The Making of the Turkish Financial Crisis

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Summary. — At the turn of the century the Turkish economy was in need of an urgent stabilization in order to halt a treacherous process of inflation, unsustainable public debt accumulation, and increasing financial fragility, resulting from irresponsible policies and lack of fiscal discipline that had been endemic since the early 1980s. The stabilization program launched with support from the IMF has, however, failed to deliver its promises, plunging the economy into an unprecedented recession, largely because of serious shortcomings in its design as well as in crisis intervention which appears to have drawn no useful lessons from recent crises in emerging markets.

1. INTRODUCTION

In December 1999 the Turkish government launched an exchange rate-based stabilization program with the support of the Bretton Woods Institutions (BWIs) in order to bring down inflation and check what looked like an unsustainable process of public debt accumulation. The program appeared to be on course in the subsequent nine months, enjoying wide public confidence and support as well as gaining praise from International Monetary Fund (IMF) officials. But, it started running into problems in Autumn 2000, necessitating a relatively large IMF bailout to keep it on course. After a few months of muddling through it became clear that the program was not viable, and in the face of massive attacks on the currency and rapid exit of capital, the currency peg had to be abandoned in February 2001 and replaced by a regime of free floating, again on advice from the IMF. As in most other episodes of financial crisis the currency overshot, interest rates rose sharply and the economy contracted at an unprecedented rate. But the bust in the financial cycle came much earlier in Turkey than in most other episodes of financial crisis, before inflation could be brought under control.

What went wrong? The Turkish crisis has a number of features common to crises in emerging markets that implemented exchange rate-based stabilization programs. Such programs typically use the exchange rate as a credible anchor for holding down inflationary expectations, often leading to currency appreciations and relying on capital inflows attracted by arbitrage opportunities to finance growing...
external deficits. The consequent build-up of external financial vulnerability eventually gives rise to self-fulfilling expectations of sharp currency depreciations and a rapid exit of capital, resulting in overshooting of the exchange rate in the opposite direction and hikes in interest rates. Through such a boom-bust financial cycle, some countries (e.g., Mexico, Brazil and Russia) have succeeded in overcoming their chronic price instability and avoiding a return of rapid inflation, despite the collapse of their currencies and the external adjustment necessitated by the crisis. The Turkish program initially followed a similar path, but ran into difficulties at a much earlier stage of the disinflation process.

The difficulties arose largely because the program was launched in the face of structural problems and fragilities on many fronts, notably in public finances and the banking sector. In particular, the banking system was heavily dependent for their earnings on high interest spreads between deposits and T-bills associated with rapid inflation, and thus highly vulnerable to disinflation. Consequently, there was a basic policy dilemma at the core of the program, since much of the fiscal adjustment was predicated on declines in the very nominal and real interest rates on which many banks depended for their viability. Furthermore, while the program incorporated a preannounced exit from the crawling peg after 18 months, it failed to meet its inflation targets despite full implementation of its monetary and fiscal policy targets. Thus, what initially looked like a strength of the program backfired, as persistently high inflation, together with widening current account deficits, fed into expectations of a sharp depreciation of the currency. These shortcomings in the design of the program, rather than a failure to implement it, are the main reason why the boom in capital inflows was much shorter in Turkey than in most other experiments with exchange rate-based stabilization, and why the crisis broke out before inflation was brought under control.

That the Turkish crisis has proved much deeper than most crises in emerging markets is not only due to problems in the design of the stabilization program. Equally important is mismanagement in crisis intervention, which had been premised, as in most other emerging markets, on restoring confidence, maintaining capital-account convertibility, and meeting the demands of creditors through fiscal and monetary tightening. While the implementation of the program had created a tradeoff between public and private finances, abandoning the peg and moving to free floating under full capital account convertibility and extensive dollarization aggravated the difficulties of both public and private sectors. The collapse of the currency hit hard those sectors with high exposure to exchange rate risks which the earlier peg had encouraged. Public finances were squeezed from rising external and domestic debt servicing obligations due to the collapse of the currency and the hike in interest rates. Fiscal austerity and monetary tightening served to deepen recession, and even the response of exports to the sharp depreciation of the currency was delayed because of disruptions in the credit and supply systems, in very much the same way as in the earlier phase of the crisis in East Asia. Various packages of legislation passed in order to initiate structural reforms in the public and private sectors failed to restore confidence, while their initial impact was to add to stagflationary pressures. Furthermore, the external economic environment deteriorated further with the downturn in the major industrial countries and the events of September 11. These events have, however, helped Turkey in mobilizing unprecedented amounts of external support from the IMF due to the strategic position that the country occupies in the United States’ “war against terrorism.” Despite four IMF bailout packages in two years, however, the economy shrank at an unprecedented rate of some 9.5% in 2001, and prospects for sustaining the recovery underway are highly uncertain as the problem of debt and fiscal sustainability remains unresolved.

2. THE BUILD UP OF IMBALANCES: INFLATION, DEBT AND CAPITAL FLOWS

Many of the imbalances and fragilities that characterized the Turkish economy at the turn of the century had their origin in the policies pursued in the previous two decades. Turkey started the 1980s with a stabilization-cum-liberalization experiment under a military rule in response to a debt and balance-of-payments crisis beginning in late 1970s. The program enjoyed some initial success and was widely praised as an example of successful transition from an inward to an outward development strategy and generously supported by multi-
lateral institutions. Inflation was brought down from three digit levels in 1980 to some 30% in the subsequent two years. The current account deficit was halved from a level of 5% of GDP while the public sector borrowing requirement (PSBR) fell from around 10% of GNP to less than 4%. After an initial contraction the economy enjoyed an export-led growth averaging above 6% per annum during 1983–87, supported by favorable exchange rates and tax incentives.

Macroeconomic imbalances reappeared, however, after 1987. The PSBR reached almost 10% of GNP and inflation accelerated rapidly. Two factors played a significant role. First, the return to parliamentary democracy in 1987 led to the reversal of regressive incomes policies pursued during the military regime of 1980–83 and the subsequent civilian government (Boratav & Yeldan, 2001). Second, domestic financial markets were liberalized before fiscal discipline had been secured and inflation brought under control. Deregulation of interest rates and the shift from central bank financing to direct security issues raised the cost of financing public sector deficits, pushing up the cost of domestic debt and interest payments as a proportion of GDP.

The policy response was to liberalize the capital account in 1989 in order to facilitate the financing of public deficits without crowding-out private investment. But, the outcome was to aggravate the fiscal problem, forcing the government to pay interest rates incorporating a higher spread compared to the safer dollar assets which had become easily accessible. During the 1990s interest rates on government debt exceeded the inflation rate, on average, by more than 30 percentage points (Table 1). This led to a rapid build up of public debt, acceleration of currency substitution and the emergence of a banking system which came to depend on arbitrage margins offered by high rates on government debt in comparison with international borrowing and domestic deposits, including forex deposits, at the cost of large currency risks. Government was increasingly engaged in Ponzi financing whereby rising interest payments could only be met by issuing new debt. Thus, while interest payments on domestic debt absorbed less than 20% of tax revenues at the end of the 1980s, this

### Table 1. Turkey: macroeconomic indicators, 1990–2000

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth rate</th>
<th>CPI (per cent change)</th>
<th>Interest rates</th>
<th>Exchange rate</th>
<th>Public sector balance</th>
<th>Of which primary balance</th>
<th>Net debt of the public sector</th>
<th>Of which net domestic debt</th>
<th>Current account deficit</th>
<th>Gross external debt</th>
<th>Billions of dollars</th>
<th>Per cent of total deposits</th>
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</thead>
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<tr>
<td>1990</td>
<td>9.3</td>
<td>60.3</td>
<td>51.9</td>
<td>22.9</td>
<td>−7.6</td>
<td>−3.6</td>
<td>28.8</td>
<td>9.4</td>
<td>−1.7</td>
<td>32.6</td>
<td>7.4</td>
<td>20.4</td>
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<tr>
<td>1991</td>
<td>0.9</td>
<td>66.0</td>
<td>109.6</td>
<td>60.0</td>
<td>−11.3</td>
<td>−6.2</td>
<td>35.2</td>
<td>14.0</td>
<td>0.1</td>
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<td>70.1</td>
<td>97.8</td>
<td>64.6</td>
<td>−12.4</td>
<td>−7.0</td>
<td>35.7</td>
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<td>−0.6</td>
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<td>1993</td>
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<td>90.3</td>
<td>59.8</td>
<td>−13.1</td>
<td>−5.6</td>
<td>35.1</td>
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<td>150.6</td>
<td>171.6</td>
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<td>−0.2</td>
<td>44.7</td>
<td>20.8</td>
<td>2.2</td>
<td>50.1</td>
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<td>41.3</td>
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<td>−1.5</td>
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<td>−1.3</td>
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<td>85.7</td>
<td>119.2</td>
<td>86.5</td>
<td>−13.1</td>
<td>−2.1</td>
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<td>1998</td>
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<td>84.6</td>
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<td>71.8</td>
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<td>96.6</td>
<td>71.8</td>
<td>−24.5</td>
<td>−2.0</td>
<td>61.7</td>
<td>24.5</td>
<td>−0.9</td>
<td>55.6</td>
<td>34.1</td>
<td>43.5</td>
</tr>
<tr>
<td>2000</td>
<td>7.4</td>
<td>54.9</td>
<td>37.0</td>
<td>49.0</td>
<td>−19.3</td>
<td>2.8</td>
<td>59.0</td>
<td>41.4</td>
<td>−4.9</td>
<td>57.1</td>
<td>37.7</td>
<td>43.5</td>
</tr>
</tbody>
</table>

Source: IMF (2000a, 2001c); OECD (2001); Central Bank of Turkey (various issues), Quarterly Bulletin; and Türkiye’nin Güçlü Ekonomiye Geçiş Programı, 2001, Undersecretary of Treasury.

a During 1990–91: overnight interest rates, annual simple basis. During 1992–97: Treasury bills, three-month or close to maturity realized at Treasury auctions, compounded and weighted by net sales. From 1998 onward: Treasury bills, up to three months traded in the secondary market, compounded and weighted by the volumes.

b Percentage change in the lira/$ exchange rate.

c Percentage of GDP.
proportion rose steadily throughout the 1990s exceeding 75% at the end of the decade. As a result, the PSBR rose rapidly during the same period, reaching, on IMF definition, 24% of GDP. 2

Like many other emerging markets with open capital accounts, Turkish financial markets, interest rates and exchange rates went through large swings during the 1990s, associated with boom-bust cycles in international capital flows. The increased financial instability was almost fully mirrored by unprecedented instability in economic activity. The initial boom coincided with the surge in capital inflows to Latin America in the early 1990s: during 1990–93, cumulative net capital inflows by nonresidents reached $25 billion while the current account deficit remained below $10 billion. The boom was associated with an appreciation of the currency, a strong recovery and widening public sector and current account deficits (Table 1). It was followed by a bust in early 1994, about a year before the Mexican crisis, with a sharp reversal of nonresident capital flows by 12% of GDP. The economy went into a deep recession as the lira collapsed, and inflation and interest rates reached three-digit levels.

As in Mexico the downturn was short-lived and the recovery rapid. Capital flows returned and the cumulative sum of nonresident flows reached $26 billion over 1995–97. The economy enjoyed three successive years of growth in excess of 7%. Currency appreciation was generally avoided as the Central Bank of Turkey (CBT) effectively pursued a policy of stabilizing the real exchange rate. This together with the initial real depreciation of the lira meant a sharp recovery in exports, which helped to keep the current account at sustainable levels despite rapid growth. Capital inflows were attracted in large part by short-term arbitrage opportunities as interest rates on public debt remained well above the rate of depreciation of the nominal exchange rate. But, they slowed sharply after the East Asian crisis, falling from 5.8% of GNP in 1997 to 1.8% in 1998. Growth was halved and the current account went into surplus. The fallout from the Russian crisis and a devastating earthquake in 1999 pushed the economy into a deep recession. While a currency crisis was averted over the turbulent years of 1998–99, the banking sector felt the squeeze from tightened external financial conditions and contraction in economic activity. Eight insolvent banks had to be taken over by the public saving deposit insurance fund (SDIF), in accordance with the full insurance granted to deposits after the 1994 crisis, thereby adding to public debt and deficits.

Thus, on the eve of the launching of the 1999 stabilization program, the Turkish economy was undergoing a sharp contraction and there were serious difficulties in the banking system. By contrast the external sector looked relatively healthy. The balance of payments position was sustainable and the currency did not seem to be out of line with the underlying fundamentals thanks to the 1994 devaluation and the exchange rate policy pursued by the CBT. 3 Domestic imbalances were serious, however. Government debt had grown rapidly over the preceding decade exceeding 60% of GDP at the end of 1999, and two-thirds of this was domestic debt. Interest payments from the budget had reached 22% of GDP while primary deficits were around 2%. With interest rates exceeding inflation by some 30 percentage points, fiscal sustainability could not be secured without lowering inflation and hence interest rates; at the end of the decade the operational deficit of the consolidated public sector, allowing for the inflation component of interest payments, was at an unsustainable level of 12.4% of GDP (Table 2). The banking system was extremely fragile, as it had been deregulated and granted deposit insurance without effective supervision.

3. STABILIZATION AND CRISIS

(a) The stabilization program

The government launched a stabilization program in December 1999 after extensive consultations with the BWIs, supported by an IMF stand-by credit. 4 Its target was to bring down the CPI and WPI to 25% and 20%, respectively by the end of 2000, and to the single-digit level by the end of 2002 from over 60% in 1999 (Table 2). The inflation target was anchored to a preannounced crawling peg set in
terms of a basket made up of the dollar and the euro, with a greater weight accorded to the former. The value of the basket in lira was set to increase by 20% for the year 2000 as a whole (i.e. at the target rate for WPI), at declining monthly rates starting with 2.1% for the first quarter and going down to 1% for the last three months of the year. A gradual shift toward a more flexible exchange rate regime would begin in July 2001 with the introduction of a symmetric, progressively widening band about the central exchange rate.

This preannounced exit from the peg was considered a major strength of the Turkish program (Fischer, 2001, p. 9; IMF, 2000b, p. 48; IMF, 2001a, p. 137). Earlier experiments with exchange rate-based stabilization, particularly in Latin America, had often been criticized on the grounds that they were launched without adequate attention to the potential problem of currency appreciation and without a clear exit strategy as to when and how to alter the currency peg or the regime and realign the exchange rate (Eichengreen et al., 1998; Fischer, 2001). While appreciation is unavoidable, governments are often unwilling to abandon the peg and devalue as they are afraid of triggering a sharp reversal of capital flows. But delaying exit only aggravates currency misalignments and external imbalances, eventually making it difficult to engineer an orderly realignment of the exchange rate. The Turkish exit strategy was designed to avoid these problems. It was also a gamble on the pace of disinflation: a failure to meet inflation targets could reinforce expectations of a sharp depreciation at the time of the preannounced exit date, risking an earlier attack on the currency. This was, in the event, what happened in Turkey.

The program also provided for a “quasi-currency board” whereby money printing against domestic assets was precluded. As the CBT was committed not to engage in sterilization, macroeconomic equilibrium was to be attained mainly through changes in interest rates: if capital inflows fell short of the current-account deficit, liquidity would be withdrawn from the economy and interest rates would rise, thus restoring external equilibrium by

| Table 2. Turkish stabilization and crisis: macroeconomic targets and performance |
|-------------------|-------------------|-------------------|-------------------|
|                   | Target            | Performance       | Targeta           | Performance       |
| **Real sector**   |                   |                   |                   |                   |
| GNP growth rate   | −6.1              | 5 to 5.5          | 6.1               | −3.0 (5–6)        | −9.4             |
| WPI inflationb    | 62.9              | 20.0              | 32.7              | 57.6 (10 to 12)   | 88.6             |
| CPI inflationb    | 68.8              | 25.0              | 39.0              | 52.5 (10 to 12)   | 68.5             |
| **Average T-bill interest rate** |                   |                   |                   |                   |
| Nominal           | 106.2             | −                 | 38.0              | 81.1              | 100.4            |
| Real (backward looking) | 25.2             | −                | −11.4             | 23.7              | −                |
| Real (forward looking) | 32.0             | −                | −6.5              | 36.4              | −                |
| **Consolidated public sectorc** |                   |                   |                   |                   |
| Primary balance   | −2.0              | 2.2               | 2.8               | 5.5 (5.0)         | 5.5              |
| Net interest payments | 22.1            | 17.2              | 21.9              | 22.6              | 25.0             |
| PSBR (inc. CB profits) | 24.2             | 15.0              | 19.1              | 17.1              | 19.5             |
| Operational balance | −12.4            | −7.4              | −6.6              | −3.2              | −                |
| Net debt          | 61.0              | 58.0              | 58.4              | 78.5 (561/2)      | 93.5             |
| Net domestic debt | 40.9              | −                 | 38.8              | 44.3              | 53.9             |
| **External sectorc** |                   |                   |                   |                   |
| Current account balance | −0.7            | −1.5 to −2        | −4.8              | −0.6 (−1.5 to −2) | 1.5              |
| Net external debt | 34.0              | <34.0             | 37.0              | 44.3              | 51.8             |


*Figures in brackets give the targets set in the original stabilization program of December 1999.*

*b* 12-month, end-of-period.

*c* In percentage of GNP.
attracting more capital, on the one hand, and by restraining domestic demand and imports, on the other.

Fiscal goals included an improvement in the primary balance of the consolidated public sector, to yield a surplus in 2000 to be attained with additional taxation, cuts in current public primary spending, and pension reform. This was seen to be sufficient to stabilize the public debt-to-GDP ratio over the medium term although disinflation was expected to result in a temporary rise in the burden of interest payments on previously issued fix-rate securities.

All these were to be supported by incomes policy designed to end backward indexation of wages and salaries, and by upfront structural reforms. Rationalization of agricultural policies and the pension system, improvement in fiscal management and tax administration, privatization of state-owned enterprises, including in particular Turk Telekom, and strengthening of the banking regulations were among the structural reforms agreed with the IMF.

(b) The outbreak and deepening of the crisis

In the event, during the course of 2000 the targets for the nominal exchange rate, net domestic assets and primary deficits were all attained, but prices proved to be stickier than expected, resulting in a significant appreciation of the currency in real terms. The CPI inflation on a year-to-year basis started to fall steadily after February 2000, but the pace was slow and the end-year target was overshoot by some 15 percentage points. A number of factors contributed to price inertia. First, the large increase in international energy prices added to domestic costs and inflation. Second, a tradeoff emerged between fiscal adjustment and inflation since reducing losses of state-owned enterprises required increases in their prices. Third, wage increases in the public sector often exceeded the inflation target as a result of implementation of collective agreements reached in previous years while in the private sector wage settlements continued to be based on backward indexation. Finally, certain components of CPI, notably rents, rose much faster than the inflation target.

Interest rates fell significantly faster than the rate of inflation, and indeed much faster than expected, resulting in negative real rates (Table 2). This was greeted with enthusiasm since earlier attempts at stabilization had failed to lower interest rates despite some success in disinflation (IMF, 2000b, p. 46). It brought considerable relief to the budget and played an important role in restraining debt accumulation. The improvement in the budget was very impressive, with the primary surplus reaching 2.8% of GDP against a target of 2.2%. This, together with the decline in interest rates, was sufficient to cut the operational deficit as a proportion of GDP by a large margin and stabilize, and in fact reduce, the public debt ratio.

There was a fine balance between interest rates and capital inflows throughout the first three quarters of 2000. While capital inflows helped to lower interest rates, the latter were nevertheless high enough to create large international arbitrage opportunities, since the nominal depreciation of the currency fell far short of the differentials with foreign interest rates: the average interest rate in dollar terms on government paper was close to 15%. Consequently, private capital inflows and large-scale foreign borrowing by the Treasury were more than sufficient to meet the growing current-account deficit, resulting in an increase in international reserves which reached some $24 billion, exceeding the year-end target of the program. Under the policy rule of nonsterilization, this meant a considerable expansion of domestic liquidity. This, together with the shift in government borrowing from domestic to international markets and the decline in risk premiums brought about by tight fiscal policy and the exchange rate anchor, helped to lower interest rates.

The economy enjoyed a net capital inflow of $12.5 billion during the first 10 months of 2000 on account of a large inflow by nonresidents which financed not only the mounting current account deficits, but also net outflows by residents and increases in reserves (Table 3). Over 90% of these were debt-creating with international sovereign bond issues and bank credits constituting more than 80% of the total. Since investment and lending in domestic currency by nonresidents were a small proportion of net capital inflows, currency risk was borne largely by borrowers. An important part of these risks were concentrated in commercial banks. Just before launching the stabilization program, the government had lowered the upper limit on banks’ open forex positions to 20% of their equity. Banks could exceed this limit subject to a reserve requirement of 8% in the form of a deposit at the CBT. The reserve requirement was raised to 100% in June 2000 in order to
eliminate open positions. But as banks were allowed to engage in forward forex transactions outside their balance sheets, these limits were exceeded. Banks’ open positions are estimated to have exceeded $22 billion in October 2000, to fall to some $12 billion at the end of 2001 (Kaplan, 2002, p. 19, 23).

Disinflation, currency appreciation and exceptionally low real interest rates combined to generate a strong domestic demand-led recovery in much the same way as in most episodes of exchange rate-based stabilization programs. Together with the appreciation of the currency and a rising oil bill, this led to a surge in imports which increased by 35% in 2000, while export growth remained at 7%. The trade deficit doubled to more than $20 billion, pushing the current-account deficit to an unprecedented 5% of GDP, about three times the level targeted in the program.

Clearly, the rise in international reserves, strong as it was, would not have been sufficient to sustain external payments in the event of an interruption of capital inflows. While at the beginning of the year reserves were just enough to cover short-term external debt, at the end of the year short-term debt exceeded reserves by 50%, similar to the figure in Thailand on the eve of the 1997 crisis. Again, the ratio of the current-account deficit to reserves rose from 10% to 50% during the same period.

Thus, the Turkish exchange rate-based stabilization program followed a familiar path: a surge in capital inflows, an upturn in economic activity, a significant appreciation of the currency, mounting trade deficits, worsening balance sheets and rising exchange rate risks. But the program ran into trouble before a significant progress could be made in disinflation. As in most emerging-market crises, it is difficult to identify a single event behind the sudden collapse of confidence and capital flight. The events that led to a rapid exit of capital in November included disappointing inflation results for October, unexpectedly high monthly trade deficits, political difficulties encountered in privatization, worsening relations with the EU, the economic situation in Argentina, and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the SDIF. There may also have been a rush to liquidity due to competitive maneuvering among some private banks.

Quite apart from all this, however, the program had clearly run into the familiar problems of exchange rate-based stabilization that relies on arbitrage flows. As confidence eroded, foreign creditors refused to roll over their contracts with local banks or sold assets to exit while domestic banks sold liras in an effort to reduce their end-of-year open positions. The exit from the lira resulted in a liquidity crunch and a hike in interest rates by draining international reserves. Banks carrying large T-bill portfolios with funds borrowed in overnight markets suffered significant losses and started to bid for funds in the interbank market, at the same time unloading large amounts of government paper. Within a few days stock prices plummeted, rates on benchmark T-bill rose from 35% to 50% and overnight rates reached three-digit levels. The CBT faced the dilemma posed by loss of confidence under currency-board regimes: either to defend the monetary rule and, ultimately, the currency peg at the expense of a financial crisis, or to act as a lender of last resort and rescue the financial system by injecting liquidity at the risk of deepening the currency crisis (Chang & Velasco, 2000). After some hesitation it started supplying liquidity to troubled banks. But this only served to accelerate the erosion of international reserves as the sale of liras on the foreign exchange market accelerated. Thus, the injection of liquidity did not prevent a contraction in the monetary base.

| Table 3. Boom and bust in capital flows in the turkish crisis (millions of dollars) |
|---------------------------------|------------------|---------------|
| Net nonresident flows          | 15,179          | -12,416       |
| Net resident flows             | -2,707          | -1,247        |
| Total net capital flows        | 12,474          | -13,663       |
| Changes in reserves            | -2,324          | 16,585        |
| Errors and omissions           | -2,550          | -3,215        |
| Current account balance        | -7,598          | 293           |

Source: Central Bank of Turkey.

*Includes IMF credits and changes in official reserves. Minus sign indicates increase.
Within a few days the CBT reversed its policy and, evidently after the insistence of, and securing commitments from, the IMF, reinstated the currency-board rule with a new ceiling on domestic assets. As liquidity injection was discontinued and reserves were still sufficient to meet short-term external liabilities, capital outflows stopped, but interest rates shot up with overnight rates reaching four-digit levels. Persuaded that the program was on track, at the beginning of December the IMF agreed to a new financial package of some $10.5 billion, including $7.5 billion, or 600% of Turkey’s quota, from the Supplemental Reserve Facility. The government undertook fresh commitments, including further spending cuts and tax increases, the dismantling of agricultural support policies, liberalization of key goods and services markets, financial sector restructuring and privatization. It also extended guarantees for foreign creditors as well as for all depositors of local banks in order to help restore confidence in the banking system.

By mid-January international reserves had been replenished, exceeding their pre-crisis level, and interest rates had stabilized. Imports slowed with the weakening of aggregate demand, and inflation continued to fall even though it remained at twice the rate of the crawl. Because of the underlying weaknesses, however, stability proved short-lived and it became increasingly clear that the program was not viable. While external funds remained invested at extremely short maturity, maturities in T-bill auctions started to shorten drastically already in late-January and interest rates started to shoot up, reaching 70% in mid-February. These cast serious doubts on the sustainability of public debt, and exposed banks with large portfolios of government bonds with maturities of 12–18 months purchased at low interest rates during 2000. Rising public debt, high inflation and the continued real appreciation of the currency created considerable uncertainty over the sustainability of the peg. It took a political skirmish between the Prime Minister and the President to break the peg in the second half of February 2001. Massive flight from the Turkish lira could not be checked despite rising interest rates, with overnight rates reaching 5,000% and liquidity drying up. As the attack on the currency threatened complete loss of control over monetary policy as well as a rapid depletion of international reserves, the government was forced to abandon the peg and to float the currency, again with the support of the IMF. Within a single day the currency lost about one-third of its value against the dollar.

As the financial turmoil deepened, the economic team was changed and an agreement was reached with the IMF in May 2001 on a new program supported by an additional stand-by credit of $8 billion, bringing the total IMF credit extended since December 1999 to $19 billion (IMF, 2001b). New macroeconomic targets were set for the rest of the year as well as for 2002–2003. Growth and current account deficit targets for 2001 were significantly lowered while inflation and public debt targets were raised (Table 2). It was expected that the economy would stabilize and growth would resume in the second half of 2001 as inflation declined and exports rebounded (IMF, 2001c, pp. 52–53). All these were predicated on a strong fiscal adjustment to generate a primary surplus 5.5% of GNP for 2001, primarily through cuts in public employment and investment (IMF, 2001c, p. 18). But while the government was on the one hand trying to stabilize its debt by creating large primary surpluses and converting domestic debt to external debt, it was on the other hand adding to its liabilities by capitalizing the banks taken over by the SDIF and meeting the losses of state banks exposed to mounting interest rates (IMF, 2001c, pp. 7–8, Box 1, p. 10, & Table 5, p. 78).

Even though fiscal and monetary performance criteria were generally met throughout 2001, stabilization and growth proved elusive. Despite a sharp turnaround in the current-account balance brought about by the collapse in economic activity and the freeing of the central bank from its obligation to defend the currency peg, reserves fell drastically as a result of continued exit of capital (Table 3). Thus, for the entire period from the launching of the stabilization program until September 2001, the swing in net capital flows reached $28 billion, or 14% of GDP, compared to some 10% during the Mexican boom-bust cycle. Inflation and interest rates remained well above projections, and the exchange rate continued to overshoot under speculative pressures in a rather thin market as the CBT stood-by and watched, to recover only on the news that the Fund would provide some additional finance. The government and the Fund only gradually came to grasp the gravity of the situation. All targets set for the real sector for 2001 were missed by a large margin (Table 2), leading to repeated downward revisions in GDP and upward revi-
The move to floating under distress effectively removed any control policy may have had over exchange rates, interest rates and inflation. Although the currency was left to markets in order to free monetary policy from defending a particular exchange rate, the erosion of confidence in the lira and capital outflows tended to reduce liquidity and push up the interest rates which in turn aggravated the fiscal problem and resulted in further loss of confidence. The collapse of the currency and hikes in interest rates, a combination often observed in emerging markets applying orthodox recipes in response to capital flight, have appeared with greater force in Turkey because of the accompaniment of high inflation and fiscal imbalances. There has been little scope for monetary policy to bring down interest rates so as to stimulate the economy and facilitate fiscal adjustment. Not only have there been restraints on monetary expansion owing to a ceiling on net domestic assets and a floor to international reserves, but a move in the direction of monetary relaxation would also raise fears of monetization of budget deficits.

Hopes were thus pinned on the return of arbitrage capital to stabilize the exchange rate and to bring down interest rates by restoring confidence through greater political commitment to structural change, but the reform program created difficulties in the fragile coalition. Again, the IMF became the key player, not only by providing the funds needed to support the fiscal and financial systems, but also the much-needed positive signals to financial markets. Persuaded that implementation of the program was very strong but that the external shock of September 11 had raised the financing gap, the Fund stood ready at the end of 2001 to establish a new stand-by agreement and to provide the country with an additional $10 billion. This was the fourth bailout package in two years, bringing the total of IMF financing to almost $30 billion.

While the Fund bailout package helped stabilize the currency market, much of the impetus came through the familiar deflationary process. On the one hand, as debt deflation and recession deepened, many debtors became insolvent and unable to raise funds to purchase foreign exchange to service their debt, thus reducing the sales of domestic currency for foreign exchange. On the other hand, the collapse of economic activity brought a massive turn-around in the balance of payments mainly as a result of a sharp decline in imports: these fell by 26% in 2001 after growing by 35% in the previous year, while export growth remained at a modest 11%. The acceleration of exports in 2002 provided a major stimulus to recovery, with current growth projections for the year ranging between 5% and 6%. As in most other emerging market crises, the lira started appreciating against the dollar both in nominal and real terms. Three years after the initiation of the stabilization program, inflation stood at around 30% on a year-to-year basis, unprecedented since the mid-1980s but not a very impressive performance compared to most exchange rate-based stabilization programs (Table 4; see also IMF, 2001a, p. 136, Table 4.4). More important, fiscal sustainability has not been secured. With the shift to floating, interest rates have lagged considerably behind the decline in inflation with benchmark rates staying around 60%, in large part because of increased exchange rate and credit risks attached to lira assets. In dollar terms public domestic debt increased by some 10% over 2001–02, and its average maturity has remained short compared to 1999–2000 despite some improvement over the previous year.

4. ACCOUNTING FOR THE CRISIS: OMISSION OR COMMISSION?

As in other recent crises in emerging markets, the IMF has come up with a number of ex post facto explanations for why the crisis broke out and why it has proved so deep, putting the blame on policy slippages and external shocks rather than on the design of the stabilization program or misguided intervention in the crisis: “The speculative attack on the Turkish lira took place against the background of increased political uncertainty, policy slippages and a weakening of economic fundamentals” (IMF, 2001c, p. 2); “The Turkish authorities were initially very effective in implementing the IMF-supported program, but they were less successful in coping with unexpected events such as the tripling of oil prices, the strong dollar, rising international interest rates, and an overheating economy” (Cottarelli, 2001); “The recent difficulties in Turkey relate more to banking sector problems, and the failure to undertake corrective fiscal actions when the current account widened, than to the design of the exchange rate arrangement” (Fischer, 2001,
Indeed, as it became clear that the program was no longer viable, the Fund started to harden its position in an effort to shift a greater share of the responsibility onto the government, interfering in such matters as appointments in public bodies, an action which created conflicts within the coalition government. As in Indonesia, this proved to be counterproductive, eroding further the confidence that the Fund and the government were desperately seeking to reestablish.

The explanations given by the IMF for the crisis have been challenged by many Turkish economists, including some former senior economists of the BWIs, on grounds that the policies advocated were based on a poor diagnosis of economic conditions in the country and the Fund was experimenting with programs that lacked sound theoretical underpinnings (e.g., Kumcu, 2001; Yenal, 2001). There is no denying that many other exchange rate-based programs supported by the Fund had also ended in financial crisis. Again, the policy response was broadly the same as in Turkey: namely, to provide funds in order to guarantee repayment of foreign creditors and to ensure the maintenance of convertibility of the lira and free capital movements, while also promoting tight macroeconomic policies and structural reforms to restore confidence in financial markets. In Turkey, however, capital flows were reversed in less than one year, the currency peg had to be abandoned before a significant progress could be made in disinflation, and output and employment losses were greater than in most other countries facing similar crises. Compared to most other exchange rate-based stabilization programs, the Turkish inflation target did not look overambitious. For instance, in nine such programs implemented over 1985–98, at the end of the first year the inflation rate was reduced, on average, to one-quarter of its initial level (IMF, 2001a, p. 137) while the target in Turkey was to reduce inflation from some 60% to 20–25%. Disinflation was also very rapid in the Latin American and most other countries facing similar crises. In Turkey the program overlooked a number of factors which introduced additional impediments to rapid disinflation in its initial stages including, as already noted, the tradeoff between disinflation and fiscal adjustment and built-in backward indexing in salary and wage settlements.

### Table 4. Disinflation and initial conditions in selected exchange rate-based stabilization programs

<table>
<thead>
<tr>
<th>Country</th>
<th>Start of program</th>
<th>Inflation, consumer prices (%) year over year</th>
<th>GDP growth rate (%)</th>
<th>Fiscal balance (% of GDP)</th>
<th>Current account balance</th>
<th>External debt</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>At start of program</td>
<td>After one year</td>
<td>Third year of program</td>
<td>Annual</td>
<td>Annual</td>
</tr>
<tr>
<td>Mexico</td>
<td>December 1987</td>
<td>143.7</td>
<td>51.7</td>
<td>29.9</td>
<td>1.9</td>
<td>1.9</td>
</tr>
<tr>
<td>Argentina</td>
<td>April 1991</td>
<td>287.4</td>
<td>25.0</td>
<td>4.3</td>
<td>−2.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Brazil (Cardoso)</td>
<td>July 1994</td>
<td>4922.6</td>
<td>27.5</td>
<td>6.1</td>
<td>2.5b</td>
<td>2.5b</td>
</tr>
<tr>
<td>Russia</td>
<td>July 1995</td>
<td>225.0</td>
<td>43.7</td>
<td>5.5</td>
<td>−12.6</td>
<td>12.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>December 1999</td>
<td>64.6</td>
<td>39.0</td>
<td>31.0c</td>
<td>−5.1</td>
<td>−5.1</td>
</tr>
</tbody>
</table>


*a Annual figures refer to the same year as the start of program for Mexico and Turkey and the preceding year for other countries.

*b Calculated on the basis of quarterly data (year over year).

*c Estimated.
In terms of initial macroeconomic conditions, the Turkish economy was not particularly handicapped compared to various countries that succeeded in overcoming inflation under similar programs (Table 4). As in Argentina and Russia, the Turkish stabilization program was launched under recessionary conditions. There was thus considerable idle capacity in the economy that could provide a buffer against a rapid surge in demand associated with capital inflows, alleviating potential pressures on costs and prices. The initial Turkish current account position was sustainable while, according to Fund’s own judgment noted above, the lira was estimated to have been undervalued by some 10%. The subsequent appreciation was in the same order of magnitude and somewhat less than the average rate of appreciation in the nine exchange rate-based stabilization programs mentioned above. While Turkish external debt as a proportion of GDP was somewhat higher than in Argentina and Brazil (but lower than in Mexico), Turkey had a much lower debt-exports ratio than the Latin American countries because of its wider export base. Again, debt service in Turkey as a proportion of export earnings was similar to or lower than the ratios observed in the other countries in Table 4. Finally, Turkey, like Brazil, Mexico and Russia, launched its stabilization plan in the presence of large and unsustainable fiscal deficits.

A better diagnosis of the conditions in the Turkish banking system together with a proper understanding of the dynamics of the exchange rate-based stabilization programs could have alerted policymakers to the risks entailed by a rapid decline in interest rates as well as to the vulnerability of the economy to boom-bust cycles in capital flows. Both theory and empirical evidence show that the involvement of the banking sector adds considerably to the severity of a currency crisis in large part because of destabilizing feedbacks between bank balance sheets and currency markets, and in most emerging markets banking crises precede currency crises (Eichengreen & Arteta, 2000; Kaminsky & Reinhart, 1999; and Pesenti & Tille, 2000). In Turkey, overhauling the banking system before launching the stabilization program would have helped to avoid many of the subsequent difficulties noted above. Restructuring was attempted however only after the outbreak of the November turmoil, ignoring one of the most valuable lessons from the East Asian crisis that the worst time to “reform” a financial system is in the middle of a crisis (UNCTAD, 1998, p. iii).

Recent bouts of financial instability in emerging markets have given rise to a debate over whether currency crises can best be explained by inconsistent monetary and fiscal policies and fundamental macroeconomic imbalances, as emphasized in the first-generation models (e.g., Krugman, 1979), or by sudden spontaneous shifts in market sentiments and self-fulfilling prophecies, as in the second-generation models (e.g., Obstfeld, 1986). While sudden shifts in expectations are often triggered by macroeconomic imbalances, evidence suggests that crises have occurred under varying macroeconomic conditions including in countries with strong fundamentals (Akyüz, 2000b). Moreover, a careful examination of recent experiences with soft-peg and exchange rate-based stabilization programs shows that many of the weaknesses in economic fundamentals including currency appreciation, deterioration of the current account, and increased exposure of the banking sector to exchange rate risks often result from the effects of capital inflows themselves rather than from policy slippages (UNCTAD, 1998, Chapter III). The Turkish program overlooked such potential weaknesses despite mounting evidence from recent history. Indeed, as noted above, both monetary and fiscal targets of the stabilization program were fully met, but external payments became increasingly unsustainable and the banking sector highly vulnerable. But while both the Fund and the government were quick to take credit for a strong economic upturn in 2000 after a deep recession in 1999, they were unwilling to discourage the capital inflows underlying this unstable process. Reserve requirements introduced to discourage open positions were not implemented effectively. More generally, although after the recent bouts of financial crises the Fund has admitted that some such market-based restrictions over arbitrage flows (including the Chilean-type reserve requirements) could be useful, it has rarely encouraged developing countries to check such flows even when it was clear that they could not be sustained over the longer term.

Again, experience shows that even countries with fiscal discipline have not always been able to pursue countercyclical policies at times of massive capital inflows to prevent overheating and currency appreciation. The room for such policies was more limited in Turkey owing to the size of initial fiscal imbalances and the
extent of retrenchment already incorporated in the stabilization program. More fundamentally, the program was so designed that there was little policy space left for corrective macroeconomic action in the face of widening current-account deficits. By the time the difficulties became apparent, the 2000 budget had already been finalized according to the targets set in the program, and there was effectively little room either on the spending side or on the revenue side to act rapidly to slow demand expansion. This role could have been achieved by monetary policy, but this was excluded by the quasi-currency board and nonsterilization rules stipulated in the stabilization program.

While poor diagnosis of economic conditions and shortcomings in the design of the program played a key role in the quick reversal of capital flows in Turkey, it should also be recognized that recent bouts of liquidity crises in emerging markets have significantly eroded the confidence of international investors in the sustainability of soft pegs, so that rapid exits tend to be triggered at the first signs of trouble. In this sense the Turkish experience also suggests that the chances of successful disinflation by means of an exchange rate anchor may now be lower. Indeed, the behavior of private capital flows to emerging markets in the current global downturn shows that, unlike in the first half of the 1990s, international investors have become much more nervous in raising their exposure to emerging markets despite falling investment opportunities in the major industrial countries (UNCTAD, 2002, pp. 21–27).

5. STANDING STILL AND MOVING FORWARD

The Turkish debt problem is predominantly an internal one. With high and volatile inflation, real interest rates tend to hover at double digit rates, necessitating large primary fiscal surpluses in order to check a rapid build up of domestic debt, but this in turn depresses growth, thereby making it more difficult to sustain government debt without recourse to Ponzi financing. By contrast, as noted above, the stock of external debt is low relative to export capacity, and the current account remains at sustainable levels even at times of rapid economic growth as long as the currency is properly aligned.

The Turkish stabilization program, designed to halt the unsustainable process of public debt accumulation by reducing inflation and interest rates, has led to an unprecedented financial crisis with massive costs in terms of output and employment. After November 2000, the economy faced a liquidity crisis in meeting its external debt obligations, necessitating large IMF bailouts. But, the orthodox policy response to the crisis failed to prevent the collapse of the lira and hikes in interest rates which, in turn, aggravated the domestic debt problem. Although inflation has now come down to levels not seen for almost two decades, real interest rates remain high and the problem of sustainability of public domestic debt unresolved.

Much has been written on possible solutions to the problem of internal debt, but no one has done so more forcefully and with greater persuasiveness than did Keynes in his analysis of what he called “progressive and catastrophic inflations” in Central and Eastern Europe during the early 1920s:

The active and working elements in no community, ancient or modern, will consent to hand over to the rentier or bond-holding class more than a certain proportion of the fruits of their work. When the piled-up debt demands more than a tolerable proportion, relief has usually been sought in one or other of two out of the three possible methods. The first is repudiation. But except as the accompaniment of revolution, this method is too crude, too deliberate, and too obvious in its incidence…

The second method is currency depreciation… The owners of small savings suffer quietly, as experience shows, these enormous depredations, when they would have thrown down a Government which had taken from them a fraction of the amount by more deliberate but juster instruments. The remaining, the scientific, expedient, the capital levy… is the rational, the deliberate method. But it is difficult to explain, and it provokes violent prejudice by coming into conflict with the deep instincts by which the love of money protects itself… But if it has become clear that the claims of the bond-holder are more than the taxpayer can support, and if there is still time to choose between the policies of a levy and of further depreciation, the levy must surely be preferred on grounds both of expediency and of justice (Keynes, 1971, pp. 53–55). 15

The Turkish government has been demanding sacrifices from “the active and working elements” of the society in order to be able “to hand over the rentier or bond-holding class” a large portion of “the fruits of their work” (the entire tax revenues in the past two years), refusing to seek remedies in some other ways including “in one or the other two out of the three possible methods” favored by Keynes.
For obvious reasons neither monetization and accelerated inflation nor a capital levy nor any other measure that would place a sizeable burden on the rentier class can be successfully applied when the capital account is open and the currency is fully convertible. In other words, the conditions that make it difficult to manage the external value of the currency also aggravate the difficulties in managing domestic debt. Consequently, temporary suspension of convertibility and standstills on external debt payments are a practical policy option for stabilizing the exchange rate in countries facing international liquidity problems as well as for addressing the problem of domestic debt.

These measures have long been advocated by the UNCTAD secretariat drawing on the rationale for an orderly debt workout as found in domestic bankruptcy procedures, most notably Chapter 11 of the United States Bankruptcy Code, in order to overcome the difficulties associated with official bailouts and crisis intervention. These procedures involve three principles: (a) provisions for an automatic standstill on debt servicing that prevents a "grab race" for assets among the creditors; (b) maintaining the debtor's access to working capital required for the continuation of its operations; and (c) an arrangement for the reorganization of the debtor's assets and liabilities, including debt rollover, extension of existing loans, and debt write offs and conversions. The main objective of these procedures is to maintain the firm as a going concern through financial restructuring rather than liquidation. The need for such bankruptcy procedures arises because contracting parties cannot always make provisions for all possible contingencies or redraw contracts in situations for which provisions had not been made due to certain imperfections such as incomplete information, imperfect enforceability of contracts and high negotiating costs (Cornelli & Felli, 1995).

Naturally, the application of these principles to crossborder debt involves a number of complex issues. But, fully-fledged international bankruptcy procedures would not be needed to ensure orderly debt workout of international debt, particularly for liquidity crises. The key element is internationally sanctioned mandatory standstills. Under certain circumstances, it might be possible to reach agreement on voluntary standstills and rollovers with creditors but as recognized by the IMF, "in the face of a broad-based outflow of capital, it may be difficult to reach agreement with the relevant resident and non-resident investors" (IMF, 2000c, p. 10). Standstills on sovereign debt involve suspension of payments by governments themselves, while on private external debt they require the imposition of temporary exchange controls which restrict payments abroad on specified transactions, including interest payments. Further restrictions may also be needed on the capital-account transactions of both residents and nonresidents.

The rationale for the application of such principles to crisis management is based on self-fulfilling prophecies and the collective action problem (Eichengreen & Portes, 1995, pp. 8–9). As noted above, a loss of confidence by creditors and investors can be self-justifying, leading to a collapse of the currency and hikes in interest rates, and plunging the economy into recession. Whether or not it is justified by imbalances in economic fundamentals, the outcome is often overshooting of exchange rates and interest rates which can, in turn, exert serious damages on balance sheets. Such behavior can easily turn a liquidity problem into widespread insolvencies and defaults, hurting creditors as well as debtors. Even though the creditors as a group are better off if they continue to roll over their maturing claims on a debtor, an individual investor has an incentive to rush for the exits. Such debt runs reflect the failure of markets to coordinate individual decisions so as to generate a superior outcome for the creditors as well as the debtors. In the absence of immediate access to adequate amounts of international liquidity, a possible way out is "to rule out bad equilibrium by force majeure, imposing capital controls as a temporary emergency measure during a crisis (Krugman, 1999, p. 4).

Provision of international liquidity under crisis conditions in the form of IMF bailouts is neither immediate, nor unlimited. In almost all recent emerging market crises, assistance coordinated by the IMF usually came after the collapse of the currency, and was combined with policies which often failed to restore confidence, but served to deepen economic contraction. Provision of large amounts of liquidity to countries as needed would require turning the Fund into an international lender of last resort and eligibility of countries to automatic access to Fund resources, but such proposals face political opposition as well as practical difficulties (Akyüz, 2000a, pp. 11–12; Akyüz & Cornford, 2000, pp. 133–135). Furthermore, it is generally agreed that bailouts
create moral hazard for lenders and shift the burden onto debtor countries. In fact they are difficult to reconcile with the rationale of free markets since it is generally agreed that market discipline will work only if creditors bear the consequences of the risks they take. Recognizing these difficulties UNCTAD economists have proposed that “a credible strategy for involving the private sector in crisis resolution should combine temporary standstills with strict limits on access to Fund resources” (UNCTAD, 2001, p. 140).

The IMF Board has also recognized that it may be necessary to impose a unilateral standstill:

Directors underscored that the approach to crisis resolution must not undermine the obligation of countries to meet their debt in full and on time. Nevertheless, they noted that, in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally. Directors noted that… there could be a risk that this action would trigger capital outflows. They recognize that if a tightening of financial policies and appropriate exchange rate flexibility were not successful in stanching such outflows, a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls… Most Directors considered that the appropriate mechanism for signalling the Fund's acceptance of a standstill imposed by a member was through a decision for the Fund to lend into arrears to private creditors. 17

Until recently, however, the Fund Board was unwilling to provide statutory protection to debtors in the form of a stay on litigation because of strong opposition from some of the major economic powers and market participants. Governments in some debtor countries, notably in Latin America as well as in Turkey, have also been reluctant to back this proposal for fear of impairing their access to international capital markets. But, in view of the difficulties encountered in implementing voluntary workouts for the Argentinian debt and the failure of IMF interventions to stabilize Argentina and Turkey, together with the economic difficulties faced in industrial countries themselves, international bankruptcy codes and standstills have been getting a fuller hearing. The IMF now appears to be moving in the direction of establishing some international debt workout procedures. Its First Deputy Managing Director has described the new approach in the following terms:

A formal mechanism for sovereign debt restructuring would allow a country to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling with its creditors, given the Fund's consent to that line of attack. During this limited period, probably some months in duration, the country would have to provide assurances to its creditors that money was not fleeing the country, which would presumably mean the imposition of exchange controls for a temporary period of time. Sovereign debt owed to domestic residents may well need to be included in any restructuring for three reasons. First, in the absence of capital controls, balance of payments problems are as likely to arise from the flight of domestic investors and lenders as from withdrawal of foreign ones. Second, domestic debt may impose an unsustainable fiscal burden, especially as the crisis will already be weakening the country's budgetary position by depressing economic activity. Third, external creditors are less likely to agree to a reduction in the value of their own claims if they know that domestic investors are simultaneously being repaid in full or in much greater proportion (Krueger, 2001, pp. 7–9). 18

While this initiative has recently encountered difficulties due to the opposition of international bankers and investors (Blustein, 2003), it certainly reflects a growing recognition that the approach so far adopted in official intervention in emerging market crises, built on the principle of maintenance of open capital accounts and convertibility and guaranteed repayment to creditors, and combined with restrictive monetary and fiscal policies may not always be successful in stabilizing the markets and avoiding costly crises.

Despite this recognition, most countries facing currency crises have been unwilling to resort to unilateral standstills and capital controls, and even oppose to the introduction of a statutory basis for such actions. A notable exception is Malaysia. Unlike other East Asian countries that followed orthodox programs designed and supported by the IMF in response to the 1997–98 crisis, Malaysia chose to impose comprehensive but temporary controls over capital account transactions and to fix the exchange rate after failing to restore confidence and stabilize the currency through orthodox policies. Despite initial prognostications by credit-rating agencies and the IMF that such controls would only serve to deepen the crisis, they proved to be highly effective in accelerating recovery by allowing expansionary macroeconomic policies (UNCTAD, 2000, pp. 54–55; Kaplan & Rodrik, 2001). Furthermore, there was only a limited outflow of capital when the
controls were lifted, suggesting that “controls can be successfully advertised as temporary measures, and removed when the risk of self-fulfilling pessimism has abated” (Krugman, 1999, p. 5). It was suggested in a Korean government report to G-20 that such a strategy could have also been more effective in dealing with the crisis in Korea (G-20, 1999, p. 13).

Like most other developing countries Turkey followed the orthodox route, combining tight macroeconomic policies with IMF bailouts. Two unsuccessful attempts were made to reach agreement with foreign banks on voluntary standstills and rollover of interbank credits. The first one occurred soon after the November 2000 turmoil, organized by the IMF with a few large creditor banks from the G-10 countries in accordance with its catalytic approach designed to involve the private sector in crisis resolution alongside multilateral lending to overcome the immediate liquidity crisis (Eichengreen, 2001, p. 24). No firm commitment could be obtained from these banks to maintain their December 11 level of exposure, in large part because the central banks of the countries concerned were unwilling to exert moral suasion. The second attempt was made in June 2001. Even though it was combined with explicit public guarantees for the credits lines used by private Turkish banks, the initiative was again largely unsuccessful: at the end of 2001, the exposure of foreign banks on interbank credit lines stood at half of its December 2000 level. Furthermore, the decline in exposure was associated with sharply rising spreads despite rapidly declining dollar interest rates brought about by the aggressive easing of monetary policy in the United States: “interest payments for short-term borrowing for liquidity needs were about two times higher than the pre-crisis period despite decreasing debt stock” (Senel, 2002, p. 25).

In view of the failure of the Fund’s catalytic approach in involving the private sector in the resolution of the Turkish crisis, an option would have been to combine a unilateral standstill with lending-into-arrears and exchange restrictions. After all, the conditions in Turkey were broadly consistent with those stipulated by the IMF Board for resort to such an action: the government was committed to meeting its external obligations in full and was pursuing a Fund program, but private creditors were not cooperating. A standstill mechanism could have been introduced during the first months of 2001 when it became clear that the stabilization plan was no longer viable and the foreign banks were not willing to cooperate. Because of high inflation, it would have been necessary to combine it with a crawling peg regime (rather than a fix rate as in Malaysia) in order to stabilize the real exchange rate after a one-off devaluation to correct for the appreciation of the lira.

Given the weaknesses in the Turkish economic fundamentals, particularly with respect to inflation, fiscal deficits and the stability of the banking system, exchange restrictions and capital controls may not have been fully effective in preventing capital flight. It is not clear however if more capital would have left the country than that actually did throughout 2001, particularly if the IMF had given its full support by lending-into-arrears. A standstill could have saved the country large sums of additional interest charges on existing credit lines. More important, preventing the overshooting of the exchange rate could have limited the damage exerted on private balance sheets and saved the public sector alone more than one percentage point of GDP in budgetary resources, thereby helping reduce the primary surplus and easing the deflationary pressures in the economy.

In Malaysia the main purpose of exchange restrictions was not to check capital outflows or support external payments, but rather to stop speculative pressures against the currency so as to bring down interest rates in support of a rapid recovery. In Turkey, too, there was a need to bring down interest rates in order to check the downturn in economic activity, but the real question was (and still is) how to stop the unsustainable pace of public debt accumulation associated with double-digit real interest rates. During 2000 when real interest rates on government paper issued in the previous year reached 36% because of the decline in inflation, a relatively moderate one-off tax was successfully imposed on interest incomes, resulting in a significant revenue collection and reducing the effective rate on government debt. The acceleration in inflation in 2001 associated with the sharp drop of the currency resulted in negative real interest rates on government papers issued during 2000 when interest rates were falling. But, as interest rates rose rapidly in 2001 and inflation started to decline in 2002, ex post real rates on government papers issued in 2001 rose to almost 30%. Clearly, under crisis conditions it would be difficult to tax financial incomes without suspending convertibility. Indeed, the
government has maintained full convertibility and kept the capital account open while interest payments continued to drain budgetary resources, necessitating larger primary surpluses to check public debt accumulation.

Even if the current program based on fiscal austerity were eventually to bring inflation and interest rates under control and resolve the debt problem, its costs in terms of welfare and economic growth are likely to be onerous. Indeed, a study investigating welfare and growth implications of various fiscal policy alternatives in bringing debt sustainability in Turkey, including a capital levy à la Keynes, has concluded that the continued implementation of the current program may resolve the public debt problem, but “the productive sphere of the real economy might be severely hampered.” By contrast, an alternative program based on a one-off wealth tax “is likely to produce the most superior outcome in terms of both growth performance and fiscal accounts” (Voyvoda & Yeldan, 2002, p. 26). In any case, with real interest rates still hovering at rates over 20% and fiscal austerity reaching the limits of political acceptability, debt sustainability in Turkey remains unresolved. Moreover, economic prospects are further complicated by political uncertainties in the region. A combination of capital controls with taxes on financial incomes and/or wealth may not only be a superior alternative to the current policy of fiscal austerity in terms of equity and growth, but it may also be the only viable and orderly way to resolve the public debt predicament in Turkey.

NOTES

1. For various aspects of this experience see a collection of papers in Aricanli and Rodrik (1990).

2. This definition, adopted by the IMF to measure the true stance of fiscal policy and hence the extent of adjustment needed, includes state-owned enterprises, extra-budgetary funds and social security institutions as well as the central government.

3. This was also the conclusion reached in an IMF staff report issued on the eve of the stabilization program: “the results suggest that the lira could appreciate by about 10 per cent from its 1998 average while remaining consistent with a sustainable current account deficit” (IMF, 2000a, p. 68).

4. For the details of the program see IMF (1999a) and IMF (2000b, box 2.1, p. 46).

5. On some accounts the crisis was triggered because a number of banks pushed up the interbank rate in a competitive manoeuvring with their rival, Demirbank, forcing it to unload substantial amounts of T-bills and creating a break in market liquidity and putting pressure on interest rates. For a view from financial markets on the possible contribution of various factors to the outbreak of the crisis in Turkey see JP Morgan (various issues).

6. IMF’s Fischer says Turkey Program on Track, IMF News Brief No. 00/17, November 26, 2000. See also the subsequent statement by Köhler just before the February crisis, IMF News Brief No. 10/13, February 5, 2001.

7. This move appears to have had the full support of the Managing Director of the IMF: “I particularly welcome the government’s firm commitment to implement a bold set of measures to strengthen the soundness of the banking sector aimed at tackling the root causes of the current problems. I welcome the firm action already taken in this respect, including the decision to protect depositors and other creditors in Turkish banks,” IMF, News Brief No. 00/113, December 6, 2000.


9. During the East Asian crisis there was a widespread criticism of Fund conditionality, including from some mainstream economists (e.g., Feldstein, 1998), on the grounds that it was intrusive, often resulting in unnecessary interference with the proper jurisdiction of a sovereign government. Subsequently, the International Monetary and Financial Committee recognized the need to streamline IMF conditionality, and urged “the Executive Board to take forward its review of all aspects of policy conditionality associated with Fund financing in order to ensure that, while not weakening that conditionality, it focuses on the most essential issues” in its Communiqué of September 24 2000. The Fund policies in Turkey however have shown no tendency to depart from past practice.

10. For description and comparison of various boom-bust cycles and exchange rate-based stabilization programs, see UNCTAD (1995, Chapter II; 1999, Chapter III; & 2000 Chapter IV); Mussa et al. (2000, Appendix III); and IMF (2001a, Chapter IV).
11. For comparability across countries the definition adopted for fiscal balance in Table 4 is different from the PSBR used in Table 2 (see note 2).

12. Before the stabilization program was launched in December 1999, one of the authors of this paper had urged that priority should be given to legal and institutional arrangements in order to reform the banking system and social security institutions, and in order to bring fiscal discipline before attacking inflation; see Süleyis/Yılmaz Akyüz, “Türkiye’nin isi zor!”, Power, July 1999. See also Milliyet, June 6 1999.

13. For a comparison, contrast and reconciliation between these models see Pesenti and Tille (2000).

14. For the problems faced in countercyclical policies at times of boom in capital flows see Ocampo (2003).

15. The political difficulties of introducing a capital levy, Keynes’ preferred instrument for dealing with a debt overhang, are exemplified by the eventually abortive attempt to use this approach by another famous twentieth-century economist, Joseph Schumpeter, during his seven-month tenure as Minister of Finance in Austria in 1919 (Stolper, 1994, Part IV).

16. This proposal was first made in the context of the debt crisis in the 1980s (UNCTAD, 1986, Annex to Chapter IV), and more recently in relation to emerging-market crises (UNCTAD, 1998, pp. 89–93). For a detailed description of these principles, the problems with bailouts and IMF intervention in crises and the state of the debate on involving the private sector in crisis resolution see Akyüz (2000a, 2002) and Akyüz and Cornford (2000).


18. There are some differences between UNCTAD and IMF proposals. In the UNCTAD proposal the decision to impose standstill should rest with the debtor country but would then be subject to an examination and endorsement of an independent panel very much along the lines of the WTO safeguards procedures. UNCTAD proposal also includes strict limits on crisis lending. In the IMF proposal, the “standstill would be activated if a request by the debtor country was endorsed by the Fund” (Krueger, 2001, p. 9).

19. This account is based on an insider view from a staff member of the CBT, Senel (2002).

20. This estimate is based on a one-off real devaluation to correct for the appreciation that had taken place after the launching of the stabilization program, and an unchanged real exchange rate thereafter.

21. Indeed, the controls were introduced well over a year after the outbreak of the crisis, during which time most of foreign short-term capital had already left and the current account had turned into a surplus because of sharp contraction of economic activity: see UNCTAD (2000), p. 55.

REFERENCES


Central Bank of Turkey (various issues). Quarterly Bulletin. Ankara: CBT.


