TURKEY’S PATHWAY THROUGH FINANCIAL CRISIS

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From 2003-5, Calum Miller was a research associate at the Global Economic Governance Programme. During this time, he undertook research on the political economy of financial crises, alongside completing an MPhil in International Relations, based at Nuffield College, Oxford. Calum has now returned to the UK Treasury, where he had previously worked from 1999-2003. Calum was awarded a distinction in his MPhil. He holds a First Class Honours degree in PPE from University College, Oxford and was awarded the Oxford University Gladstone Prize for his undergraduate thesis. The views expressed in this paper are Calum Miller's alone and should not be taken as those of the Treasury.
Abstract

Turkey’s deep financial crisis in 2000-2001 implicated the IMF programme adopted in 1999. The IMF was associated with the successful 2001 recovery programme. Which factors influenced the IMF’s willingness to be flexible in negotiation with the Turkish authorities? What impact did the IMF’s intervention have on domestic politics in Turkey? I find that the IMF was more willing to be flexible when IMF staff and shareholders were implicated in the policies which had contributed to a crisis situation and when IMF staff and shareholders had confidence in the analysis of the Turkish economic bureaucrats and commitment of the Turkish authorities to the programme. In addition, when IMF shareholders were divided over approving a Programme, there were more opportunities for Turkey to influence decisions. The IMF’s interventions in this period empowered reformers within the administration and contributed to the downfall of a government.
Introduction

The Turkish general election of 18 April 1999 ushered into power a new coalition government. On 9 December 1999, that government submitted a Letter of Intent (LOI) to the IMF, setting out the economic policies it intended to pursue over the next three years and requesting that the IMF back these with a Stand-By Arrangement of 4 billion USD. However, an economic crisis peaked in November 2000 and February 2001. From July 2000 to December 2001, Turkey experienced a real terms contraction of 3.5%, with official unemployment doubling to 11.8%. From January 2001 to April 2002, borrowing from the IMF increased by 23 billion USD. In the general election of 3 November 2002, none of the parties (government or opposition) elected in 1999 were returned.

Turkey consequently raises two questions about the IMF’s interaction with the governments of emerging markets facing financial crises. Firstly, how much flexibility is there for individual countries to tailor their crisis management policies? Secondly, what impact does the IMF’s intervention have on domestic politics in the crisis country: which actors are empowered or enfeebled; and what are the lasting consequences for domestic politics?

This study focuses on events from November 1999 to October 2001 as this period includes three interventions by the IMF, which might be characterised as representing crisis prevention, crisis management and crisis resolution and captures the initial consequences of the third. I set out to analyse the key decisions associated with these interventions, from the perspectives of the Turkish authorities and the IMF: setting out which alternatives were considered and rejected, and why. Through this analysis, I draw more general conclusions about the relationship between the IMF and Turkey.

The Crisis

Turkey’s wave of economic liberalisation began under the stewardship of Economy (then Prime) Minister Turgut Özal from 1980-1989. This period displayed twin tendencies: liberalising reforms, combined with increasingly clientelistic distribution of the spoils. The decision to liberalise the capital account in 1989 was particularly significant for Turkey’s fiscal position. A new source of capital allowed governments to put off unpleasant choices and delay reform. A further consequence was the rapid expansion of the banking sector.

In the second half of 1997, a number of officials in the Turkish economy ministries became alarmed at the direction of Turkey’s underlying economic aggregates. Inflation looked set to reach 100% by December. They turned to the IMF and requested the initiation of a Staff Monitored (or ‘shadow’) Programme, which
was announced in June 1998. The Turkish authorities were keen for a full IMF programme, but there was no appetite from the IMF’s side, given the repeated failure to meet fiscal and structural targets set in the shadow programme.

In 1998, the poor underlying structure of the economy was further impacted by two negative shocks. First, the Russian economic crisis and default in August 1998 hit Turkey hard. There was a contagion effect in the spreads of all emerging markets as investors called in their capital but Turkey’s real economy was also affected: exports to Russia fell 35% in 1998, yet still constituted 5% of total exports from Turkey. Second, the Marmara earthquakes of 1999 afflicted highly populated, industrialised regions. As growth rates plunged into negative figures, it became clear that Turkey was facing an economic crisis. IMF Management and Staff began to consider seriously a full programme. An increased commitment from the newly elected Turkish government to economic reform, signalled by the adoption of pension reform measures in August 1999 convinced them to proceed.

The December 1999 Programme set out to tackle inflation and interest rates through a new monetary policy, based on an exchange rate stabilisation anchor which incorporated a pre-announced and staggered move through widening bands to a free float. A central part of this approach was a firm money supply rule: the Turkish Central Bank would provide liquidity only in line with increases in its FX reserves. It was intended that this signalling would improve the credibility of the peg, while still allowing the economy to capture the inflation-reducing benefits of a fixed exchange rate. The monetary policy was supported by an array of fiscal, incomes and structural policies.

Within a few months the programme was in trouble. The April 2000 inflation figures showed that wages and prices were stickier than expected due to the backward indexation of pay agreements and the exogenous shock of a steep increase in world oil prices. At the same time, while the Government was broadly sticking to its expenditure commitments, total public liabilities continued to rise, due to contingent liabilities and delays in adopting cost-saving structural actions. Furthermore, the interest rate (which fell almost immediately on adoption of the programme from 100 to 30-40%) was low enough to stimulate a credit-funded consumer boom but did not decline rapidly enough to eliminate strong opportunities for arbitrage by portfolio investors. These inward flows generating real terms appreciation of the TL of over 10%, damaging domestic competitiveness at the same time as it further fuelled domestic consumption. Turkey was soon running a significant trade deficit. As imports rose by 37% in the first eleven months of 2000, the trade deficit more than doubled to 25 billion USD.

By the late summer of 2000, the Turkish economy was teetering on the edge, held back only by the continuing inward flows of portfolio capital. As domestic private banks competed hard in a fevered atmosphere, the Banking Regulation and Supervision Agency (BRSA), whose establishment by March had been a condition of the 1999 programme, was stymied by party political haggling over the composition of its Board. Nevertheless, in October and November, the BRSA acted on rumours of malpractice and two banks (Etibank and Bank Kapital) were brought under management of the Savings Deposit Insurance Fund (SDIF), the public body created...
after the 1994 crisis to back up the Turkish Government’s guarantee of bank deposits. This further contributed to the sense of volatility in Turkey’s banking system.

Shortly after these actions, interest rates started to rise, bringing immediate liquidity problems for a banking sector highly leveraged with borrowed foreign capital. Constrained by a strict money supply rule, the Central Bank did not initially act. However, as interest rates continued up, the Central Bank did intervene, providing 6 billion USD from 22-29 November. When it reverted to its rule, interest rates skyrocketed: from 160.8% overnight on 29 November to 873.1% at their peak overnight on 1 December.

Facing increasing speculative attacks on the Turkish Lira (TL), the Turkish authorities turned to the IMF for further assistance. On 21 December, the Executive Board agreed to the Turks’ request for a further 7.5 billion USD from the Supplementary Reserve Facility (SRF), in return for a tightening of the programme which included strengthening the primary surplus target for 2001 from 3.75 to 5%. Central Bank reserves rose from 18.3 billion USD on 5 December to 28.2 by 15 February.

Tensions within the Government continued to fuel the fragility of market confidence in Turkey, however. On 19 February, following an ill-tempered meeting of the NSC, Prime Minister Ecevit complained to assembled journalists about a crisis at the heart of the Government. The immediate reference was to a dispute over the right of the President to investigate public banks. However, in the context of diminishing confidence about commitment of the Turkish authorities to the Programme, the stubborn inertia of inflation and concerns about continuing corruption, investors and creditors took the message to heart.

The TL came under severe speculative attack. Interest rates soared: from 43.7% on 19 February, overnight rates reached 2,057.7% on 20th and 4,018.6% on 21st. The Central Bank sought to maintain the peg with dramatic reserve outflows but this position was unsustainable. On 22 February, the Turkish authorities abandoned the peg. The TL plunged from its pegged value of 685,000 to 958,000 against the USD in one day.

There were some immediate political ramifications of the crisis. Central Bank Governor Ercel resigned: primarily on account of his association with the Programme, but also under the cloud of allegations about his personal financial transactions. Treasury Undersecretary Demiralp also resigned. The Government desperately needed some way of restoring credibility to their economic policies.

On 2 March, the appointment of Kemal Derviş as State Minister responsible for the Economy was announced. Derviş had worked at the World Bank since 1978 and was serving as a Vice-President (Poverty Reduction and Economic Management) when the phone-call came from Ecevit. The full detail of Derviş’s recovery plan for the Turkish economy was set out in the LOI of 3 May and marked a substantial new step in Turkey’s economic reforms. There was to be significant restructuring of the banking system to address the structural weaknesses demonstrated in the crisis. Fiscal controls would be tightened (including through a new Debt Law which prohibited government departments and agencies from securing credit independently of the
Calum Miller, GEG Working Paper 2004/05

Treasury) and a new primary surplus target of 5.5% for 2001 was set (described by IMF staff as 'a massive effort'). Monetary policy would move towards inflation targeting, with greater independence for the Central Bank. Renewed commitments were made to privatise state-owned economic enterprises (SEEs) and to foster greater FDI.

The May Programme did not have the immediate effect on markets that was hoped for. While Turkey’s interest rates did improve, ‘up to October 2001 the markets’ reaction was not in line with fundamentals’. It was only in October that Turkey’s interest rate began a downward movement. This process coincided with the decision by the IMF, following the economic impacts of the 11 September 2001 terrorist attacks in the US, to approve 3 billion USD for Turkey. In February 2002, the EB underlined the IMF’s financial commitment to Turkey with a renewed Stand-By Arrangement, with 16 billion USD of new capital.

Key Decisions

Focussing on three key decisions involving the Turkish economic bureaucracy and the IMF, I hope to illustrate the factors, which affect the nature and form their interaction.

1. The Choice of an Exchange-Rate Based Stabilisation Anchor

The process of engaging the IMF from 1997 was driven by the bureaucracy: in particular the Treasury, State Planning Organization (SPO) and Finance Ministry. Of course, there are few countries (particularly outside a full-blown crisis) in which the Finance Minister or Prime Minister would negotiate the detail of a Programme. Nevertheless, the 1999 Programme was initiated (as well as developed) through technocratic collaboration.

The IMF team proposed an exchange-rate based stabilisation (ERBS) anchor as the central element of an inflation-targeting programme as early as 1998. Subsequently and citing meetings in Washington, Ercel would claim that the policy had been pressed most hard by the US Treasury. In practice, the picture is more complex than this suggests. Following the Russian default, the Turkish authorities were adamant that a debt restructuring was inconceivable. Given this position, only two realistic alternatives existed to achieve the twin goals of tackling debt levels and bringing down inflation: a severe, fiscally-induced economic contraction; or ERBS. The former was politically infeasible (the necessary speed and scale of the fiscal cuts were not something the government was willing to contemplate), and so ERBS became the default option. Once discussion was engaged on this policy, the US Treasury was insistent that it should not have the same weaknesses as previous designs: it had to have a credible exit strategy.

The Central Bank and the Treasury advocated ERBS but the SPO, led by Undersecretary Faik Oztrak, opposed. Oztrak felt there was growing evidence of the risks of pegging a currency. Furthermore, the IMF’s argument seemed to be based on an analogy between Turkey and Bulgaria (which had adopted a peg in 1997), which Oztrak disputed on the grounds that Turkey’s economy was much less open than Bulgaria’s. Members of the Turkish bureaucracy were not alone in their
concerns about the proposed peg. To address the concerns of the US Treasury and of Oztrak, the standard model of a currency peg was modified in innovative ways for Turkey’s Programme: the widening bands and pre-announced exit were partially an attempt to meet concerns about credibility and speculative attack.

Subsequent events gave *ex post* validity to Oztrak’s *ex ante* concerns (although this plays back into the debate over whether Programme design or implementation was to blame for the crisis). The puzzle in the 1999 Programme is to explain why Turkey accepted the IMF’s controversial prescription.

First, there were strong political and economic reasons for the new Turkish Administration to seek IMF support for an early reform programme. Second, even for those who were opposed to this element of the Programme, there were trade-offs. The IMF offered new capital, with which to bolster Central Bank reserves and to start to restructure the debt stock. An IMF-endorsed Programme would be a strong credibility signal to the markets. From the perspective of bureaucrats, frustrated by their ministers’ inabilitys to tackle the root causes of Turkey’s economic sluggishness, undertaking an IMF obligation was a means to bind the hands of domestic politicians. Third, it is not necessarily correct to suppose that the Turkish Authorities had more leverage with the IMF because Turkey was not facing an immediate crisis. At a time of financial crisis (it is usually assumed), the crisis country is in a weak position because it desperately needs capital to stave off default or excessive currency overshooting. Yet the IMF is also in a weaker position since, as custodian of international financial stability (and often as a creditor), it wishes to avoid messy defaults and the contagion they may entail. Conversely, outside an immediate crisis situation, IMF shareholders have less reason to disburse loans in the absence of convincing commitment to reform. So, given the desire to access IMF capital and to signal a reform commitment by entering a programme, Turkey was not in a strong position to resist the IMF’s central policy prescription, particularly since it was a ‘least-worst’ option from the menu offered.

In the light of this, a key question is whether there was ‘ownership’ of the Programme by Turkey’s political leaders. The LOI of 9 December was signed by Recep Onal, the DSP Economy Minister, and Gazi Ercel, Governor of the Central Bank. However, it was Ercel and, to a lesser extent, the Treasury Undersecretary, Selcuk Demiralp who became the chief spokesmen for the Programme. Critics argue that this was indicative of the way in which the IMF had ‘imposed’ a Programme on a reluctant government.

It seems more likely, however, that the Government was both willing to adopt the Programme and reluctant to promote it. For the political and economic reasons set out earlier, there was little alternative. However, there would be unpopular short-term effects of the economic reforms. Whereas a strong, single-party government might have argued the case for short-term pain in exchange for long-term gain, a weak coalition government suffered from a debilitating ‘first-mover’ problem. No one of the party leaders wished to be personally associated with a programme, which the other two might then distance themselves from. In consequence, no minister made the case for the Programme.
2. To Float or Not to Float? Managing the November 2000 Crisis

In the midst of the November crisis, the Turkish Authorities had to choose their immediate policy response. They needed to halt the outflow of Central Bank reserves and they needed to bring down the interest rate to avoid a massive debt default.

One choice would have been to abandon the exchange rate regime, accept that a peg was not sustainable, and pick up the pieces of economic policy from there. This was the approach advocated by the IMF. Turkish policy makers recall that Michael Deppler, the Director of the European Department in the Fund (and hence responsible for overseeing Turkey’s Programme) had been suggesting this at the September 2000 Annual Meetings of the IMF in Prague. Of course, this represented a significant change in the IMF’s position from nine months previously: one which the IMF would justify on the basis of a loss of faith in the Turkish authorities’ commitment to the accompanying reforms necessary for the peg to be sustainable.

Turkey’s political leaders and senior officials were not, however, willing to agree to such a policy. Their political credibility rested on the Programme they had endorsed. Furthermore, Turkey had been thriving on a borrowed boom throughout 2000 and they realised that moving off the peg would trigger a massive devaluation with severe consequences for Turkish domestic demand and employment. Finally, there were suggestions that a number of members of the Government had substantial personal financial interests in maintaining the peg so as to avoid losses to Turkish banks and corporations overexposed to a devaluation. Instead, they hoped that funds from the IMF to bolster the reserves of the Central Bank could stave off the speculators and buy Turkey time.

That the IMF was forthcoming with these additional funds raises a question in itself about the decision-making of the Fund. Given the apparently strong position of the Management and Staff against maintaining the peg, why did the Board agree to this loan? One answer is that the IMF’s principal shareholders intervened for non-economic reasons. According to one line of this argument, a US Administration with strategic interests in Turkey was inclined to be supportive. At the least, faced with strong Turkish opposition to a float, an outgoing US Administration would be unlikely to want to use a key strategic ally as the test case for a tougher lending policy. By withholding financial assistance and pressing for a float, a full-blown crisis would likely have been precipitated. A different answer concerns the IMF’s culpability for the failure of the Programme. Since the ERBS design was arguably the critical factor in prompting Turkey’s crisis, the IMF was in a weak position to resist requests from Turkey for assistance to maintain its policy. A last answer is the legalistic view that the Fund has a duty, under its Articles of Agreement, to support the exchange rate chosen by a sovereign government. The subtext to this view is that constructive engagement by the IMF with Turkey’s policies is better than self-induced exclusion.

Although the new capital sanctioned by the Executive Board in December 2000 took Turkey’s authorised borrowing to over 900% of quota, these funds were, arguably, too little, too late. Since the Central Bank had seen losses of over 3.5 billion USD in one day, an immediate replenishment of 2.8 billion (even with a
promise of up to 6.9 billion USD to follow\textsuperscript{27} looks inadequate. More would have been needed to see the TL through to the widening of its bands, foreseen from 1 July 2001. Thus a messy compromise between Turkey and the IMF merely served to delay the inevitable, and deepen its effects (for both parties) when it came.

3. Negotiating the May 2001 Programme

In March 2001, the new Turkish economic team had to think radically. An involuntary debt restructuring was considered by Dervi\c{s} and his team. Critical to their decision to reject this course of action was analysis of the ownership of outstanding debt. They calculated that over 60% was held by domestic banks owned by Turkish capital\textsuperscript{28}. In light of this, an involuntary restructuring would have severely damaged the domestic economy and retarded any recovery. The long-term economic effects of damaging Turkey’s international credibility were a factor but were secondary to consideration of who would pay for such an imposed restructuring. By implication, if the debt had been held 60% by foreign banks, this course of action would have been much more likely.

Having played a significant role in the crisis, the inflation target was a critical element in the May 2001 Programme. The IMF initially wanted to see a CPI target of 20% for 2002\textsuperscript{29}. With end-year inflation for 2000 at 52%, Dervi\c{s} and his team did not think this target feasible. They ran their own calculations and decided that something in the range 30-40% was more realistic. Lengthy negotiations ensued between the two parties. The Turkish authorities won out and the target was set for 35%.

A second area of controversy concerned public sector wages. In late May, the Turkish authorities faced the threat of a general strike, spearheaded by representatives of Turkish Airlines (THY) (one of the SEEs which had been singled out for privatisation). Dervi\c{s} was convinced that the effects of such a strike (particularly on the tourist sector) would be more damaging to the economy than the increase in wages that the unions were seeking\textsuperscript{30}. He took this argument to the IMF. Even though it meant revising an agreement previously reached with the Turkish authorities, the IMF team did accept this upward revision of the public sector wage cap.

These two examples give two insights into the dynamic of the negotiations. Firstly, the inflation discussions in particular demonstrate the advantage to be had from commanding credibility with the IMF team in negotiating on the economics. Dervi\c{s} brought some of this and was supported by the quality of the analysis provided by the Treasury team beneath him. Dervi\c{s} also argues that the inflation target was an example of long-term calculations on political credibility. The 2002 inflation out-turn of 31% meant that an inflation target had been met for the first time in 20 years and that this had a huge credibility boost (domestically and internationally) for the Programme.

Secondly, the wage level negotiations show that there was scope within the Programme for flexibility and variation. The IMF team were willing to accept that the economic consequences of domestic political reactions to a feature of the Programme might be detrimental to the overall goals, and therefore were prepared to relax a target.
Generally, Derviş notes that he was not simply negotiating with the IMF Management and Staff. Rather, he exploited his contacts with the key officials in G7 capitals and spoke regularly with the G7 Deputies. This allowed him to seek to influence them directly and to exploit differences within the Deputies Group and between the Deputies and IMF Management\textsuperscript{31}.

These observations prompt some questions concerning Derviş’s role. How critical was it that he was an outsider, quasi-independent of the Government: did this make him more credible to the IMF? How much did his Washington insider-knowledge matter: not just in terms of knowing the people but also of commanding the terms of discourse that reassured the IMF team?

These points also raise questions about the conditions under which the IMF team can maximise their flexibility to negotiate. In most cases, reform costs money and so a key variable of IMF flexibility are the beliefs of the negotiating team and of IMF management about the willingness of the key shareholders to approve funds. In the Turkish case, the influence of the new Bush foreign policy team may have been critical. The US Treasury of the Bush Administration was reluctant to support a new Turkey programme. Instead, Germany was the primary advocate of a sizable new programme: going so far (partly at the behest of IMF Managing Director Horst Köhler) to offer bilateral finance to support Turkey, if the other G7 members would also contribute. Over time, however, the US foreign policy interest in maintaining strong relations with Turkey trumped attempts by US Treasury to push for a tough limit on excessive lending for moral hazard reasons. This being the case, the IMF team had more freedom to accommodate Derviş’s revisions than in other crisis packages.

A final observation concerns the dynamic between the economic team assembled around Derviş and the rest of the Government. This team was the interface between domestic political interests and the international economic possibilities (as represented by the position of the IMF negotiators). Its leverage consequently ran both ways. To the extent that the IMF team considered it to be trusted and capable of delivering, it had some flexibility in negotiations (as illustrated in the two examples given previously). To the extent that it was able to convince other members of the Government that certain actions were necessary to achieve economic objectives, it had influence over them. So Oztrak notes that the conjuncture of international pressures could be a useful stick in implementing the Programme\textsuperscript{32}. The extent to which the market effect of political back-sliding could be seen with a floating exchange rate helped to maintain pressure to deliver the Programme. Meanwhile, commitments entered into with the IMF (on which future finance depended) could be used to break domestic political deadlock (e.g. over appointments).

**Who Paid for the Crisis?**

The IMF was implicated in Turkey’s crisis in consequence of its involvement in the design of the 1999 Programme and its continuing support for these policies in December 2000. In weighing the effects of the IMF’s role, it is important to consider the social and political outcomes of the crisis.
Distributive Consequences

The crisis depressed the economy and raised the national debt of Turkey significantly. Overall, the World Bank concludes that, taken together with the significant effects of the Marmara earthquakes of 1999, the financial crisis led to a loss of 23% of GDP\textsuperscript{33}. The assumptions underlying this estimate are open to challenge but the figure gives some indication of the depth of the Turkish crisis. Meanwhile, Turkish national debt rose by 28.5 billion USD\textsuperscript{34}.

Previous works on the social impacts of financial crises\textsuperscript{35} have emphasised the particular vulnerability of the poor and poorly educated to severe economic shocks\textsuperscript{36}. In line with such analyses, other things equal, we would expect the impact of a crisis to disproportionately affect the poor. What does the data from Turkey tell us about this?

The first remark to make is that the data is limited and characterised by long intervals between household surveys, making it very hard to attribute changes to the crisis. Notwithstanding this caveat, the following evidence is available:

\textit{Poverty:}

The 2001 World Bank survey (World Bank (2003)) found that there had been no change between 1994 and 2001 in the number of households living in extreme poverty (under 1 USD per person per day). However, it did find a significant increase, from 6.2% to 17.2%, in the number of urban households experiencing food poverty (defined as having equivalent consumption less than the cost of a food basket).

\textit{Inequality:}

The 2002 HIES (Turkish State Institute for Statistics (2002)) found that the Gini coefficient\textsuperscript{37} had fallen from 0.49 in 1994 to 0.44 in 2002. The HIES also found that the share of total income of the top 20% had fallen from 54.9% to 50.0%, whereas that of all other quintiles had risen (for the bottom 20% from 4.9 to 5.3%). In short, on all available measures, inequality had fallen\textsuperscript{38}.

\textit{Employment:}

The SIS Household Labour Force Survey shows a fall of 6.5% in total employment from 1998 to 2002: this was more concentrated among men (-7.1%) than among women (-5.0%), although the fall in employment among women was 7.5% from 1999 to 2002. World Bank data shows a doubling of unemployment from the third quarter of 2000 (5.63%) to the first quarter of 2002 (11.76%) (World Bank (2003), p. 8). At the same time, significant falls in real wages were noted: 20.2% in the fourth quarter of 2001 alone.

These outcomes should be set against the measures included in the government’s package to manage the financial crisis in order to see what impact policy had on these outcomes. We can break this down into three categories: government expenditures; tax revenues; social safety nets.

\textit{Government Expenditures:}

Overall, government expenditure was largely unchanged as a percentage of GNP from 2000-2002\textsuperscript{39}. Given the 9.5% fall in GNP in 2001, this indicates a sharp
real fall in expenditure in that year. Data from SIS shows that the share of central
government expenditure assigned to education fell significantly from 1998 to 2001
(by 42%) before picking up again in 2002. The SIS data shows that there were dips in
the otherwise upward trends of net secondary school enrolments in 2000 and of net
primary school enrolments in 2001. Health expenditure as a share of central
government total fell somewhat from 1998 to 1999 before rising consistently to 2002.

Social Safety Nets:
The World Bank advanced Turkey a significant (500 million USD) Social
Risk Mitigation Project (SRMP) loan in September 2001. This reflected the
judgement that the government was making a ‘substantial effort to reform the safety
net in Turkey and to attack poverty’\textsuperscript{40}. Evidence for this was found in the August
2001 transfers to the Social Solidarity Fund (SYDTF) (part of which was used for
‘back-to-school-packs’ to encourage re-enrolment) and in the subsequent
development of a new social assistance benefit.

Tax Revenues:
Derviş argues that, despite a desire to balance the budget through progressive
tax measures (raising the upper rates of income tax, or a windfall tax on the gains of
those who speculated against the TL), such measures proved infeasible under
conditions of full capital convertibility. Consequently, the burden of tax increases
(around 1% of GDP\textsuperscript{41}) fell on value added tax, which typically has a regressive effect.
Reinforced social security measures were an attempt to deal with the anticipated
consequences for the poorest in Turkish society\textsuperscript{42}.

What, then, can we conclude about the social impacts of the crisis? In short,
the evidence appears to suggest that measures taken to insulate the poor against the
crisis had some positive effects in that the overall position of the poor relative to the
rest of society does not appear to have worsened against the reference year of 1994.
Indeed, inequality has fallen (largely because the impacts of the crisis fell mostly on –
relatively wealthy – industrial areas). Nevertheless, unemployment more than
doubled, there was a significant increase in food poverty among the urban poor and
the World Bank found that the lives of the poor were particularly stretched by the
consequences of the crisis. Some had to withdraw children from school to reduce out
of pocket expenses and to seek informal earnings. Many reported the collapse under
strain of the informal coping mechanisms of reliance on friends and family and an
attitude survey revealed most households to feel worse off in 2001 than in the
preceding years.

Electoral Consequences

Despite the economic improvements from autumn 2001, there were still
tensions within the Government. A combination of Ecevit’s continuing ill-health and
splits within the DSP led to an early general election on 3 November 2002.

The economy was the central issue of the election – reflecting the impact on
living standards described in section 5A. While there were strong improvements in the
aggregate economic performance by mid-2002, the experience of the crisis and its
enduring effects on employment and living standards (a comparison made all the
more unflattering by the boom of 2000) were still fresh in electors’ minds. Opposition
parties varied in the focus of their attacks on the governing parties’ economic record. Some blamed it for the crisis. Others added that, not only had it mismanaged the economy, but that it had subsequently capitulated to the IMF. The most straightforward of these criticisms came from the newly formed Youth Party (GP), which stood on a ‘No to the IMF’ platform – and won 7.2% of the popular vote.

The final results were a striking demonstration of the public’s rejection of the coalition government. The Justice and Development Party (AKP), successor to the moderate wing of the Islamist Virtue Party (FP – which had been outlawed in 2001), won 34.3% of the vote and 362 seats, while the CHP, with Derviş in it, came second with 19.4 and 177 seats. No other party obtained the requisite 10 per cent of the vote. What is equally noteworthy is that the two parties, which had formed the 1999-2002 opposition, were also thrown out of parliament\(^4\). On the face of it, it was a stunning rejection of the Turkish politicians who had presided over the crisis.

The attitude of the AKP towards the IMF and the 2001 Programme is revealing. Prior to the start of the campaign, its leader, Recep Erdogan, was highly critical of the Programme, promising that his party would negotiate a new programme if elected. This hard-line position was significantly moderated during campaigning and particularly as the AKP’s prospects of victory became clear. Immediately after the AKP’s success, new Economy Minister, Ali Babacan, was despatched on a tour of key financial centres to reassure market players that the AKP would implement the Programme.

This gives us a useful insight into the importance of domestic perceptions of the IMF. In criticising the IMF, the AKP was pandering to a domestic Turkish hostility to the IMF, largely based on perceptions of its challenge to national sovereignty. However, political leaders in Turkey have to be attentive to the IMF’s signalling effect on a second audience: international investors. For this group, the imprimatur of an IMF Programme is a key indicator of the soundness of investment (whether because of improved credibility of the Authorities or due to a belief that the IMF will bail out investors in the event of difficulties). To the extent that their investments are necessary for economic wellbeing, and to the extent that this is determinant of voting decisions, the Government must convey a signal of commitment to the IMF to them (even while maintaining a perception of caution towards the IMF for the benefit of domestic observers).

**Conclusions**

The context for decision-making in Turkey varied over the period under consideration. However, in the approach to the crisis, the constraints faced by economic policy-makers in Turkey can be summarised in Table 1 on the next page.
Table 1: Constraints on Economic Policy-making in Turkey in 2000

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<th>External constraints</th>
<th>Internal constraints</th>
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<td><strong>Economy</strong></td>
<td>Unsustainable debt stocks and interest payments; crawling peg exchange rate; negative trade balance; volume of/ dependence on portfolio investment; behaviour of external investors.</td>
<td>Rising budget deficit; inflation inertia; demanding inflation target; CB non-intervention policy; extreme fragility of banking sector – public sector duty losses, private sector exposure to exchange rate risk (state absorption of losses).</td>
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<tr>
<td><strong>Political system</strong></td>
<td>Commitment to ‘Helsinki’ EU accession process; NATO membership; relationship to US foreign policy objectives; financial commitment to the IMF.</td>
<td>Weak coalition government; clientelistic relationship with big business; very loose control of budget (state banks, SEEs); abuse of budget for patronage reasons; dispersed ministerial responsibility for economic policy.</td>
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The IMF’s involvement in Turkey’s economic programmes from 1999-2001 was not without criticism. It now seems clear that misjudgements of programme design (as well as the failures in programme implementation) led to the 2000-2001 crises. Some policy specific lessons can be drawn from this.

In terms of programme design, the risks inherent in ERBS programmes have been widely acknowledged. In particular, the need for a stable and prudentially regulated banking sector as a prerequisite for pegging exchange rate has been highlighted. The volatility of portfolio capital flows was also a key factor in Turkey’s crises. Yet there is little agreement on how these can better be managed in future.

As for crisis management, in retrospect, it was an error in December 2000 to seek to sustain the exchange rate peg without either more capital or a more convincing demonstration of government unity. This probably reflects ambivalence within the IMF over how to respond to the November 2000 crisis. There were those who felt that the right response was to float. When the Turkish authorities ruled this out, the IMF was faced with a choice between providing more capital or allowing Turkey to default. In the end, it opted for a limited capital fix. That this was inadequate was demonstrated in February 2001. While some responsibility lies with the Government for not pulling together to inspire confidence in its management of the economy, this weakness might have been overcome had the Central Bank reserves been more generously replenished. An alternative view is that more money would have only delayed further the inevitable crash. Contrasting the November-December 2000 crisis management with that from March-May 2001, there seems to be support for the argument that, at least in Turkey’s case, it took a deep crisis to force the Turkish Administration to undertake radical commitments.

Politically, Turkey’s crises emphasise the need for full ownership of the Programme by the whole Government (from the top down). In Turkey’s case, this proved much harder due to a weak, coalition government. Furthermore, the need for
transparent, incorrupt governance and strong institutions is underlined by Turkey’s experience.

In the introduction, I cited two questions, which this paper would seek to answer. **Firstly, how much flexibility is there for individual countries to tailor their crisis management policies?**

The intuitive supposition is that countries experiencing a financial crisis are in a weak position relative to the Fund. They need capital to stave off deeper crisis and the Fund can provide it. So they have to accept the Fund’s terms. The evidence from Turkey challenges this. In November 2000, Turkey refused to come off its exchange rate peg and was instead provided with more IMF capital. This suggests that, when the IMF is implicated in poor programme design, leading to a crisis, it may in fact be the IMF that is in a weak position. From March to May 2001, the Turkish authorities demonstrated that (despite their crisis) they could negotiate over elements of a new Programme. This was based largely on the credibility of Turkey’s negotiators with the IMF.

The May 2001 Programme negotiations also demonstrate that – when it has confidence in the analysis and capabilities of the domestic economic authorities – the IMF is willing to compromise on economic targets in the interests of the sustainability (and credibility) of the Programme.

**Secondly, what impact does the IMF’s intervention have on domestic politics in the crisis country: which actors are empowered or enfeebled; and what are the lasting consequences for domestic politics?**

A first observation from Turkey’s experience is that when the IMF and the country get economic policies wrong, the effects can bring down the Government. This highlights a more general point: that, when the IMF is involved before the crisis, it may be hard to distinguish the direct effects of the IMF on domestic politics from its indirect ones, through the crisis. The questions then become: is the crisis of the IMF’s making or not? Are political consequences directly attributable to IMF involvement or not?

The ‘failure’ of the Programme represented by the November crisis is contested by a number of scholars. ‘Orthodox’ accounts point to implementation failures by the Turkish authorities. One group of scholars have, however, focused their criticism on design failures of the Programme. On their account, the Turkish authorities met their commitments on monetary and fiscal policy. For them, the Programme’s failure was therefore due to inherent weaknesses in an exchange rate stabilisation programme, symbolised by the dependency on flight capital. This debate highlights the earlier point about ownership. If the Programme was, ultimately, owned by the Turkish Government, then the exchange rate policy was also ‘theirs’. If, however, the IMF (perhaps acting through the Turkish economic bureaucracy) ‘imposed’ the Programme, then the basis for blaming the IMF is clearer.

Secondly, in Turkey’s case, the IMF empowered the economic technocrats within the administration. These were the IMF’s interlocutors and, to the extent that the rest of Government chose to accept the IMF’s engagement (or saw no alternative),
this association gave them greater leverage with others. In the wider economy, the
IMF tended to focus principally on macroeconomic aggregates and on the functioning
of capital markets. Consequently, the IMF was perceived to favour holders of capital
over providers of labour, and, through policy recommendations, to empower these
interests.

Thirdly, Turkey’s recent experience demonstrates something of a paradox
about the IMF’s participation in economic policy-making at the time of a crisis. On
one hand, the IMF was deeply unpopular with certain groups, leading to contestation
and debate about economic policy at a level not previously seen. Thus the
combination of the crisis and the IMF ‘popularised’ economic discourse. On the other
hand, however, the rhetoric of the IMF and economic managers tends to treat
‘politics’ as the problem and ‘sound economics’ as the solution. In this way, it seeks
to neutralise the political dimension of all economic decisions: claiming that the
‘right’ economic policies are value-neutral. This Janus-headed approach can be seen
in the behaviour of the AKP.

In conclusion, the experience of Turkey’s engagement with the IMF before,
during and after its economic crisis, suggests that the simplistic view that the IMF
holds all the cards in negotiations with developing countries facing economic crises is
wrong. When the IMF is reputationally and financially exposed by its involvement in
programme design, there are strong opportunities for domestic actors to shape
outcomes. Similarly, when domestic actors command the trust of IMF Management
and Staff or when the crisis country receives strong support from influential
shareholders in the IMF, more flexibility opens up for policy choices.
Endnotes

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2 Calculation based on Yeldan (2002), p.2, Table 1.

3 From 5.63% in Q3 of 2000 to 11.76% in Q1 of 2002: World Bank (2003), p.8


5 Alper and Onis (2003)

6 Allen (2000), p.3


8 Ekinci and Erturk (2004) sets out the argument that speculative capital and the expectations behaviour of portfolio investors were the principal causes of the crisis.

9 See Eichengreen (2001)

10 Yeldan (2001), p. 6

11 In keeping with the clientelistic pattern of Turkish politics, most public banks had strong links to particular political parties. It was therefore of primary importance to parties to ensure they were represented on the Board so that their political opponents could not use the new agency as a means to weaken their links to client banks.

12 Öztatay and Sak (2002), p. 149

13 The Turkish Daily News reported on 20 February that ‘for the first time in the history of the National Security Council (MGK) a prime minister stormed out accusing the President of preaching at him in a manner "beyond the rules of politeness or the traditions of the state" and that "a very serious state crisis" has arisen.’

14 Sezer and Ecevit had fallen out over the respective jurisdictions of the State Inspection Board (controlled by the President) and the BRSA when it came to failed banks.

15 Öztatay and Sak (2002), p. 153

16 Öztatay and Sak (2002), p.151
17 Ercel was subsequently prosecuted for the equivalent of insider dealing. He sold 50,000 USD of TL in the days before the Central Bank abandoned the peg.

18 Some of the reporting makes clear the extent of the Government’s confusion at this time and desire to avoid blame for the crisis. For example, on 3 March, the *Turkish Daily News* reported (emphasis added): ‘A cabinet decree appointing Derviş the State Minister responsible for the Treasury was sent to President Ahmet Necdet Sezer yesterday afternoon. Derviş will be in charge of coordinating all economic units, while the Capital Market Board will continue reporting to Recep Onal, State Minister responsible for the Treasury, NTV news channel reported yesterday. Onal would not resign, the channel said. Thereby the government manage to save faces, persistently denying the political responsibility of the crisis.’

19 International Monetary Fund (2001), p. 18

20 Özatay and Sak (2002), p. 157

21 International Monetary Fund (2001)

22 As stated at a seminar on “Turkey’s Financial Crisis”, hosted by the Programme on Contemporary Turkey, University of Oxford, on 22 February 2002. I am grateful to Yahya Tezel for bringing this to my attention.

23 See Calvo and Végh (1999) for an overview of ERBS schemes.

24 Interview with Faik Oztrak, 10 March 2004.

25 For a representative critique of the programme’s lack of ownership, see Cizre and Yeldan (2004).

26 It is apparent that they are referring here to Article IV Section 3 *Surveillance over exchange arrangements* (b), which states, *inter alia*, ‘The principles adopted by the Fund shall be consistent with … exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.’

27 On 21 December 2000, the IMF Executive Board approved 7.5 billion USD in new resources for Turkey, of which 2.2 billion USD was made immediately available. Turkey already had access to facilities under the decision of 22 December 1999, of which 2.2 billion USD was undisbursed on 21 December 2000. The Executive Board also approved the release of 0.6 billion USD of this sum.


29 Speech given by Kemal Derviş to the ABCDE Conference in Paris, 16 May 2001 (as above).
30 Ibid.

31 Comment made by Kemal Derviş at the ‘Pathways Through Financial Crises’ roundtable, Oxford University, 29-30 April 2004.

32 Interview with Faik Oztrak, 10 March 2004.


34 Source: Turkish Treasury figures, http://www.treasury.gov.tr/yayin/hazineistatistikleri/3-4B-Dev.xls

35 See, for example, Haggard and Birdsall (2000)

36 Of course, the relationship between trade and capital account liberalisation, growth, poverty and inequality is strongly contested among economists and political scientists (see Dollar and Kraay (2001), Cornia (2004)). However, accounts generally recognise that economic crises have particularly damaging impacts on the poor. Typically, those living on the lowest incomes are the least able to insure against the shock of crisis, they are the most likely to derive income from casual work (without employment protection) and their children are the least likely to be enrolled at school.

37 The Gini coefficient measures the deviation from a purely equal distribution of income across the population, where 0 would be perfect equality.

38 It should be borne in mind that Turkey sees wide disparities in regional income with, in particular, a substantial gulf between the industrial Marmara region (17.3 million people, 153% of average per capita income) and the rural region of East Anatolia (8.1 million people, 28% of the average per capita income) Ahtisaari, Beidenkopf and et al (2004).

39 International Monetary Fund (2002)

40 World Bank (2003, volume I), p. ii

41 International Monetary Fund (2002)

42 Dervis (2005), pp. 119-120

43 Note that the decision to ban the FP had led to its split into the AKP and the Felicity Party (SP).

44 Representative articles include those Akyüz and Boratav (2003) and Yeldan (2002). Boratav and Yeldan both belong to the Ankara-based Association of Independent Social Scientists, which have been highly critical of the IMF’s role in Turkey’s economic management.
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