberalization in 1989 was another major turning point for the Turkish economy. The export-led growth of early 80's was replaced with a new growth

path which was financed by capital flows. This new pattern of growth referred to by [7] as “boom bust growth” has volatile due to financial cycles [6]. After 1988, there were five recessions (1989, 1991, 1994 and 1999, 2001) and four booms (1990, 1992-93, 1995-97 and 2000). That growth pattern indicates that the business cycles were quite short [6]. Another important outcome of the capital account liberalization was the increase of the share of the short-term capital (“hot money”) flows. The net balance of hot money for 1990-2001 was \$13.1 billion [6]. Another important characteristic of the 90’s was the increasing domestic debt of the Turkish economy. The ratio of PSBR to GNP increased from 4.8 percent in 1988 to 15.1 percent in 1999. Parallel to the increase in PSBR, the share of domestic borrowing in PSBR increased and share of foreign borrowing declined. As a result, the stock of government debt instruments also increased 5.7 percent in 1988 to 29.3 in 1999 [6]. To compound matters, in 1999 Turkey was struck by two devastating earthquakes centered on the most populous and industrial part of the country. Over 20,000 people were killed, even more were left injured, homeless and jobless, and extensive damage was inflicted on the industrial and civil infrastructure.

II.2. Preconditions of the November 2000 and February 2001 Crises

Following the years of high interest rates, low average growth, and an unsustainable path of public finance and high inflation in 1990’s, Turkey initiated an economic program after the April 1999 elections with the ambitious goal of freeing the country from the high inflation. By December 1999, the program was strengthened and redesigned under a three-year stand-by arrangement with the IMF. The primary goal of the program was to bring inflation down to lower single digits abruptly. CPI inflation, which averaged close to 80 percent over the last ten years, was targeted to be 25 percent by the end of December 2000 and to move to lower single digits (about 5-7 percent) by the end 2002 (Our main reference for the policies and targets of the economic program is the letter of intent of Turkey for stand-by arrangement [9]).

In accordance with the IMF’s standard approach, the program rested on fiscal adjustment, structural reform and a firm exchange rate commitment supported by tight monetary and incomes policy. The goal of the fiscal adjustment was to raise the primary surplus of the public sector from 2.8 percent of GNP in 1999 to 3.7 percent of GNP in 2000. This level was expected to stabilize the net public debt to GNP ratio over the medium term. The debt to GNP ratio, which was 58 percent at the end of 1999, was projected to fall to 54.5 percent in 2002. The attainment of this fiscal goal was to be monitored through a set of cost cutting and revenue generating indicative targets. Structural reforms were primarily focused on the fiscal and banking sector. Structural reforms in the fiscal

area were planned for agriculture, the pension system, fiscal transparency and tax policy. Reform in the banking sector was designed to strengthen key prudential regulations and standards for banking activities. The exchange rate policy, designed to counter inflation, required a shift from a managed float to crawling peg. An exchange rate path was announced for the first 18 months of the stand-by agreement. However, at the end of the 18-month period, a gradual shift to a more flexible exchange rate were also promised. A progressively widening band around the central exchange rate path was to be introduced. Monetary policy was formed as if there was an implicit currency board system. All base money was created through the balance of payments. That meant that neither capital inflows nor capital outflows sterilized and, therefore, interest rates were fully market determined. Depending on the direction of flows, the rapid decline as well as the prompt increase in the money market interest rate was possible. In effect the domestic rate of was totally dependent upon the availability of foreign capital flows. As a result the central bank had no standard avenue for controlling the money supply. At the end of the 18 months, a gradual shift from a monetary framework entirely centered on the exchange rate to one that allows greater flexibility in pursuing the inflation target was scheduled. Finally, a soft incomes policy was incorporated into the disinflation and exchange rate policy. To this end, salary increases for civil servants was set in line with targeted CPI inflation. However, the government promised to pay the difference if the CPI inflation exceeded the target salary increase. A new law was passed to limit the increase in rent contracts according to the inflationary target. These measures were expected to encourage the private sector to set wages and prices in line with the inflation target.

II.3. Program targets and realizations

The disinflation program was initiated in January 2000. The main macroeconomic targets and realizations are given in Table.1.

Table.1. Program Targets and Realizations

| | 1999 | 2000 | |
|---|-------|--------|-------|
| | | Target | Real. |
| Economic Growth (%) | -6,1 | 5,0 | 6,1 |
| CPI (Year End %) | 68,8 | 25,0 | 39,0 |
| WPI (Year End %) | 62,9 | 20,0 | 32,7 |
| Average Treasury Bonds Interest Rates (%) | 106,2 | ----- | 38,0 |
| Primary Budget Balance (% of GNP) | -2,0 | 2,2 | 2,8 |
| Current Account Balance (% of GNP) | -0,7 | -2,0 | -4,8 |

Source: CBT (Central Bank of Turkey). (2001). *Yearly Report*. (www.tcmb.gov.tr). [22.12.2002]. [10].

The economic growth rate of 6.1 percent was slightly greater than the target. Average interest rates on treasury bonds and public budget performance were better than the targets. Monetary and exchange rate policy had been successfully implemented. Most of the macroeconomic indicators displayed a positive stance in 2000 compared to 1999. Preliminary budget targets announced for the year 2001 was implying a stronger fiscal stance. Deviation was observed only in terms of the inflation and current account data. Year-end CPI inflation in 2002 realized as 32.7 percent, whereas the target was 20 percent. A major deviation was observed in current account deficit (CAD). The ratio of CAD to GNP realized as 4.8 percent, even though the target was 2 percent. Hence, despite some worrying figures, the economic program was on track.

Nevertheless, financial turmoil emerged in the second half November 2000. Overnight interest rates jumped over 850 percent and over 5.5 billion dollars drained from international reserves [11]. The pressure in the market calmed down soon after a new letter of intent was presented to the IMF. However, average interest rates were almost five times higher than the pre-announced year-end depreciation rate of the Turkish Lira [11]. The November crises caused the banking system to incur huge profit and capital losses. The banking system as a whole was carrying significant government securities. Despite the fall in interest rates with the support of IMF, the average interest rate, swinging around 55 percent, was not enough to cover the losses in the banking sector. As a consequence, Demirbank, one Turkey's largest banks, defaulted on its liabilities and was taken over by the SDIF (Saving Deposits Insurance Fund).

Interest rates at first should have decreased to the levels (about 35 percent) preceding the November crises (Most of the treasury bonds carried out by the banking system were bought at average interest rates). There was also inconsistency between the pre-announced depreciation of the TL and the prevailing interest rates. The upper limit for the depreciation of TL against the basket of Euro and dollar was 12 percent in 2001 whereas the interest rates were around 55 percent in January 2001. That was not sustainable. A weak financial system, worries about the size of the consolidated public sector debt (including state banks) left the risk premium and the interest rates high. Because interest rates did not sufficiently decline, the collapse of the exchange rate system was inevitable. The lack of political leadership of

the program contributed to the uncertainty. This unsustainable situation ended on the February 19, 2001, when the Prime Minister walked out of a National Security Council meeting (MGK) after a heated exchange with the President (The MGK is a body composed of the Prime Minister and senior Cabinet members, the President and senior members of the Turkish Armed Forces. Due to a wide reading of the notion of security and the Turkish public's continued reverence for the military establishment, the Turkish Armed Forces are able to use the MGK as an instrument to fulfill its role as the self-ordained guardian of the secular and indivisible character of Turkish Republic. It remains, therefore, a powerful executive organ of government in spite of its non-democratic composition). As a result, overnight interest rates jumped to 6200 percent, the exchange rate system collapsed and Turkey declared that it was going to implement a floating exchange rate system from that time onwards. In that year, Turkey faced one of the deepest economic contractions and biggest capital outflow in her economic history; the economy contracted 9.4 percent, net 14 billion USD was withdrawn from the country [11] and [12]. The Unemployment rate which was 6.3 percent in the 4th quarter of 2000 had risen to 10.6 percent by the 4th quarter of 2001 [12].

III. REASON FOR THE CRISIS

As noted above, the microstructure of Turkish financial sector, in particular the banking sector, was not adequately considered by the IMF. Indeed, that failure was apparent even during the early stages of the economic program. Banking reform was aimed to strengthen key prudential regulations and standards for banking activities. Those measures were expected to strengthen public confidence in the banking sector and remove upward pressure on interest rates [9]. However, before the measures were implemented, interest rates decreased within the first few weeks of the program. This we contend was because of the microstructure of the banking sector.

The structure of the Turkish banking system can be examined both at the macro and micro level. At the macro level, the risk exposure of the banking sector can be viewed in terms of credit risk, foreign exchange rate risk and interest rate risk. Table.2 presents the indicators related with those forms of risk.

Table.2. Selected Ratios of Commercial Banking Sector

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|------|------|------|------|------|------|
| Non-Performing Loans / Total Loans | 2,8 | 2,2 | 2,4 | 7,2 | 10,7 | 11,6 |
| FX Liabilities – FX Assets | | | | | | |
| Excluding off the balance sheet | 3,0 | 2,5 | 5,0 | 8,4 | 13,2 | 17,4 |
| Including off the balance sheet | 0,6 | 1,2 | 1,9 | 2,9 | 2,9 | 5,5 |
| Liquid FX Assets / FX Liabilities | 44,8 | 44,6 | 41,0 | 39,5 | 40,0 | 35,9 |
| Assets / Liabilities (With 3 months or shorter maturities) | n.a | n.a | 45,8 | 45,7 | 46,3 | 39,9 |
| Share of deposits with 6 months or greater maturity in total dep. | 26,1 | 26,6 | 24,7 | 22,9 | 28,2 | 15,1 |

Source: Özatay, F. & Sak, G. (2002). *The 2000 – 2001 Financial Crisis in Turkey. Brookings Trade Forum 2002: Currency Crises, Washington D.C., May, 2. [13].*

The ratio of non-performing loans to total loans tended to increase after 1997. A growing number of banks were taken under the control of the SDIF (Saving Deposits Insurance Fund) thus explaining the rapid increase of the ratio. It certainly raised doubts about the quality of both information disclosure and rule enforcement in the banking sector. Nevertheless, it may be misleading to suggest that there existed a typical credit crunch in Turkey. Both the size of the credits and its non-performing part was considerably low compared to other emerging countries during the pre-crises period [14].

The increasing open exchange rate position was another structural problem in the banking sector. This was due to persistent high inflation and the inability of banks to borrow in domestic currency. As can be seen from Table.2, the open foreign exchange position of both the balance sheet and the aggregated balance sheet, including off the balance sheet items, indicate a significant increase in foreign exchange risk. Another measure, namely, the decrease in foreign currency denominated assets to foreign currency denominated liabilities ratio supports this finding (Table.2).

To measure the interest rate risk, maturity mismatch figures derived from the balance sheets of banks can be used. The ratios of assets to liabilities with matching maturities are given in the Table.2. A rising interest rate risk is evident as it shows that the maturities of assets are longer term when compared to liabilities. Thus, all the figures related to the likely risks of the banking system deteriorated preceding the crises. At the macro level, the fragile structure of banking sector was similar to other emerging countries. The policy measures of the economic program were designed to reform that structure. The microstructure of the Turkish banking system is well documented by [13]. They point out two different dichotomies in the banking system. One is

between private and state banks. The other one is within the private banking system. The dichotomy between private and state banks were both on the asset and liability side of the balance sheets of the two types of banks. On the asset side, the duty loss accumulation of state banks and the need to finance it was the problem (After 1992, the government through loans taken from state banks financed some activities of treasury. Instead of repaying the principal and interest accrued, the treasury allowed a non-performing loan to be treated as a performing loan by the state banks. The accumulated loss of state banks is called duty loss). There was an increasing funding demand of state banks in the money markets. The total amount of duty losses was first publicly announced by the government as 20 billion USD just a few weeks before the November crises (Indeed, the figure was first released in World Bank report on the Turkish economy in September 2000. Afterwards it was confirmed by state ministers on various occasions. This figure negatively effected market sentiment on the sustainability of the domestic debt stock [15]). It was equivalent to about 10 percent of GNP. Considering that the public sector borrowing requirement was about 12 percent in 2000, one can judge the size of the quasi-fiscal deficit and its pressure on the financial system. On the liability side, the ratio of foreign exchange to TL liabilities was higher for private banks. At the beginning of 2000, that ratio was 285 percent and 32 percent for private and public banks respectively. The asset liability structure of state banks show that while state banks were more open to interest rate risk, private banks were more open to exchange rate risk. That is why the November 2000 crises had hit the state banks hardest and the collapse of the crawling peg system in February 2001 hit the private banks hardest.

The dichotomies across the private banks were connected to the highly leveraged positions of some mid-sized banks. They carried an excessive government debt

instruments portfolio in the anticipation of a continued decline in interest rates. Among those mid-sized banks, one of them, namely Demirbank had a risky portfolio significantly exceeding both the other mid-sized banks and the banking sector as a whole. The position of

Demirbank made it act as market maker in order to defend its position. The marked difference between the position of Demirbank and other private banks are given in Table.3.

Table.3. Dichotomy in The Private Banking Sector: Demirbank Versus Others

| | | 1997 | 1998 | 1999 | 2000 |
|---------------------------------|------------------|-------|-------|-------|-------|
| Total GDI* /Total Assets | Sector | 31,72 | 29,03 | 34,64 | 25,18 |
| | Demirbank | 58,54 | 57,09 | 65,12 | 67,50 |
| REPOs / GDI + REPOs | Sector | 60,24 | 48,51 | 38,66 | 33,04 |
| | Demirbank | 68,30 | 57,16 | 69,48 | 70,69 |
| Bank REPOs / Total REPOs | Sector | 20,64 | 22,51 | 19,09 | 5,48 |
| | Demirbank | 29,02 | 24,08 | 41,97 | 48,31 |

* Government Debt Instruments

Source: Özatay, F. & Sak, G. (2002). *The 2000 – 2001 Financial Crisis in Turkey. Brookings Trade Forum 2002: Currency Crises, Washington D.C., May, 2. [13].*

The major difference was the ratio of government debt instruments portfolio to total assets. That ratio was about 60 percent for Demirbank since 1997. It approached 70 percent preceding the November 2000 crisis. The sector average tended to be less than half of the Demirbank ratio. Demirbank was using short term REPO's to carry out its government debt instruments. The ratio of REPO's to total government debt instruments tended to be around 60 – 70 percent for Demirbank. That was almost twice the sector average. These REPO agreements were mostly done with other banks on the basis of overnight borrowing. The ratio of bank REPO's to total REPO's, which was nearly 30-40 percent, indicate the extend of that activity. One implication of that activity was that the other banks were aware of the position and risks of Demirbank.

Hence, we claim that microstructure of the Turkish banking system played a major role in bringing about the November 2001 crises. The increasing public sector borrowing requirement was one of the main reasons for that structure. First, it deteriorated the state banks by accumulating their duty loses. Second, it caused a significant increase in government debt instruments in the balance sheets of private banks both in absolute and relative terms. This structure increased the fragility of the banking sector overall.

Several factors brought about the crisis in the banking system. Among them, delays in the structural reforms agenda decreased the credibility of the program. A five-month delay in making operational the Board of the Banking Regulation and Supervision Agency (BRSA) led to suspicions that the government was manipulating the board. Soon after the board became operational, two banks were taken over by the Saving Deposit Insurance Fund (SDIF). At the same time, a criminal investigation

was initiated on the owners and executives of some of the banks taken over by the SDIF. Some of those owners and executives were arrested. All these developments increased the doubts about the future costs of the banking reform and contributed to the polarization in the banking sector between good and bad banks.

This environment deteriorated the conditions for state banks and private banks (particularly for Demirbank, which heavily relied on overnight borrowing). A potential cut of credit lines would have jeopardized the viability of those banks. That happened to Demirbank by mid-November 2000. Demirbank could not borrow in the overnight market. That forced it to sell a part of its government securities, thus causing an increase in interest rates. That triggered Treasury bond sales that, in turn, contributed further to the increase in interest rates (given that Demirbank was the biggest market maker on the buying side of the market). Treasury bond interest rates rose from 38 per cent to 79 percent between November 16 and 29, 2000. During the same period overnight interest rates rose from 73 percent to 161 percent [11].

Increasing interest rates meant further loses for Demirbank and made it difficult to sustain the existing structure. Market participants were aware of the default risk of the Demirbank. Meanwhile, rising interest rates led foreigners to sell their bonds and return their portfolio to safe heavens. That meant increasing demand for foreign exchange. Pressure on interest rates and domestic currency significantly raised doubts on the public debt sustainability and the stability of the exchange rate based stabilization program.

A recent study by Danielsson and Saltoğlu used an econometric order flow model to examine the impact of individual trading strategies on interest rates in

November 2000 crisis [16]. Their research shows that in a market with a small number of large players, each institution's trading has a significant impact on interest rates. It validates the story of Demirbank during the November crisis. The authors of the paper emphasize that "...in implementing policy prescriptions during financial crisis, monetary authorities in emerging markets and supranational bodies, such as the IMF should acknowledge that the market microstructure in domestic money markets might be different than that in developed countries." [16].

The IMF's crisis management

The next issue concerns how the monetary authority intervened in the market during the initial stages of the crises and what was the reaction of the IMF. First of all, CBT was aware of the risk of the cut of credit lines to Demirbank. When it happened by November 15th, CBT could not lend to Demirbank due to IMF ceilings on net domestic assets of the CBT's balance sheet. In other words, CBT could not stabilize the market due to the restrictions imposed by the implicit currency board system. The way in which the IMF had designed the program meant that the CBT's hands were tied. In order to achieve the IMF's performance criteria, CBT gave way to the default of the Demirbank. While the CBT was in contact with IMF about what to do, Demirbank continued to carry out massive bond sales thus pushing up interest rates. By November 22nd, the CBT and the IMF agreed to ignore the program ceilings and end the problematic banks. However, by then it was too late to re-establish credibility and reverse the trend. The CBT stopped the rise in interest rates, but new money supply created by CBT resulted in an increase in the demand for foreign exchange. Credibility loss accelerated the capital outflow. The result was the depletion of the official reserves. The drain on international reserves led the CBT to change the policy again. CBT announced a return to IMF ceilings on net domestic assets by November 30th. Within a few days, overnight interest rates jumped to nearly 900 percent. The default of Demirbank was inevitable and thus it was taken over on December 4. Following the takeover, IMF announced that it would continue to support the program by opening a new credit line. The revised IMF program kept the crawling exchange rate system as it was, but changed some of the ceilings on the balance sheet of the CBT.

Hence, there was a critical delay in the initial response of IMF to the November crisis. There was a wide belief in the market that due to a drain on CBT reserves, the IMF had first thought that there was a currency attack and not, as it turned out, a liquidity crisis. That diagnostic failure again stemmed from the fact that Fund did not factor in the microstructure of the banking system. If Demirbank was immediately taken over or if the CBT had provided liquidity to that bank in a timely

fashion, the size and the spillover effects of the crisis would have been contained. Thus the crises occurred because of shortcomings in the design of the IMF program itself and because of the Fund's inability to diagnose and quickly respond when the crisis eventually occurred (In Turkey, both orthodox economists like Eğılmez and Kumcu and non-orthodox economists like Akyüz and Boratav (2002) have emphasized the failure of IMF in the design of the program as well as in its initial response to the crisis [17] and [18]).

IV. WAGE-LED DISINFLATION

Both the economic theory and experiences of developed countries suggest that price expectations are directly related with the increase in wages. But in Turkey, this relation is not so strong. The share of wage earners in Turkish labor market is about 45 percent whereas that share is about 90 percent in developed countries [19]. Dependence of price setting on cost of labor is relatively low compared to developed countries. The incomes policy to support disinflation program relied on the civil servants salary increases, which was in line with target inflation. It was expected to guide the private sector in setting wages. But, it did not work. Some big conglomerates provided wage increases even greater than prior inflation [20-21]. The dynamics of the price setting and hence the formation of price expectations in Turkey have some special aspects. For example, price increases of services in the non-tradables sector tend to be significantly greater than the tradables sectors (Table.4).

Table.4. Annual CPI (%)

| | 1998 | 1999 | 2000 |
|-------------------------------|------|------|------|
| CPI | 69,7 | 68,8 | 39,0 |
| Tradable Goods CPI | 62,9 | 55,3 | 34,6 |
| Non-Tradable Goods CPI | 78,6 | 85,1 | 42,1 |

Source: SIS (State Institute of Statistics). (2002). Various News Bulletins, September 30 and December 3 (www.die.gov.tr). [25.12.2002]. [12].

Despite the legal price ceiling for rent contracts in line with inflation target (25 percent), average rent increase realized as 46 percent in 2000 [12]. Breaking inflation inertia is not an easy task in a country where there is a long history of inflation. Finally, it should also be noted that the concentration ratio in Turkish manufacturing industry is very high by international standards. It allows those firms to mark-up pricing easily. Yeldan well demonstrates the significant increase in mark-up ratios while the share of wages decreases in total value added in the past 20 years [22]. We would argue that Turkey needs a more comprehensive incomes policy setting a consensus across the different segments of the

society to break the inflation inertia. Moreover, in 2002 the CPI inflation rate reached 29.7 per cent, the lowest figure for the past 20 years. Historically low domestic demand in the same year implies that demand-pull character of Turkey's inflation should not be ignored.

Again there was a failure of the IMF to recognize and adapt its policies to the facts on the ground. Wage led disinflation failed because the oligopolies have continued to increase wages and/or the price of goods and services. As a result the predicament of low earning state workers was worsened without the requisite macroeconomic gains.

V. FISCAL AUSTERITY

A central component of the 1999 and 2001 stand-by agreements was the requirement to increase the primary surplus of the public sector. Given the level of inflation and the size of the public debt financial conservatism was unavoidable. However, we will argue that the IMF demanded (and continues to demand) an unnecessarily high surplus requirement in return for its loan support.

V.1. Rectifying Coordination Failure in The Credit Market

As has now been well documented, the effect of asymmetric information is to break down the matching process between principals and agents that is supposedly engendered by the silky touch of the free market. Of particular concern for developing economies like Turkey is the prevalence of that phenomenon in the financial markets.

When there is asymmetric information the loan market is characterized by credit rationing. Stiglitz and Weiss used the term credit rationing in the sense that (a) among loan applicants who appear to be identical some receive a loan and others do not, and the rejected applicants would not receive a loan even if they offered to pay a higher rate of interest; or (b) there are identifiable groups of individuals in the population who, with a given supply of credit are unable to obtain loans at any interest rate, even though with a larger supply of credit, they would [23]. As the interest rate rises, the average "riskiness" of those who borrow increases, possibly lowering the bank's profits. Hence the interest rate at which the expected return to bank is maximized is the equilibrium rate (r^*) which is lower than the interest rate which equates demand and supply. At r^* not all of the investors can obtain credit. Rather than eliminating the excess demand by increasing the interest rate, credit rationing is applied. In other words banks deny loans to borrowers who are indistinguishable from those who receive loans. Based on the assumption that the higher the borrower's stake is in the project the more likely it will succeed, credit is rationed according to each borrower's

access to collateral and not just their observed prudence. That leads to a situation where those who are less wealthy are precluded from the market for credit.

Because information is even more incomplete in developing countries the extent of adverse selection is even more pronounced [1], [24] and [25]. That is born out by the evidence in Turkey. Based on a questionnaire, Atiyas and Ersel found that only 10-20% of Turkish borrowers could obtain credit without collateral [26]. Only those companies for which the banks had more complete information or who were part of the same conglomerate group could obtain collateral-free credit. Moreover, the banks indicated that they were reluctant to augment their existing customer base due to the absence of an adequate information-gathering system. Similarly over the course of the 1990's less than 10 percent of total credit supply was allocated to medium and small sized firms [11]. Clearly the situation is exacerbated by the fact that banks have been more preoccupied with extending their profit margin by financing the government debt rather than 'ordinary' transactions. In that regard the reform of the banking system discussed above is even more critical.

Because the possession of wealth is largely contingent on whether one is born into it rather than one's ability, the preclusion of the less wealthy may also deny the economy more productive agents. The economy's productive potential is further undermined given that the possession of credit strongly encourages effort [25,27,28]. The basic problem here is that collateralizable wealth is required even though it is not actually used in the activities sponsored by the loan. It should also be pointed that a tight monetary policy only serves to accentuate the problem therefore to further stifle the growth potential of the economy [23,29]. That is to say higher interest rates channel through to the credit market such that there is less credit available and even greater preclusion of those without collateral (i.e. collateral and contractual demands will increase whilst the interest rate for credit remains below the market clearing rate) (Indeed Blinder and Stiglitz argue that the credit channel works because of incomplete information and not, qua credit rationing, because of interest rate elasticity: Access to credit is curtailed because the banks are taken as the most reliably informed when it comes to judging default risk and so borrowers cannot obtain credit outside of the banking system [30].

Sub-optimal coordination with an accompanying wealth bias also pervades the insurance market. That is to say, the insurer cannot discern whether the project failure was due to ill fortune or a lack of effort and therefore premiums are hiked to cover the average risk. As a result the less wealthy are unable or at least less able to insure their projects against risk. Similarly, in the case of the rental market the landlord may ask for payment in

advance or a bond in order to lessen the risk of a tenant not paying or damaging the property. As a result only those with sufficient extant wealth are selected by the market mechanism [28].

The policy implication of this therefore is that funds generated through taxation, foreign aid and loans from the IMF and World Bank should be used to enable the less wealthy to build up sufficient collateral (e.g. through the allocation of capital grants) [27,28] (See also [31]. For a discussion of alternative ways in which the information problem may be mitigated see [25]). Rather than simply leaving the market process largely unhindered and then deploying redistributive taxation to rectify any ill-effects that might have been caused in the process, there are compelling efficiency and productivity reasons to provide opportunities *ex ante*. That is further justified on the normative grounds that it is unfair to deny individuals the means to choose and pursue their aims and ambitions simply because of having a less fortunate upbringing. We now turn to elaborate on that last point.

V.2. Social Opportunities – Expenditure on Health Care and Education

When it comes to designing a reform package the focus of concern must be considerations such as illiteracy, access to health care, nutrition, infant mortality, longevity and so forth, not *just* income [5,32]. Despite its protestations to the contrary, it is the latter metric that dominates the IMF's policy prescriptions. Income can provide us with the opportunity to formulate and pursue our personal aims and projects, but our ability to use it will be undermined if we are unwell, undernourished, illiterate and so on. In other words, factors beyond our control may intervene to lessen our ability to convert income into personal well-being [33-35]. That means that policy designers should be concerned with more than just the absence of an adequate level of personal wealth (e.g. such that there is insufficient collateral to procure a loan) as other instances of brute ill luck may intervene to prevent us from obtaining our personal ends *even if* we have access to a sufficient level of personal wealth. Sen cites the example of African Americans to illustrate the point. People in China live significantly longer than African Americans even though the latter's real income is much higher. The primary reason for that is the access of Chinese people to public health care [5,33]. An exclusive focus on growth rates, and even income distribution, in order to gauge development and shape policy, therefore, fails to adequately take into account what really matters, namely human freedom. Unfortunately Turkey is a paradigm example of the discrepancy between economic development and human development. Turkey ranks 85th out of 173 countries in terms of Human Development Indicators in 2002, even though it is the world's 17th most industrialized country [36].

Moreover a strictly "growth-mediated" approach to improving life quality (i.e. focusing on long term growth through disinflation, liberalization to tap the efficiency of the free market, or supply-side support and leaving that process to eventually bolster life quality) is typically unjustified given that the provision of health care and education is labor intensive and therefore relatively cheap in developing countries [5,37,38] (In terms of health care workers, for example, the rate of nurses per 100,000 people is 109, while the world average is 333. Similarly the rate of physicians per 100,000 is 121, while the world average is 146 [39]. Moreover, a rise in per capita income will only assist a country's average life quality if it ends up in the hands of the disadvantaged. GNP per capita, for example, improves a country's life expectancy only to the extent that that the poor are the recipients [5]). In other words government expenditure on social opportunities will not severely compromise the need for fiscal restraint. Furthermore, health care and education clearly contribute to - indeed are surely essential to - the possibility of sustainable growth. In other words, there is plenty of scope for simultaneity between "growth-mediated" development and "supported" development. There appears to be no need to stall the provision of social opportunities until inflation has been stabilized or until a per capita real income has markedly increased. The upshot of this is that, if the IMF recognized that the overriding importance of human freedom - the capability to do and be -, it would not pursue its overriding focus on reducing inflation via fiscal austerity and liberalizing the economy (i.e. leaving social opportunities out of the policy mix from the outset and instead waiting for growth improvements to eventually do the job).

We concede that many of the state workers in Turkey are effectively on welfare given that the public sector is significantly overemployed [40]. The government's ongoing redundancies via early retirement (see Turkey's letters of intent to the IMF) is thereby justified *but not* in health care and education. To the contrary there is an inequality of access to those two crucial capacity-enhancing areas, both because there is shortage of educators and health care workers and because they are not distributed where they are most needed (On the latter point see [40]).

Indeed public expenditure on education, for example, was halved over the 1990's such that it is now low when compared with countries with an equivalent level of GDP and a similar emphasis on public education [41]. This is an area of major concern. To be fair a major step forward has been the inception of compulsory eight-year basic education in 1997. But that reform must be backed up with the provision of a sufficient number of trained teachers. Of those currently enrolled in primary education a considerably number are not receiving a full-time basic education. In the academic year 2001-2002,

8400 out of total of 34993 schools were double shift (24% of schools) (MONE). According to the Ministry of National Education's (MONE) figures the pupil-teacher ratio for primary schools has decreased from 30.52 in 2000-2001 to 27.46 in 2001-2002 (MONE). However, in the significantly more deprived Southeast Anatolia region the ratio in 2001-2002 was 37.67 (MONE). Moreover, attainment levels for secondary education (grade 9 and above) remain deplorably low by international standards. In 2001 only 44% of 15 year olds, 41% for 16 year olds, and 21% of 17 year olds were enrolled in secondary education [41]. In spite of the inception of 8-year compulsory education, expenditure on all levels of education as a percentage of the government budget actually decreased from 11.94% in 1997 to 8.71% in 2001 [12]. Moreover, according to the Ministry of National Education's own figures expenditure on education as a percentage of GDP has decreased from 3.75% in the 1996-1997 academic year to 2.41% in the 2000-2001 academic year (MONE).

V.3. Balancing the Budget

We have argued on the grounds of efficiency, productivity, relative cost and distributive fairness that there is a powerful case for public expenditure to rectify the severe inequality of opportunity to participate in the market, rather than relying on transfers to compensate for the ill-consequences of that process after the fact (It has to be said that even according to the traditional safety net approach Turkey's track record is not exactly glowing. In a recent study the World Bank notes that, "Remarkably, in its pre-transfer (or market-determined) income inequality, Turkey does not differ much from other OECD countries, showing levels similar to France or Italy (with a Gini coefficient for pre-tax and transfer income of around 0.4); and lower than Great Britain (with a Gini of over 0.5). But in all of these countries inequality is reduced by a progressive safety net and by redistributive taxes. This is not the case in Turkey, where market-driven inequalities are left to determine the shape of the final distribution of income, and hence living standards. Among the OECD countries, only Mexico has a more unequal distribution of income than Turkey, and less redistribution." [40]. Moreover, transfers do not accrue to the substantial portion of the community who are not connected to a formal-sector job. In other words the very people who are denied opportunities in the first place are not caught by the safety net). Despite that argument in defense of forward-looking spending noted above it may be claimed that, in the short run at least, the budget deficit must take priority. To the contrary, and in keeping with Sen's notion of simultaneity, we contend what is required is more favorable borrowing terms from the IMF and World Bank for expenditure on collateralizable grants, education, health care and the like, rather than the delay of such expenditure (World Bank support in the areas discussed has been negligible. Most of its financed

projects are directed to banking, agriculture, social security and public sector reform. It two Basic Education Projects designed to assist the government's newly implemented eight-year compulsory education are the exception to the rule). Given the linkage to a growth-augmented tax yield it is in the Fund's interests to do so if it wishes to avoid a loan default. The need to counter high inflation undoubtedly remains crucial but we contend in the following section that the fiscal restraint imposed on Turkey by the IMF is exaggerated.

Nevertheless, given that some lesser degree of financial conservatism is necessary what is required from the Turkish government is a reapportioning of spending to those crucial areas noted above. Military spending for example is an area that demands serious reconsideration. While military expenditure increased from 3.5 to 4.9 percent cent of GDP over the 1990's [42], education expenditure nearly halved [40]. Moreover, in the aftermath of the February 19, 2001 MGK meeting that triggered the second crisis we can see where the ruling establishment's priorities really lie when it comes to a budgetary squeeze. After that fateful meeting the MGK reconvened on February 26. In spite of the extreme hardship that the twin crises had inflicted on the Turkish people the military dominated MGK discussed and accepted the idea of instituting a multi-million dollar space program in Turkey [43-44]. While this can hardly be blamed on the IMF per se the signals from Washington have been contradictory on this issue. While the US Treasury uses the US's dominant shareholding in the Fund to push for fiscal austerity, the Pentagon sees Turkey as a crucial geo-strategic ally. It should be conceded that Turkey's military spending is actually below average for such a volatile region. The Middle East's average military spending as a percentage of GDP is 7.8 whilst Turkey's is 4.9; the average for industrialized countries is 2.5 [45]. Nevertheless, given the recent rapprochement between Greece and Turkey (to the point where Greece is actually supporting Turkey's accession to the European Union) and the dissipation of the bitter conflict in the predominantly Kurdish southeast there is far more scope for a reduction in military spending than has occurred.

V.4. The Informal Economy and Growth

The Turkish economy contracted 9.4 percent in the crises year, 2001. That was followed by a recovery and economic growth is estimated to be nearly 7 percent in 2002. Meanwhile, the ratio of non-performing loans in total credits rose to 25 percent from 9 percent (Anne Krueger, first deputy manager of IMF, accepted that the strong growth of Turkish economy in 2002 has been surprising for IMF as well [46]). The size of the hidden economy in Turkey is estimated to be around 45 percent of the official GNP of Turkey [47]. Some small and medium sized companies are part of the hidden economy.

The hidden economy is mostly composed of cash transactions. A part of the source of the cash is the foreign exchange (FX). In Turkey, the share of the FX deposits is greater than the TL deposits implying the existence of strong currency substitution. Though the lack of definite figure, there is a consensus among economists that the effective FX amount under the mattress is significantly greater than the TL in circulation.

Thus whilst designing the program the IMF did not recognize the level of the informal cash flow that was to reveal itself after the crisis. Prior to the stand-by agreements the money was kept 'under the mattress' in spite of the high interest rates on offer. Ironically, as a result, recent growth figures are four per cent higher than targeted and at the same time inflation reached 29.7 percent by year end 2000 even though the target figure was 35 per cent. This leads us to ask whether the fiscal restraint built into the latest stand-by agreement is exaggerated. That is to say, if we hypothetically consider the program design from the point of view of those unaware of the existence and scope of the hidden economy, then it might be argued that the level of the primary surplus that was imposed on the government (6.5 percent of GNP in 2003) was overstated. Growth, as a result of the informal economy, and disinflation provides us with a live test of the IMF's program in Turkey. In other words it was merely fortuitous on their part that the informal economy patched over the error in their policy judgment.

The strength of that argument, however, is weakened by the fact that growth was not only due to the informal economy. Exports from the manufacturing sector improved over the period because of growth in Europe, the appreciation of the Euro against the dollar, and flexibility in that sector; Firms in that sector have few basic costs (e.g. due to the evasion of taxes and high electricity costs) and their workers have no job security. As a result and in spite of the banking crises, non-performing loans, contraction in the economy and high real interest rates, there has not been the expected massive shutdown of firms in the manufacturing industry. As long as there is a demand, small and medium sized industrial firms can supply intermediate goods to the large firms and final goods to the market. Thus, one important feature of Turkish manufacturing industry is its flexibility to substitute foreign markets with domestic markets. Manufacturing industry exports have increased more than expectations following both the 1994 and 2000-2001 crises. There seems to be a dichotomy between real (goods markets) and the financial sectors of the economy. The relatively weak banking credit size could have encouraged the real sector to perform to some extent independently from the financial sector. Ironically, preclusion from the credit market may have helped to immunize small and midsized manufacturing firms from

the impact to the twin crises. This is a topic, however, that demands more detailed research.

Clearly therefore there is a tight linkage between this explanation for growth and the informal economy. It was partly due to firms' access to cash outside the banking system that enabled them to take advantage of export demand. Once we acknowledge that and the fact that the primary surplus actually reached 3.5 percent of GNP, rather than the targeted 6.5% in 2002 [48] then we must seriously doubt the wisdom of imposing such a high primary surplus in the first place. The unplanned shortfall in the surplus requirement suggests, for example, that some of the government's expenditure can be redirected towards providing collateralizable wealth and improving the provision of health care and education. In spite of the evidence to the contrary the IMF is insisting that a primary surplus of 6.5 percent is the appropriate target for 2003 as well (Admittedly the surplus will not accrue as much as it might from this recent growth as tax avoidance is a key characteristic of the informal economy. That suggests that redistributing the tax burden so as to minimize the incentive to avoid payment is crucial. Tax reform has already started, but we question the lack of progressivity in the direct tax rates and the prioritization of indirect taxes over direct taxes - the share of direct and indirect taxes in total was 40 percent and 60 percent respectively before the crisis; it changed to 30 percent and 70 percent after the crisis [49-50]. This is an issue we cannot hope to explore in detail here).

VI. CONCLUSION

A key underlying theme in this paper has been the linkage between the structure of the banking system, the credit market and the informal economy in Turkey. The bias in the portfolio of banks towards government securities and away from the provision of loans both exposed the financial markets to a liquidity squeeze and accentuated coordination failure in the credit market. The resulting wealth bias, in turn, helped to encourage an informal economy that was, ironically, more able to withstand the shock brought on by the twin crises. The intricacies of this linkage have not been adequately studied by the IMF and as a result its policy prescriptions were either premature or destined to be largely ineffectual. In the first instance the initiation of the 1999 Stand-by Agreement should have been conditional on structural reforms in the banking sector. In the second instance a tight monetary and fiscal stance will be undermined by a substantial and unforeseen informal economy. Indeed the extent of the informal economy and the shortfall on the primary surplus, coupled with the attainment of the growth and disinflationary targets, leads us to question the level of austerity that the IMF program demands. In addition the oligopolistic structure of the Turkish goods market will undermine the efficacy of a wage-led disinflationary policy. In sum, the IMF imposed

its policy prescriptions without due consideration of the market imperfections that prevail in Turkey. On the fiscal side we have defended targeted spending on key areas, particularly where there is complementariness between efficiency, productivity, relative cost and distributive fairness. We argue that both the disinflationary and growth/ human development agendas should be carried out simultaneously. The favorable disinflationary and growth figures since the twin crises goes to show that there is no need to delay the latter agenda until the former has been stabilized.

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