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Abstract

Turkey had several unsuccessful stabilization efforts during 1980s and 1990s. Thanks to policies that were put into practice after the 2001 crisis, which constitutes a turning point for Turkish economy, fiscal discipline was restored, single digit inflation was reached, and yet growth rate was doubled compared to the previous decade average. As a result investment climate improved and the economy benefited from substantial amount of foreign direct investment and other long-term capital inflows. However these developments had some adverse side effects as well. Real appreciation of domestic currency, deterioration of trade balance, and increasing private indebtedness generated vulnerability for sudden stops. Beside, increasing global integration and very rapid shift in the economic circumstances caused difficulties for traditional sectors. This paper analyzes the Turkish experience after 2001 and identifies underlying dynamics of the restructuring program, while denoting the costs of this transition. Turkish case provides evidence in favor of disinflation programs combined with sound fiscal policies in spite of some adverse effects in the short run.

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JEL Classification: E43, E52, C22, F31, F47

1.Introduction

Structural reforms and stabilization programs are costly and painful everywhere. Especially when the shift in the economy is fast, economic units, which have taken position according to previous structure's parameters, suffer significantly in the process of adapting to the new system. Consequently the question of whether the restructuring should be carried out, as a series of radical reforms and rapid transformation (shock therapy) or a more cautious and piecemeal (gradualist) approach needs to be explored. Especially since the dramatic collapse of socialist systems and central planning institutions, a voluminous literature has emerged on this issue. This reform literature offers two contrasting approaches. The first approach is to launch rapid reforms policies and to undertake as many reforms as possible in the shortest possible time. The second approach is to conduct reform policies through partial and gradual policy packages. Each path offers its own distinctive pattern of risks and rewards to policy makers and societies.

Shock therapy model for sure, received some criticism. For instance; McKinnon (1991), Poirot (1997), Marangos (2004a and 2004b) all agree that gradualist approach has significant advantages over the shock therapy reforms. Murrel (1991) and Fischer and Gelb (1991), raise doubts regarding the existence of a single detailed road map or the superiority of blanket "shock therapy" prescriptions. However, the clear lesson of the past reforms and empirical studies reveal that decisive and consistent reform pays off (Lipton and Sachs, 1992; Sachs, 1996; Aslund et al., 1996; World Development Report, 1996; Popov, 2000; Ahluwalia, 2002). Hence, governments need to embark on a critical mass of plans to build credibility and to alter the behavior of households and firms resisting against the reforms. Reformers need to move quickly to exploit a narrow window of opportunity for successful change given the "fact that reforms do arouse opposition, and that the opposition often tends to be strongest early on" (Rodrik, 1996: 30).

The term transition economy became a synonym of "ex-communist economy" particularly after 1990s. However, there are many economies, which have never been identified, as communist while having certain characteristics resembling the transition countries. In these countries, price mechanisms do not function according to the market dynamics. Governments impose varying degrees of implicit or explicit restrictions not only on domestic transactions, prices, and markets but also on external transactions like on free exchange of domestic currency or free entry of firms into domestic market. In a broader sense, transition literature needs to encompass "transformation" of any economy from the position of distorted price mechanism, fiscal indiscipline and high inflation to a situation where all prices are determined freely in well-functioning markets. Nevertheless to label an economic change as "transformation", the process should include removal of all restrictions preventing efficient allocation of economic resources, elimination of inflationary pressure of public sector deficits, rationalization of subsidies, privatization of state economic activity, assurance of the independent monetary policy, and hence moving towards a free trade, free enterprise, free market economy.

In Turkey, public sector has constituted a considerable weight and the government has played an influential role in economic activity since 1930s. After an initial period of relatively liberal "laissez-faire" policies, "Etatism" was adopted as one of the basic principles of the constitution (Krueger, 1987). Nationalization of railways, ports, infrastructure and foundation of more than forty State Economic Enterprises (SEEs) were all clear indications of this trend. Under a highly protected policy of import substitution, controls imposed on foreign trade and payments regime as a reaction to growing short-term indebtedness and increasing current account deficits, created a mélange of multiple exchange rates with various parities for each category of import and export, import licensing, tariffs, quotas, and other regulations (Krueger, 1974; Krueger, 1987).

The first serious crisis of Turkish economy in post World War II period was characterized by 1958 devaluation of Turkish lira against US dollar from 2.80 to 9.00 under the pressure of increasing inflation, import shortages, retarded economic growth, a flourishing black market, and continuous defaults in foreign debt service (Krueger, 1974; Owen and Pamuk, 1998). Despite some trouble during 1960s, until the second half of 1970s, the situation was still to be seen as manageable. Turkey completed the decade with a deep crisis and in January 1980, a comprehensive reform package was announced. However, due to the social and political tensions, measures could not have been brought to full fruition until the military coup in September 1980. In a less-than-ten year span, the economy had achieved an outstanding performance; shortages were resolved, economy recovered after the three-year recession, and balance of payment position was improved to such a level that the government had the courage of liberalizing both trade and capital accounts. However in two main issues the situation was not alike, if not worse. Inflation, which had already escalated to a double digit pace about 20s percent beginning from 1970, jumped to a higher platform of 40s percent. Public sector deficit, which had been the main factor behind all economic turbulences, remained around 6 percent of GDP. The disappointing end of the decade was an early warning of 1990s where two severe crises hit the economy.

After two-and-a-half decades of high inflation and volatile growth period, frequent crashes, and several unsuccessful stabilization attempts, in December 1999, an exchange rate based disinflation program supported by the International Monetary Fund (IMF) was launched. Initially, the stabilization program appeared to succeed in certain aspects. However, the Turkish economy later experienced the worst financial crisis of last half-century in the middle of the road. The 2001 crisis constitutes a turning point in many ways and has enduring consequences. Policies and measures that were put into practice after the 2001 crisis were aiming at removing distortions in the Turkish economy, restructuring the financial system and changing the dynamics of the economy to achieve price stability, sustainable public finances and hence sustainable growth in the long run. In a five-year period public fiscal discipline was evidently restored, single digit inflation was reached, and yet growth rate was doubled compared to the previous decade average. As a result investment climate in Turkey improved and, for the first time the economy benefited from substantial amount of foreign direct investment and other long-term capital inflows.

However above-mentioned developments had some adverse side effects as well. Paradoxically, Turkish economy was seized by its success. Real appreciation of domestic currency, deterioration of trade balance and increasing private indebtedness generated vulnerability for sudden stops. Beside, increasing global integration and very rapid shift in the economic circumstances caused difficulties for traditional sectors to reposition themselves against the new rules of the game. The aim of this paper is to analyze the success story of Turkish economy following the 2001 crisis and to define underlying dynamics of the restructuring program, while denoting the costs emerging from this transition. The paper argues that the Turkish case provides evidence in favor of disinflation programs combined with sound fiscal policies in spite of some adverse effects in the short run.

The remaining of the paper is organized as follows. Section 2 provides a background to Turkish economy while explaining comprehensive reform attempts occurred in 1980s. The reasons of failure are searched throughout the section as well. Section 3 focuses on 1990s when the macroeconomic balances and main price mechanisms were destroyed completely. Section 4 examines the 1999 stabilization program and its failure. Section 5 discusses the ongoing transformation of Turkish economy within a cost and benefit framework, searching answer to the question "why this time, in contrary to previous cases has the transformation worked?” Concluding notes are relegated to the last section.

2.Background: Early Attempts of Transformation During 1980s

Turkey’s economic performance until mid 1970s may be considered as satisfactory, though beginning from late 1950s the economy had occasionally difficulties mainly arising from intermittent expansionary fiscal and accommodative monetary policies. Especially during 1960s when the distress became more apparent, Turkey had to resort regularly to the IMF standby programs. Nevertheless, over two decades, 6.1 percent real average growth rate was attained with a standard deviation of 4 percent. Growth performance of 6.6 percent on the average had been achieved between 1971 and 1976. Later, Turkey found itself in a grave trouble materializing in the form of foreign exchange squeeze during second half of 1970s. Meanwhile, political instability due to weak coalitions and rising social tension combined with financing difficulties, increased country risk of Turkey. Ambition for vote maximization of short-tem governments paved the way for large public sector wage increases and higher agricultural price subsidies that deteriorated the central budget. In addition, elevated SEE investments financed from the Central Bank of the Republic of Turkey (CBRT) and from other state banks, and a relaxation of the limits on borrowing by the central government from the Central Bank caused a monetary loosening. With a resumption of central bank financing and more rapid money growth, the pressures on the exchange rate increased constantly despite the administrative restrictions that were used to limit demand for foreign exchange and repeated devaluations that took US dollar Turkish lira parity step by step from 19.25 in 1977 to 47.10 in 1979. As the rising tides of the first oil shock were deteriorating international economic environment, foreign creditors refused to open new lines or rollover existing loans, and Turkish economy, which ran out of foreign reserves fell into a severe debt crisis.

In addition to foreign exchange squeeze, inflation, which had rose to double-digit rates earlier in 1971, accelerated further. Unemployment was swelling, even many basic consumer goods were in shortage, frequent labor strikes almost totally blocked industrial production, and political violence was spreading throughout the country.

On January 24th 1980 the minority government, which had come to power only two months before, announced a comprehensive stabilization package designed by Turgut Özal, then undersecretary to the prime minister. The economic program included a very high devaluation of the Turkish lira against US dollar from 47.1 to 70 to eliminate its excess overvaluation, remarkable price increases for goods and services produced by the SEEs and removal of restrictions on interest rates. Özal was the architect of the program and had won confidence of both the international capital due to his experience at the World Bank and domestic capital as serving President of Turkish Metal Industrialist Union. Hence when the military took over in September 1980, he was appointed vice prime minister and minister responsible for economy and finance. Turkey’s main problem was diagnosed as foreign exchange shortage. Hence the cure directly targeted at balance of payments. The shift from import substitution regime to an outward oriented model had been impossible because of the power of vested interest groups who were benefiting from protections and subsidies until 1981. To shift towards export promotion in a country like Turkey with a large domestic market required a strong government with a long-term horizon and considerable autonomy (Pamuk, 2007). These were exactly the features assured in the Turkish political scene in early 1980s. Because of military intervention, there were no political and social oppositions. However Özal could not execute his project of outward orientation and liberalization in a shock therapy model. Export subsidies and a more realistic exchange rate policy favoring exports ameliorated foreign balance and the support from international organizations and creditors eased the foreign exchange squeeze. However, the frictions prevented Özal to go faster because many influential people, in and out of government were skeptical about this transformation. These combined with revenue and protection requirements forcing the government caused import liberalization not to function properly given that highly discretionary specific import duties were still effective (Rodrik, 1990).

Another immediate need was the reformation of financial system, which was characterized during the years before 1980 as highly repressed. The financial repression consisted of ceilings on deposit and lending rates and negative real interest rates, credit rationing and subsidized credits to priority sectors, excessive taxation of financial incomes and transactions, high intermediation costs, widespread connected ownership between financial and non-financial corporations, undeveloped capital markets and reliance on bank loans for business financing, abuse of CBRT for public expenditures financing, restriction on foreign entry and foreign asset holdings (Akyüz, 1990). Reform program of January 24th addressed many of these rigidities. However, as in the case of trade, financial liberalization also faced some setbacks. The deregulation, which lifted interest controls aiming at increasing deposits and financial savings could endure only two years before a financial crisis crystallized when large number of brokerage houses (so called "bankers") became insolvent and five private banks were declared bankrupt (Atiyas, 1990).

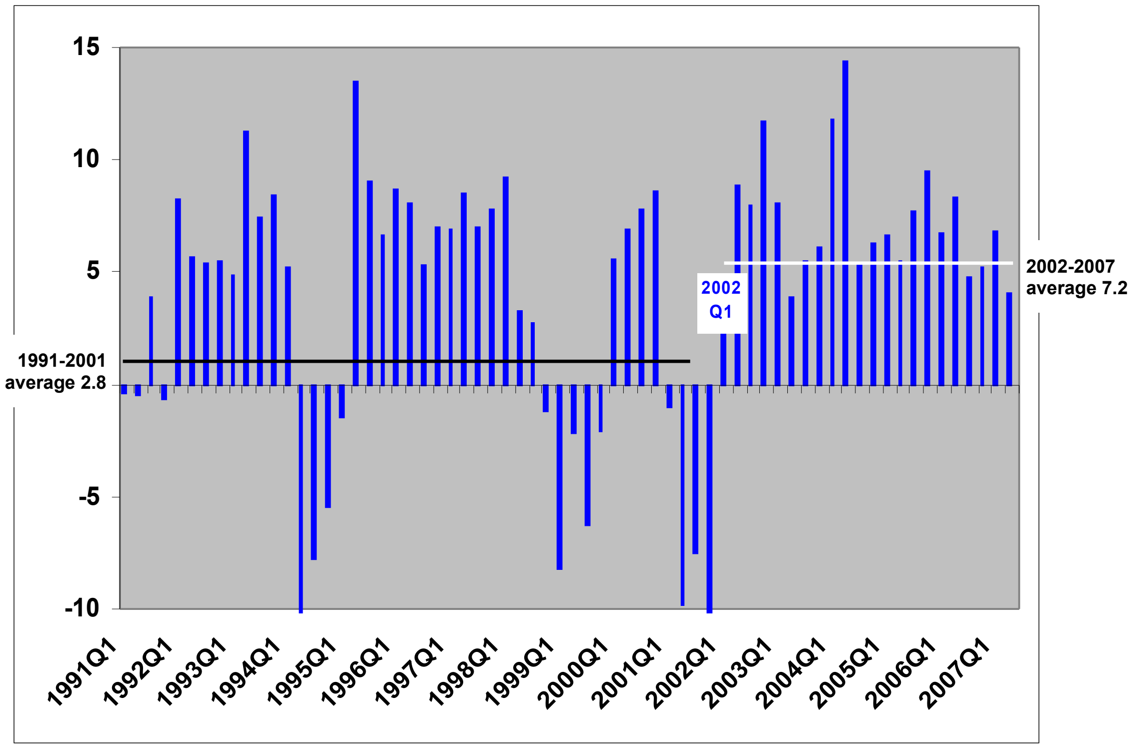
Özal, who had to resign during the crisis, became prime minister when he won the elections 16 months later. He then launched the second round of interrupted reforms in a more passionate and ambitious manner. The January 1984 reforms represented a major break with the past. Quantitative restrictions on imports were virtually eliminated. Export performance in consequence has been impressive. Exports, which stood at only 2.9 billion US dollar in 1980, soared to 11.6 billion in 1988. The government's policy to maintain exchange rate on a real depreciation path continued until 1988. After 1988, the CBRT slowed down the rate of depreciation of the Lira. A uniform rate regime was established which also eliminated the black market. The CBRT commenced daily adjustment of exchange rates (CBRT, 2002). In addition to those significant efforts, rationalization and privatization of some of the SEEs; liberalization of the credit market and banking system, and opening up of the economy were undertaken. Residents were permitted to hold foreign currency, foreign exchange deposits and to make payments via foreign exchange. Similarly commercial banks were permitted to hold foreign exchange positions, and allowed to fix their exchange rates freely by 1985. Non-residents were granted to acquire real estate and real rights, invest or conduct business activities, purchase shares and engage in partnerships. A new Capital Markets Law was accepted in 1985, İstanbul Stock Exchange became operative. At the Same time government began to issue treasury bills and bonds to finance the budget deficit. Government securities auctions were introduced. The CBRT established Interbank money market and foreign exchange market, and started open market operations. Capital account liberalization in Turkey was the last step of these reforms, and was fully completed in nine years. This period of rapid reforms prevailed until 1989 when Özal lost much popular ground and had himself elected president (Önder et al. 1993; Turhan, 2001).

Despite the enormous change occurred in Turkey between 1980 and 1989, there are several criticisms arguing that Turkey's decision of liberalization and marketization, and especially opening capital account was a wholly unnecessary rushed approach and "too immature" (Akyüz, 1991; Boratav et al., 1996; Rodrik, 1990; Ertuğrul and Selçuk, 1991; Boratav and Yeldan, 2002). However, both timing and speed of reforms were appropriate. Indeed, the path of events in Eastern Europe in the following decade verified this decision. Turkey had already been transformed in a market economy and was far ahead of many emerging markets. Nonetheless all of those criticisms were right in their claims, that is visible e.g. in Rodrik, who accurately describes this decade as "incomplete stabilization" (Rodrik, 1990). Two very crucial elements were missing in the 1980s reforms, namely providing public sector discipline and building a transparent and accountable institutional governance framework, which would have assured the progression towards an efficient free market economy. On contrary, the scope of government activity grew remarkably through extra-budgetary funds, which were often abused for discretionary purposes. Under such an environment of loose and nontransparent fiscal policy, financial liberalization turned into a harmful factor for macroeconomic stability. Because of lack of credibility arising from policy inconsistency, despite all attempts and generous incentives towards the private sector to induce more "privatization" of the economy, private investments observed to be stagnant and business conditions remained sluggish (Yeldan, 1987). The policy makers stuck in patronage-driven distribution of government benefits, preferred a gradualist and eclectic approach, instead of cutting immediately public sector deficit, granting independence to the CBRT, adopting rule-based economic policies. This did not only harm the integrity of 1980 attempt but also spilled over into 1990s.

3.Lost Decade of Turkey: 1990s

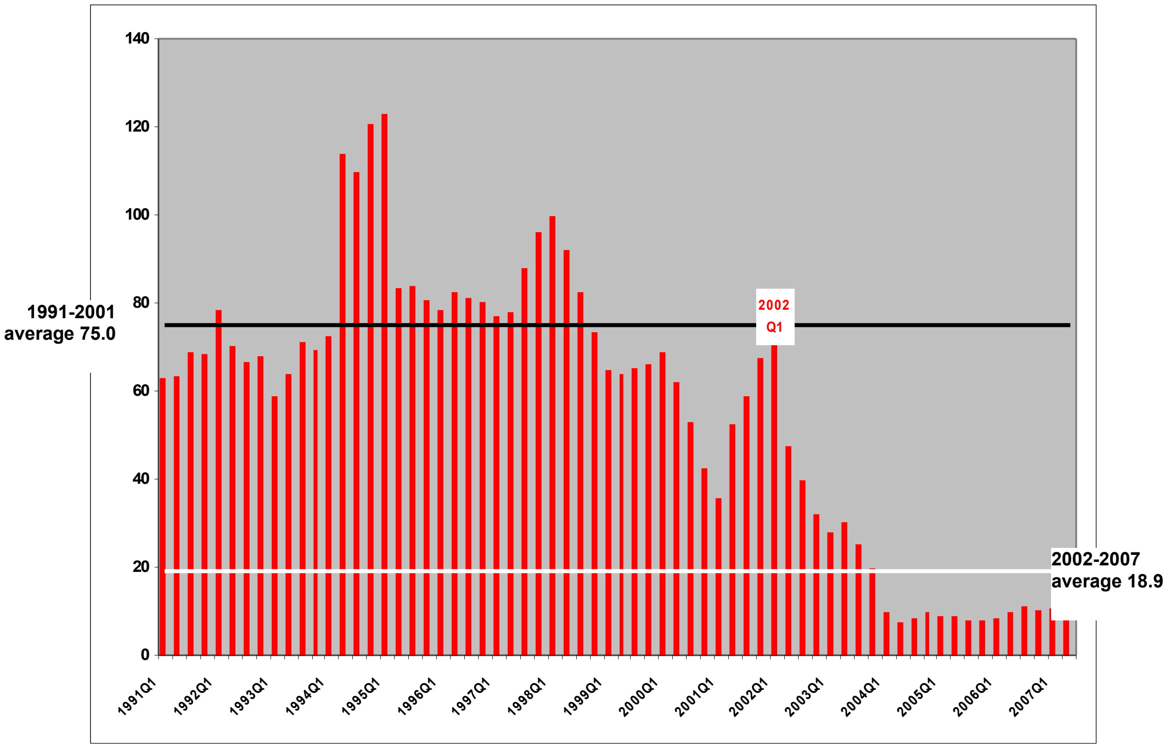
After a whole decade of political stability, Turkey was exposed to adverse effects of a series of 11 weak governments during 1990s. Economic instability naturally accompanied it with an average yearly real growth rate of 3.9 while the standard deviation of growth was 5.9, and with an average yearly inflation of 78.7 As a result, the 1990s should be considered as the lost decade of Turkey (Figure 1 and 2).

Figure 1: The Real Growth Rate Between 1991-2007 (GDP, annualized quarterly %)



Source: Turkish Statistical Institute

Figure 2: Inflation Rate Between 1991-2007 (CPI, annualized monthly %)



Source: Turkish Statistical Institute

The relaxed income policies included raise in government's personnel expenditures to 7.8 percent of GDP, the delusive obsession of controlling inflation through SEEs pricing, which eroded the both SEEs and public banks, irrational transfers to the social security institutions and to the agricultural sector. All these resulted in huge public sector deficits, that accounted on the average 6.2 percent of GDP during the 1990s (Turhan, 1995; Turhan, 2001). Consequently, as public indebtedness was escalating, Turkey faced with a dilemma regarding the domestic debt and open capital account. Increased domestic borrowing requirement implied high interest rates, which in turn led to higher interest payment costs and a further widening of the public sector deficits (CBRT, 2002). Interest payments on domestic debt to GNP ratio rose significantly to 8.4 percent on the average during the period between 1992-1999 (Table 1) Not only the interest paid on public debt was incredibly high, but also the maturity of domestic debt was very short-term. High interest rates and short term maturity structure attracted short-term capital inflows and paved the way for real appreciation. Besides, the Central Bank played a supportive role to accommodate public financing by easing short-term capital inflows with its monetary and exchange rate policies.

Table 1: Public Sector Balances (Ratio to GNP, annual, %)

	1992	1993	1994	1995	1996	1997	1998	1999
Nominal Public Balance	-12.4	-13.1	-10.2	-6.4	-13.2	-13.1	-15.9	-24.5
Net Interest Payments	5.4	7.5	10.0	9.1	11.9	11.0	16.4	20.0
Of which budgetary	3.7	5.8	7.7	7.3	10.0	7.7	11.5	13.7
CPI (annual average, %)	70.1	66.1	106.3	93.7	82.3	85.7	84.6	64.9
Treasury Borrowing Rate [a]	97.8	90.3	150.6	124.2	132.2	107.4	115.5	104.6
Depreciation Rate of TRL against USD [b]	64.6	60.5	169.9	53.5	77.9	86.9	71.6	61.0

Source: International Monetary Fund (2000), Treasury, and the CBRT

[a] : 1992-1994 Treasury bills, three-month or close to maturity realized at Treasury auctions, compounded and weighted average. 1995-1999 Treasury auction borrowing rate, compounded and weighted average in %

[b] : Year over year average change in %

As a result of above mentioned policy mix, inflation rose to triple-digit levels twice. The basic elements of disinflation efforts were in various forms of nominal anchoring and monetary tightening without any serious measure to reduce public sector borrowing requirement (PSBR), which exceeded its pre-stabilization level and reached 10 percent of GDP on the average. Furthermore, central government budget recorded a primary deficit equal to 3.9 percent of GDP as of 1994. As a result, domestic interest rates jumped up to 90 percent and Turkish lira appreciated in real terms offering a wide interest arbitrage spread to speculative short-term capital. Appreciation of domestic currency deteriorated trade balance and eventually current account deficit rose to 6.4 percent of GDP and Turkey found itself in a twin deficit position in mid-1990s (Ertuğrul and Selçuk, 2001; Özatay, 1996).

The government, aiming at relieving the interest burden in the budget, tried to control the interest rates, that is attacked the symptoms of the problem rather than the cause. This attempt to lower interest rates on debt in spite of such high levels of PSBR (12.4 in 1993) proved to be a very dangerous one. Cancellation of four consecutive auctions in the last quarter of 1993 in turn enhanced the uncertainty in the markets, and the demand for T-Bills disappeared leaving the Treasury with the CBRT short-term advances as its only domestic source to finance the budget deficit (Özatay, 1996). The excess liquidity, which arose from monetization of debt, immediately transformed into a speculative attack on domestic currency. The Central Bank, while trying to keep the interest rates at their artificially low levels, attempted to defend the exchange rate by selling foreign currency. As a result, the Central Bank lost half of its foreign exchange reserves (Ersel and Sak, 1995). The turmoil in the markets continued as exchange rates started to rise at an unprecedented rate and Turkish lira depreciated by 56.4 percent in four months.

A stabilization program, later supported by an IMF Standby was launched on April 5th, 1994. It involved significant cuts in discretionary government spending, immediate price increases for SEEs (followed by a six-month freeze), and a tightening of monetary policy. During the second quarter of the year, interest rates on three-month treasury securities averaged 275 percent (annually), moving for short periods as high as 400 percent. As part of the stability package, the banking regulations on capital adequacy and net total position, were tightened compelled the banking sector to adopt international standards, and put limits on the management of their liquidity that they had to adopt. As a result three affiliated private banks were declared as insolvent and taken out the banking system. This fueled a bank run and the government had to give a blanket deposit insurance guarantee to all deposits in the banks (Parasız, 2000). As annual inflation rate reached at

124 percent in May, and as real wages fell by 15 to 20 percent, private consumption and investment declined dramatically. (Celasun, 1998).

Elevated domestic interest rates convinced investors that first move in foreign exchange rate was a typical overshooting and expectations moved towards a much reduced rate of nominal depreciation for Turkish lira. Consecutively short-term capital began to flow back into the economy by mid-year. Hence international reserves of the CBRT were rebuilt and monetary expansion began to pick up (Parasız, 1995). The CBRT was forced to an accommodation to ease monetary tightness in order to reduce interest rates and the interest payments required on government debt. The tightness of stabilization policies was relaxed by autumn (Civcir, 2003). The inflation rate, which had started to decline regained momentum and inflation began to fluctuate around 80 percent as of the second half of 1995. Until 1998, no serious stabilization efforts were undertaken and the economy fell into an instability trap, with average Treasury auction rate for the period 1995-1997 was 121.2 percent, and annual inflation rate was 85 percent.

The malign effects of such an unstable macroeconomic environment spread over political and social structure of Turkey and caused economic units to adapt themselves accordingly and to learn to live with high inflation. Backward indexation became common in pricing behaviour and inflation entered a self-fulfilling cycle. Recurrent foreign exchange shortages prior to 1980 and the crisis of 1994 left an important mark on Turkey's collective memory that caused an exaggerated obsession of Turkish citizens on current account deficits (Akat, 2000, Turhan, 2001). Combined with the endured persistent inflation, this led a high degree of currency substitution resembling situation in similar countries (Chang and Velasco, 2002; Reinhart et al., 2003, Civcir, 2003). Dollarization of both assets and liabilities did not only damage efficient allocation of resources, as savers put most of their savings into unproductive areas, but also dramatically increased the vulnerability of the economy to exogenous shocks through deterioration of balance-sheets (Mishkin, 2001; Turhan, 2001). Unfavorable impact of this unstable economic environment has been also felt in the labor market and prevented it from functioning effectively. Economic growth within continuous boom-boost cycles led volatility to labor force. Especially unskilled workers were the first ones to lose their jobs in periods of contraction and the last ones that were employed in expansion periods. Turkey ranked low both in fields such as infrastructure, education, health and the fair distribution of income in international development indicators, so did it in indices of corruption, 64th out of 102 countries (Hodess, 2003). Chronic inflation also obscured price and quality consciousness of consumers. Similarly producers were less concerned with cost efficiency, and were willing to determine profit margins freely. As a result of missing efficiency and productivity stimuli, Turkish industry lost its competitive power.

Banking sector was influenced badly from the effects of economic instability during 1990s. Besides being exposed to all detrimental consequences of abovementioned atmosphere, because of high inflation and extremely volatile market conditions, banks had to bear huge amounts of unhedgeable financial risks. Since financing the public sector deficits with high real interest rates was an easy way to generate profits, bank did not pay attention to basic principles of risk management, such as currency and maturity mismatches. Some banks also gave huge amounts of connected loans. In addition, Treasury's blanket deposit insurance guarantee without an effective supervision was creating a serious moral hazard since depositors did not differentiate between the risky banks and the sound ones (Turhan, 2001). Banks, except engaging in connected lending were unable and unwilling to fulfill their intermediary functions effectively. This resulted mainly from the fact that the banks were the principal fund-raisers to finance public sector. Elevated ratio of public deficits and debt stock to national income caused a financial crowding-out (Turhan, 1995). While prevailed uncertainty was eroding term structure of financial contracts and induced myopic behaviour, the average maturity of domestic borrowing was only 8.4 months over the period 1995-1998. This led to a an even worsening of public debt, acceleration of currency substitution and almost complete dependence of the banking system on arbitrage margins offered by high rates on government debt in comparison with international borrowing and domestic deposits, including foreign exchange deposits, at the cost of large currency risks (Table 1). Government was increasingly engaged in Ponzi financing whereby rising interest payments could only be met by issuing new debt (Akyüz and Boratav, 2003).

In 1998 a newly established three-party coalition government launched a comprehensive disinflation program, known as Staff Monitored Program (SMP), with the aim of reducing inflation and improving the fiscal performance of the country. Central Bank lending to the Treasury was ceased and consequently, the inflation began to fall. However, five months later the government collapsed after losing a no-confidence motion over corruption allegations including Prime Minister's tampering with the sale of a state bank. The political uncertainties and the earthquakes in August and November 1999 impeded the program to obtain the expected results. Eight banks whose deposits accounted 10.7 percent of the banking system taken-over by the Savings Deposit Insurance Fund (SDIF). Moreover, contagion effect of the Asian and the Russian crises beset the already vulnerable economy and in the last quarter of 1998, after a fourteen-quarter period Turkey entered into a recession again (Turhan, 2001).

4. 1999 Program and 2000-2001 Crises

The government formed after the April 1999 elections adopted an exchange rate based disinflation program (ERBSP), which included a fiscal adjustment, structural reforms, and a firm exchange rate commitment supported by consistent incomes policies in December 1999. Its target was to bring down the CPI and WPI to 25 percent and 20percent respectively by the end of 2000, and to the single digit level by the end of 2002. The program brought a limit on the Central Bank's net domestic assets, and CBRT was committed not to engage in sterilization, hence macroeconomic equilibrium was to be attained mainly through changes in interest rates. Fiscal goal involved raising the primary surplus of the public sector (which included the consolidated central budget, the extra-budgetary funds, the local government, the non-financial SEEs, the CBRT, and the so-called duty losses of state banks) from 2.8 percent of GNP in 1999 to 3.7 percent of GNP in 2000. Structural reforms were categorized as reforming agricultural subsidies system, restructuring of pension system, enhancing transparency and accountability in public finance, accelerating privatizations, and strengthening the banking system and banking regulation (IMF, 1999; Turhan, 2001). An independent banking authority the Banking Regulation and Supervision Agency (BRSA) had already become operational a few months earlier. This was defined as one of the pro-loaded performance criteria of the program. Existence of several studies, providing evidence that countries, which adopted some form of fixed exchange rate regime in their stabilization packages were more successful to curb inflation, to decrease interest rates and to induce fiscal discipline, was legitimizing in such a decision. Moreover, countries that adopted exchange rate based stabilization programs seemed to have experienced faster output recovery than countries that pursued money based stabilization programs. In addition, as already mentioned, foreign exchange denominated or indexed contracts, pricing and saving behaviors became widespread as a part of hedging mechanism of economic units against chronic inflation, given the level of dollarization. Hence, it was very difficult to bring the inflation down without stabilizing the foreign exchange rate (Calvo and Végh, 1994; Turhan, 2001).

First, as was the case with many other ERBSPs, external borrowing by the banks and the private sector increased depending on large short term capital inflows, while foreign direct investment remained negligible. Since the CBRT did not engage in any sterilization efforts, money market liquidity increased and interest rates fell. Among other things, this eased the debt burden of the government, and caused the default risk to decrease, encouraging even more capital inflows (Ghosal, 2006). These developments paved the way to moral hazard problem, since pegged exchange rate was assuring implicit guarantees for those borrowing in foreign currency, i.e. a public insurance to the private sector against exchange rate risk. This situation attracted capital inflows further, but left the economy very vulnerable to external shocks. The sharp rise in capital flows, in turn, increased the supply of loanable funds and caused to a lending boom and concurrently a sharp decline in the quality of banks' assets. Rapid increase in nonperforming loans of the banks, worsening currency and maturity mismatches, weak capital structure combined with the delays in banking reform, prepared ground for a banking crisis. Despite the fact that both the private and state banks had accumulated risks on the road to the crisis, the nature of the problem was different. On the asset side, the increasing size of "duty loss" accumulation of the state banks and the need to finance it by short-term domestic bank liabilities were the source of the problem (Turhan, 2001; Özatay and Sak, 2002).

The reason of collapse of 1999 program was accumulated structural distortions, which put pressure on the pegged exchange rate regime, and the failure of the Turkish government to maintain its austerity targets and to implement the necessary structural adjustment reforms on time. This caused to first a liquidity crisis, which in turned precipitated a banking crisis and finally spread over the whole economy. The initial crisis started in November 2000 due to three factors. First; although during first half of 2000 the targets for net domestic assets and primary deficits were attained, and inflation fell substantially, it still remained 15 percentage points above the target, resulting in a considerable appreciation of the domestic currency in real terms. Hence disinflation, currency appreciation and exceptionally low (even negative) real interest rates combined to generate a strong domestic demand-led recovery. As a consequence trade deficit doubled causing the current-account deficit to rise to 5 percent of GDP, and global investors, whose risk perception increased, felt uncomfortable especially considering the low level of real interest rates (Akyüz and Boratav, 2003). Second; the government failed to generate a continuous flow of good news, instead, because of the intra-coalition opposition to privatization of state owned enterprises, loss of credibility regarding government policies occurred. At the same time, proposed regulatory reforms of the banking sector were postponed. These delays "increased the suspicion in the market that the program was about to end" (Ertuğrul and Selcuk, 2001: 25). Take-over of three more banks by the SDIF and a criminal investigation into failed banks aggravated the situation. In addition, contagion effect of Argentina stress, problems regarding Turkey-EU relationships, and accustomed year-end profit realization drive enhanced the troubles (Turhan, 2001). All of these developments strengthened the idea that there was a more serious problem than known in the banking sector and at least some additional banks were to be declared insolvent. The environment itself contributed to this uncertainty and created a severe polarization in the banking system between "solvent" and supposedly "insolvent" banks. When the banks having excess liquidity closed their credit lines to those, which had been heavily dependent to over-night funds, Interbank money market crashed (Turhan, 2001; Özatay and Sak; 2002). The banks which were in urgent need for liquidity, engaged in fire sales of government securities, causing interest rates to soar incredibly, their balance sheet to deteriorate and international capital to fly out of the market. The result was a credit crunch, which deepened since the CBRT could not at first inject liquidity into the financial system by its commitment to remain under limit for net domestic assets. However when the level of interest rates began to threaten the whole banking system, the CBRT had to reverse this policy. This, in turn further damaged the credibility of the stabilization program, raised doubts about the stability of the exchange rate and provoked capital flight (Ghoshal, 2006). The CBRT lost 6 billion US dollar of its foreign exchange reserves in a few days. The capital outflow ended only when the IMF agreed to a new financial aid of 10.5 billion US dollar from the Supplemental Reserve Facility, and the government reaffirmed its commitment to the stabilization and disinflation program, to bank reform and privatization efforts.

The panic reoccurred on the February 19, 2001, when the prime minister announced that there was a severe political crisis between the president and himself. This was perceived as a peril to the continuation of the stabilization program. Worries caused to both foreign investors and Turkish residents to buy foreign exchange and 5 billion US dollar withdrawn, while the CBRT again hesitated to inject liquidity, interest rates soared. The rate of one-month treasury bills jumped to 144 percent on February 20, while the overnight interest rate climbed to 6,200 percent as banks were starving for liquidity (Eichengreen, 2001; Turhan, 2001; Akyüz and Boratav, 2003; Ghosal, 2006). The day after when the Turkish lira was left to float, it depreciated against the dollar by 36 percent within two days.

5. Transformation of Turkish Economy in the Aftermath of 2001 crisis

2001 crisis was the worst ever of post-World War II period and deeply affected the country. The government called in Kemal Derviş, a former World Bank official, and appointed him as "super-minister of economy" on March 2nd. Derviş announced a strategy of exit from the crisis based on structural policies aimed at correcting the distortions caused to the crisis, and at enhancing the transparency of economic management and the role of the private sector in the economy. This strategy was adopting tight fiscal and monetary policies to restore financial stability and resume the disinflation process as a sine quo non (IMF, 2001). However the program needed the support of domestic and international market players and hence its approval by the IMF became a prerequisite. Turkey, when applied to IMF, was faced with a new approach that included the entire Fund's assistance being conditioned with providing necessary legal framework and political system reforms in advance.

In mid-April, "Transition to Strong Economy Program" was announced together with its measures and legal regulations. A detailed timing/sequencing plan has included legal regulations for re-structuring of financial sector, increasing the transparency and strengthening of public finance, and improving competitiveness and efficiency in economy by mainly removing old structures preventing effective functioning of market mechanism, e.g. discretionary pricing of publicly produced goods and services. These regulations were: Amendment to the Banking Act, the Central Bank Law, regulation on Closing of Extra-budgetary Funds, Expropriation Act, Telecom-Sugar-Tobacco-Natural Gas Laws and Law on Economic and Social Council (CBRT, 2001b). Following a quick preparatory phase and introduction of majority of the listed regulations, a new letter of intent was signed and the IMF approved augmentation of Turkey's standby credit. Hence, an additional foreign financing of 15.7 billion US dollar was extended by the IMF and the World Bank for the May- December 2001 period.

From late 2001 favorable results generated by measures, became noticeable. Inflation declined continually, the public debt to GDP ratio was significantly reduced and then inflation expectations began to follow a downward trend. The economy entered in a rapid recovery and, with 7.9 percent real growth rate registered in 2002, it took the second highest rank in major emerging market economies after China. Even though the stabilization program and the associated structural reforms restored monetary and fiscal discipline, for the debt ratio to decrease comfortable levels, a certain period of time was nevertheless required. In the meantime, still highly indebted economy was vulnerable to changes in market sentiment, in particular to concerns about debt sustainability (Özatay, 2005).

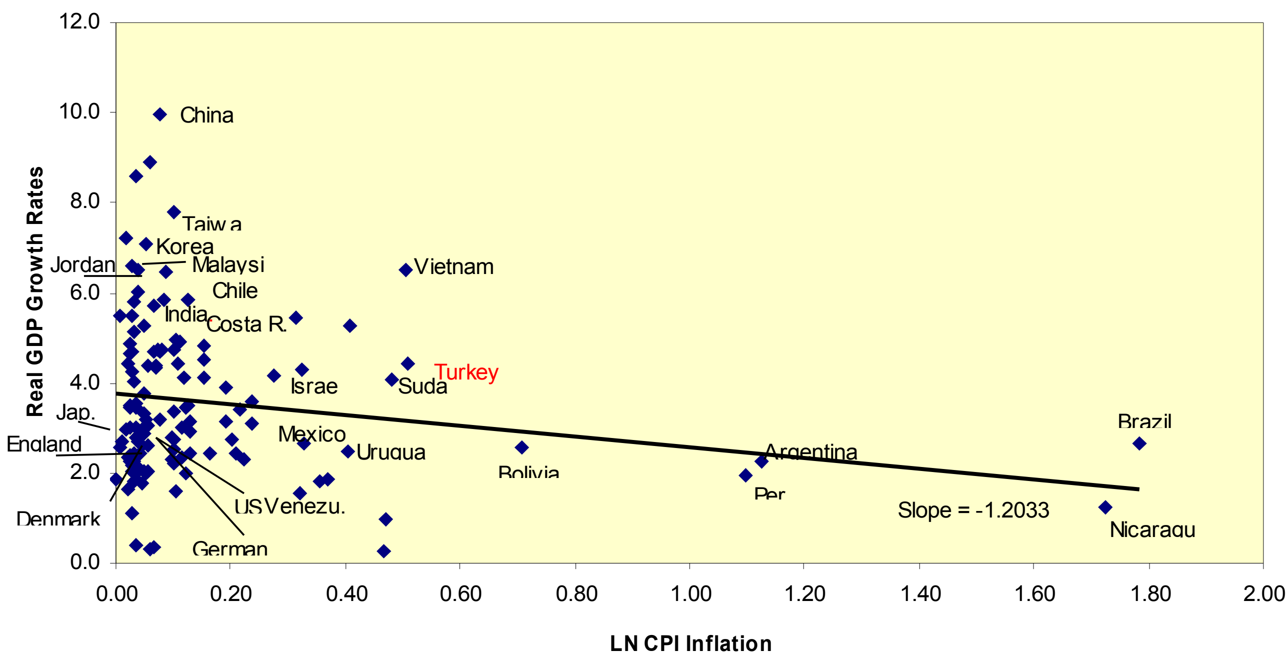
Market data supported this argument (See Appendix). Both interest and foreign exchange rates fluctuated according to the news, highlighting the role of expectations that varied according to the sustainability of the public debt. Developments like suspect on political stability such as the hospitalization of the Prime Minister Ecevit, dispute among ministers and coalition leaders or increasing tension due to the Iraq war deteriorated market conditions, independent from the existing real macro fundamentals. On the other hand, news strengthening expectations about the debt sustainability, such as single party government or positive developments regarding the relationships with the EU led to lower interest rates and stronger Turkish lira.

After the early elections on November 3rd 2002 due to continuous discord between coalition forming parties and Minister Derviş, a completely different political picture emerged. All three parties remained below the 10 percent threshold and hence could not enter into the parliament. In fact, the parliament had a dual composition with only AKP (Justice and Development Party), a 15 month-old new party in power and CHP, which had been out since last elections in 1999, in opposition. A replacement of this kind should be considered as exceptional for democratic systems. Actually, except for extraordinary conditions of military intervention periods, it was the first time since Turkey moved into multiparty democracy in 1946 that such a radical change has occurred. This shift is important to show the magnitude and scope of transformation, which covers almost all spheres of the society, observed in Turkey after the 2001 crisis.

Turkey constitutes an apparent example of no long term trade-off between inflation and growth, especially when inflation is considerably high (Figure 3 and 4). In a five-year period covering 2003 to 2007, public fiscal discipline was evidently restored, single digit inflation was reached, and yet growth rate was doubled compared to the previous decade average (Figure 1 and 2).

As significant fiscal consolidation and debt reduction gained credibility thanks to above 6 percent of GDP primary consolidated public sector surplus attained for all five

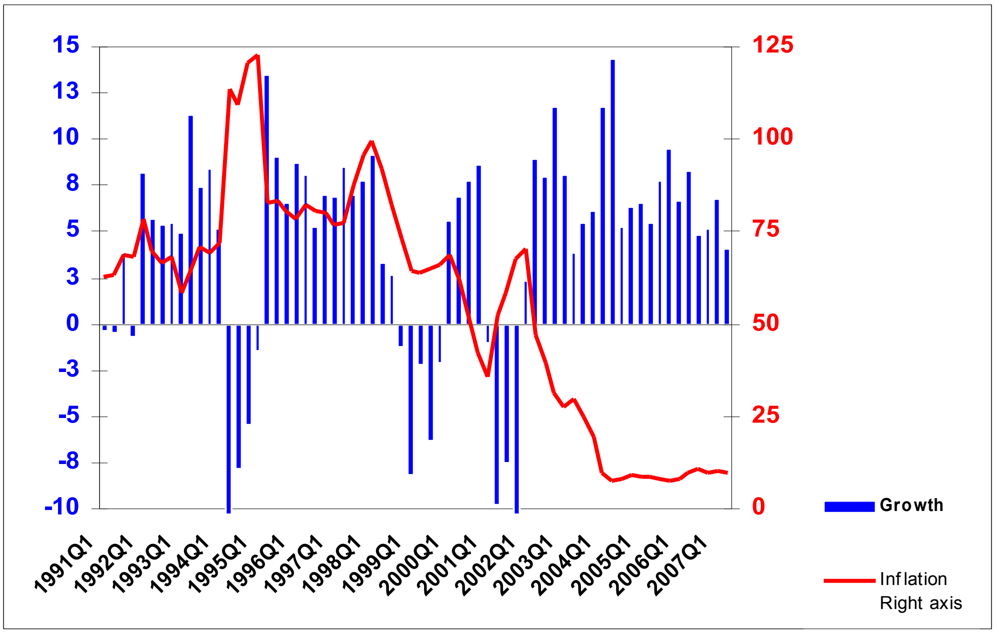
Figure 3: Average GDP Growth and CPI Inflation Between 1983-2000



successive years, this started to serve as a policy anchor. Consequently, Turkish economy, which was ranked as 28th biggest in the world, took the 16th as of 2007 according to World Bank data.

Source: IMF

Figure 4: Inflation and Growth: No Trade-off (GDP-left, CPI-right annualized quarterly %)



Source: Turkish Statistical Institute, Central Bank

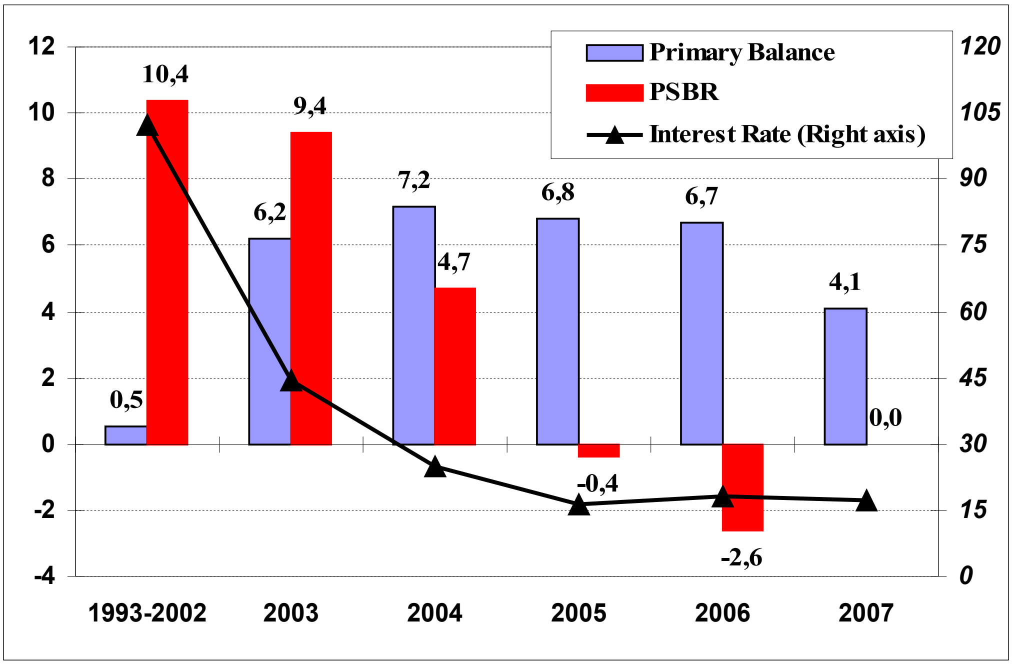
5.1. Factors of Success

The success of transformation depended on its main characteristics that also differentiated it from the previous failed attempts. Policies and measures which were put into practice aftermath of the 2001 crisis went beyond of conventional crisis management in the short term. Steps were taken to restructure the dynamics of the economy based on sustainable public finance, price stability, and private sector driven sustainable growth, to remove persistent distortions in the economy, and to restore a sound financial system. Hence three main factors of success are austere fiscal and monetary policies, rapid structural reforms, which are to be implemented without compromise, excuses or delays, and a comprehensive restructuring of once corrupted, inefficient and insolvent financial sector that aims at bringing the banking practices more closely in line with the international standards.

First, disciplined fiscal policy has been the cornerstone of the program, allowing declining debt ratios, facilitating disinflation, and reducing real interest rates (Figure 5). Fiscal consolidation achieved thanks to high primary surplus, and resulting reduction in interest rates have encouraged private capital formation, building the foundation of sustainable growth (Figure 1).

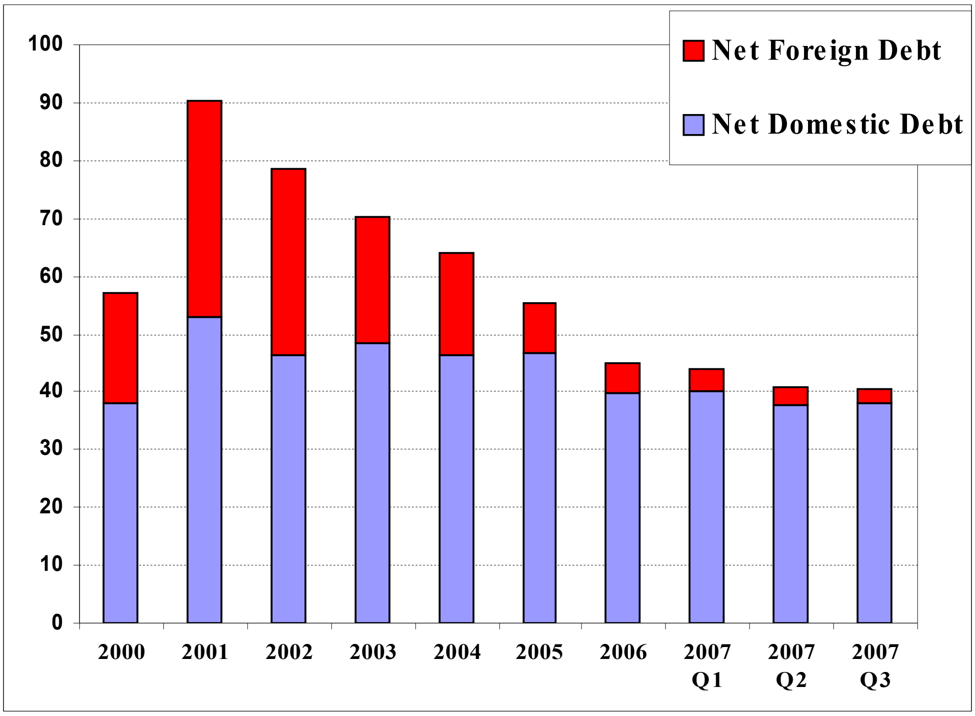
Public debt responded quickly to sound fiscal policies. Combined with economic recovery and high growth rates, this caused a drastic fall in debt to GDP ratio, which was elevated to more than 100 percent just after the crisis. In addition, decreasing public debt burden led to lower roll over ratios and risk perception of creditors ameliorated. While perceived riskiness of the Treasury was getting reduced, the risk premium associated to the public borrowing came down as well. Hence a virtuous cycle formed: primary surplus causing a decline in public borrowing requirement, which diminishes roll over ratios, resulting in significantly decreased interest rates that lessens public spending and hence alleviates further fiscal consolidation.

Figure 5: Consolidated Public Sector Balance[a], PSBR[a] and Interest Rates[b] (%)



Source: Treasury
[a] : Percentage of GDP, IMF Program definition. For 2007 forecast
[b] : Before 2003 weighted annual average of Treasury auctions and thereupon secondary market rates for public sector debt instruments

Figure 6: Public Debts (Percentage of GDP)



Source: Turkey's Treasury

Second, the CBRT was granted independence after a period of thirty years of high and chronic inflation and massive dollarization. The primary and main objective of the CBRT was determined as achieving and maintaining price stability by the amendment to the Central Bank Law. This constituted a turning point in the economy and highly contributed to the changing dynamics in the Turkish financial system. In addition, it was explicitly indicated in its law that financial stability was put into the Central Bank's auxiliary objective.

The vulnerable economy and the lack of credibility due to previous unsuccessful stabilizations and high degree of inflation inertia caused by both backward indexation and dollarization, required a transparent monetary regime with a clear nominal anchor to shape inflation expectations. Many theoretical and empirical studies show the role of expectations in economic policy formation and superiority of rule based policies (only a few and well known examples Friedman, 1968; Lucas, 1972; Sargent, 1973; Barro, 1976; Kydland and Prescott, 1977). The choice of the exchange rate as nominal anchor was out of question because an ERBSP had just been abandoned in total loss of confidence. Monetary aggregates could not be an alternative either because of several reasons. First, monetary targeting was necessitating two assumptions to hold: the velocity of the money is predictable and inflation is solely determined by money growth. However, it was almost not possible to predict money demand under a chronically high inflation environment. The final alternative was the choice of inflation itself as the nominal anchor and that refers to inflation targeting regime. The CBRT implemented this new regime implicitly under a floating exchange rate regime for the period 2002 to 2005 reflecting the fact that the preconditions such as strong fiscal position of the government and further stability in the financial markets were not yet fulfilled. Meantime, in February 2004, after 34 years inflation fell to a single-digit level, and a currency reform of dropping six zeros from the Turkish lira was realized. Transitions from implicit to full-fledged inflation targeting in 2006, after a transition where inflation targets were undershoot for the whole period (which was a positive sign, since inflation was still too high) improved transparency and predictability and hence helped to decrease further the risk premium.

Political stability and macroeconomic normalization put the Turkish economy on an above trend growth trajectory (Figure 1). GDP increased by 42 percent cumulatively from 2002 to 2006 while seasonally adjusted annualized growth rate was 8.9 percent for the same period that brought Turkey seventh fastest growing economy of the world. Uncompromising fiscal consolidation and tight monetary policy mix did not only reduce inflation but also modified the composition of gross domestic product. Since prudent fiscal policies left very little room for government expenditures, private sector has been the engine of growth since 2002. Between 2001 and the second quarter of 2007, investment and consumption expenditures of the private sector rose by 146.8 percent and 37.7 percent respectively in real terms. Since disinflation and currency stability have lowered both the actual and relative price of investment goods, this fall in the cost of capital, encouraged firms to substitute more capital in the production process. Hence from 2003, private investments became a determining component of the GDP, an element that has never seen for the last decades (Table 2).

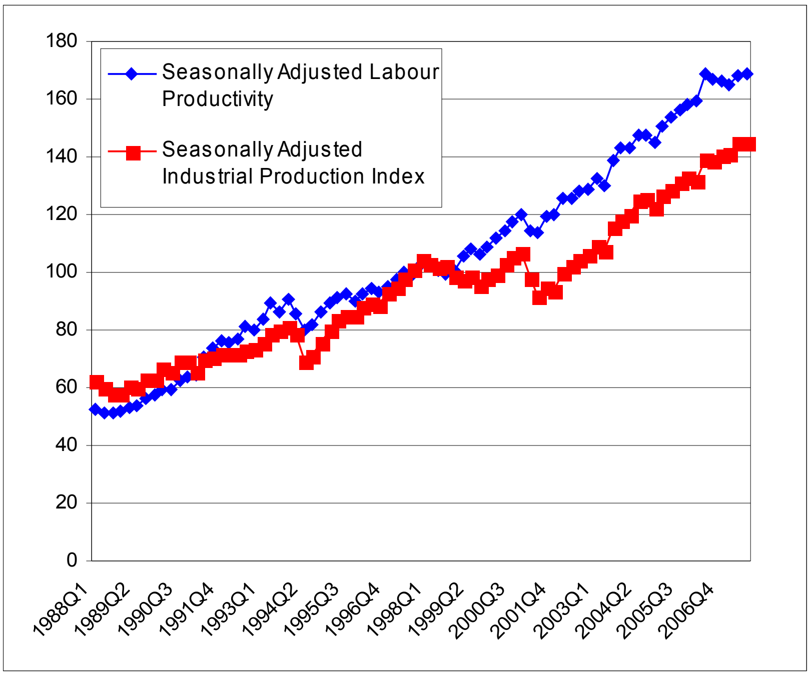
Table 2: Contribution of Sub-categories to Growth Rate (% points)

	Private Final Consumption Expenditure	Government Final Consumption Expenditure	Gross Fixed Capital Formation (Public)	Gross Fixed Capital Formation (Private)	Change in Inventories	Exports of Goods and Services	Imports of Goods and Services	Net Export	GDP Growth
1988	0.8	-0.1	-2.1	1.8	-1.9	2.9	-0.8	3.7	2.3
1989	-0.7	0.1	0.3	0.3	1.6	0.0	1.1	-1.2	0.3
1990	8.8	0.6	0.7	3.1	1.3	0.6	5.9	-5.3	9.3
1991	1.3	0.3	0.2	0.2	-2.9	0.5	-1.1	1.7	0.7
1992	2.3	0.3	0.4	0.8	1.6	1.9	2.2	-0.3	5.0
1993	5.8	0.4	0.3	6.2	1.2	1.4	7.7	-6.3	7.7
1994	-3.7	-0.3	-2.8	-2.0	-4.6	2.8	-5.9	8.7	-4.7
1995	3.9	0.5	-0.7	3.8	5.2	1.8	6.6	-4.8	7.9
1996	5.7	0.7	1.1	2.8	-2.3	4.9	5.5	-0.6	7.4
1997	5.7	0.3	1.5	2.9	-0.9	4.8	6.7	-1.9	7.6
1998	0.4	0.6	0.9	-2.1	0.9	3.4	0.8	2.6	3.2
1999	-1.7	0.5	-0.6	-4.0	2.0	-2.1	-1.2	-0.9	-4.7
2000	4.2	0.6	1.3	3.1	1.1	5.7	8.7	-3.0	7.3
2001	-6.2	-0.7	-1.6	-7.2	-4.0	2.4	-9.9	12.3	-7.5
2002	1.4	0.5	0.5	-0.8	7.1	4.3	5.1	-0.9	7.9
2003	4.2	-0.2	-0.7	2.6	3.0	6.3	9.4	-3.1	5.8
2004	6.4	0.0	-0.2	6.6	1.1	5.4	10.3	-4.9	9.0
2005	5.6	0.2	1.2	4.6	-2.5	3.8	5.5	-1.7	7.4
2006	3.4	0.7	0.0	3.9	-2.1	3.8	3.5	0.3	6.1

Source: Turkish Statistical Institute

Another aspect of the Turkish transformation is the incomparable productivity increase mainly thanks to reduced inflation. Productivity gains have been the main driving force behind the economic growth and enhanced its quality, and played a significant role in the strong growth performance. The contribution of total factor productivity to growth which was 3.3 percent on average in the 1989-2001 period rose to 42 percent in the 2001-2005 period (Saygılı et al., 2002, CBRT). Surging productivity has created an encouraging macroeconomic configuration and provided a healthy ground for direct investment. Labor productivity in the manufacturing sector rose by 41 percent in the 2001-2007 period (Figure 7). Structural reforms and the acceleration of productivity growth have also raised Turkey's potential growth rate which was about 4 percent to about 7 percent. In addition productivity gains restrained aggregate domestic demand and augmented the output gap. Hence the economy could grow without causing inflationary pressures.

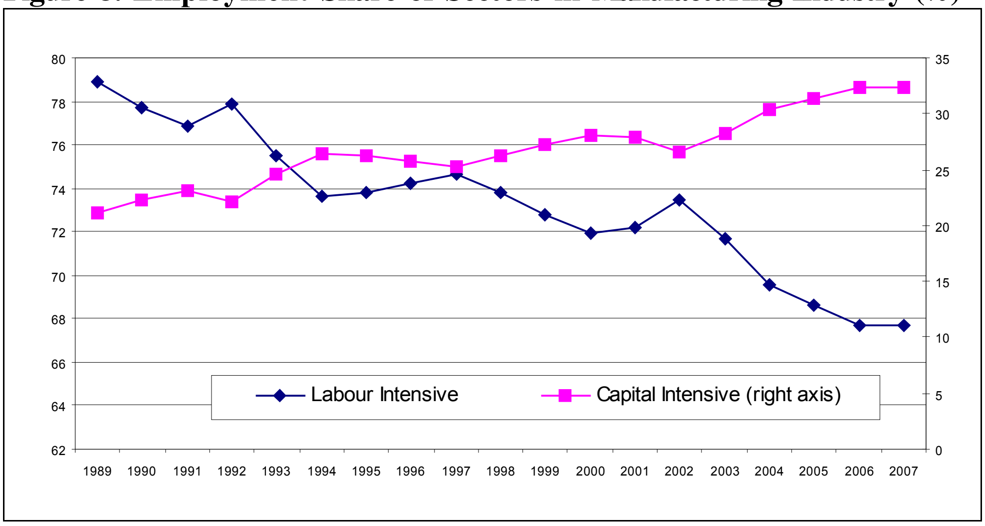
Figure 7: Productivity Increase



Source: Turkish Statistical Institute

The chronic macroeconomic instability had seriously distressed capital formation in the lost decade of the 1990s. Thanks to productivity improvement which contributed corporate profitability profit-maximizing firms' expectations about future revenues led them to increase their investments. As capital to labor ratio is increasing following the mechanism mentioned above, the composition of manufacturing industry changed in favor of capital-intensive sectors (Figure 8).

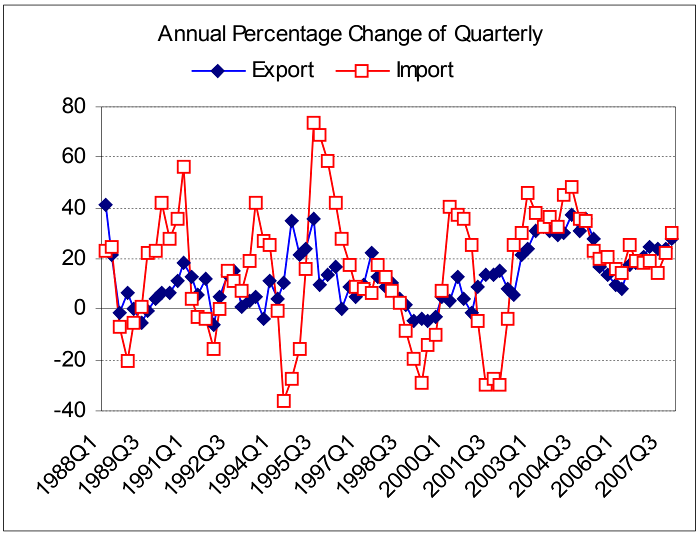
Figure 8: Employment Share of Sectors in Manufacturing Industry (%)

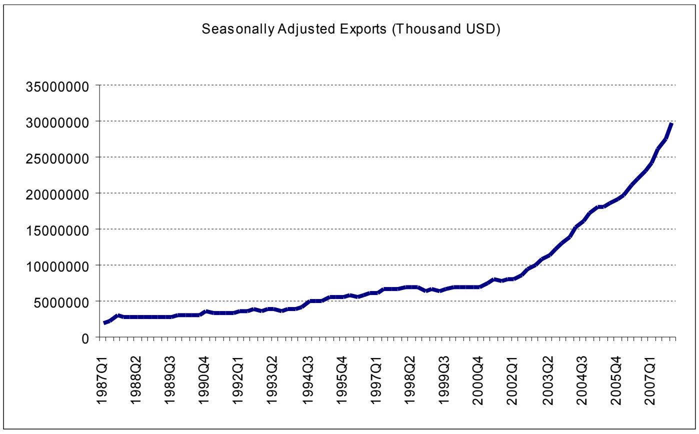


Source: Turkish Statistical Institute

Export performance was astonishing over the transformation period. Since prudent fiscal policies left very little room for disposable income growth, firms had to look for export opportunities and increased productivity provided a competitive improvement relative to the past. As a result, exports as of 2007 more than tripled compared with 2001. The increase in labor productivity has lowered unit labor costs and facilitated export-driven economic expansion in spite of almost continuous appreciation of Turkish lira and tough global competition. This is one of the patterns of 2002 transformation which differentiates it from, for instance 1980 reforms, when the high export performance was mainly due to the subsidies, especially the real depreciation of domestic currency. Exports did not only rise significantly but also volatility of foreign trade was reduced compared to previous periods. This constitutes evidence that foreign exchange stability attained through the transformation was not detrimental for exports contrary as it is often believed (Figure 9)

Figure 9: Foreign Trade Developments Between 1987-2007





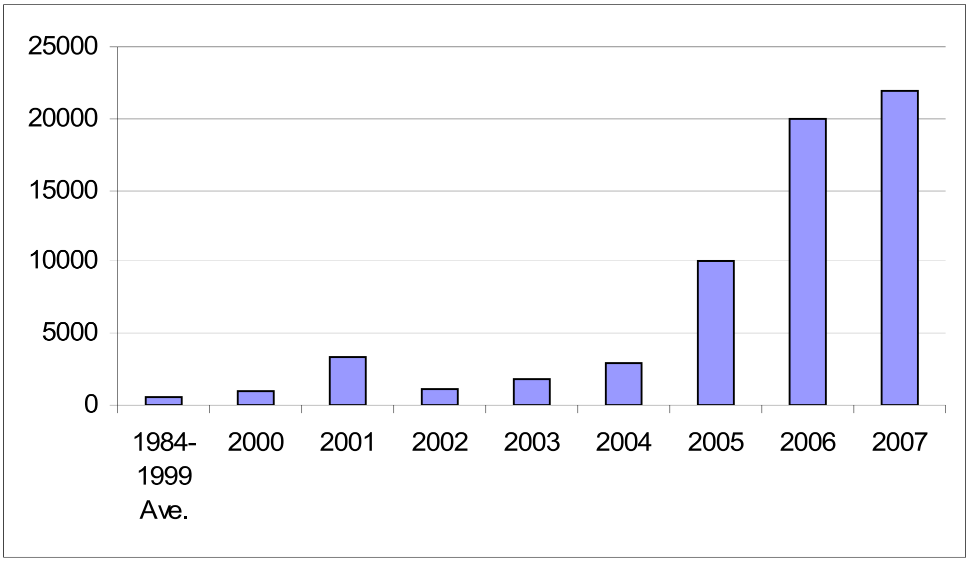
Source: Turkish Statistical Institute. CBRT

The accession process of Turkey to the EU was another anchor that provided support to the program. Even though there still exist many problems and it will take a considerable time for Turkey to become a full member of the EU, yet the accession itself has already contributed to institutional change and structural reforms by both serving as a concrete target to attain and a benchmark to satisfy. In addition, the EU membership target alleviates the acceptance of some reforms that would otherwise have been faced with keen resistance of social opposition. Institutional factors play a central role in determining a country's rate of economic growth. There exists a large and fruitful literature on this issue suggesting that it is the incentive structure imbedded in the institutional structure of countries that should be the key in explaining the growth differentials (North, 1990; North.

2003). Indeed, institutional constraints that promote distortionary policies and aggravate economic vulnerabilities are responsible for a significant part of cross-country differences in economic growth and output volatility (Acemoğlu et al., 2002). It is clear that sustainable growth and development depend on the existence of sound institutional arrangements. According to the neoclassical approach, institutions, through which market dynamics become operative, constitute the necessary condition to competition to function and thus “markets clear”. In fact, Turkish case shows that individuals and organizations with bargaining power, steaming from the old-fashioned rigid institutional structure have crucial stakes in preserving the system and hence impede institutional adjustments. Hence an external anchor such as the EU accession process actually helps by eliminating institutional inertia and reducing the cost of developing modern social configurations without a model.

Another fortunate development was seen in the composition of foreign capital inflows. As a result of stabilization and accession process, investment climate in Turkey improved and beginning from liberalization of foreign capital movements in late 1980s, for the first time the economy benefited from substantial amount of foreign direct investment and other long-term capital inflows (Figure 10).

Figure 10: Foreign Direct Investment Inflows (million USD)



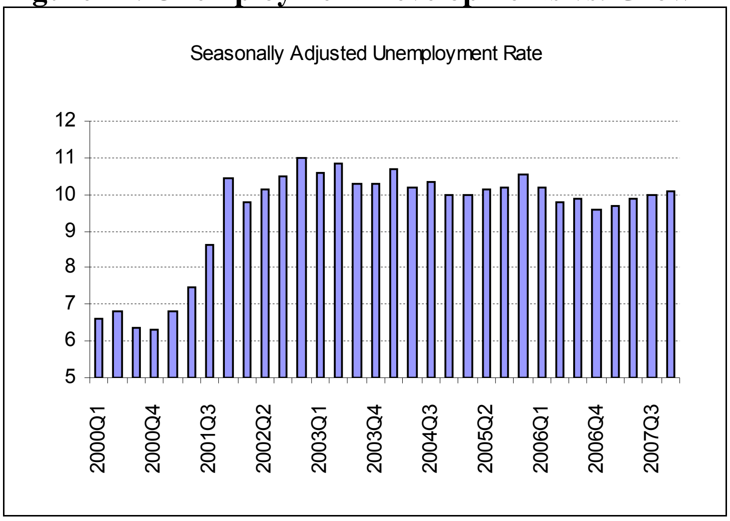
Mergers and Acquisitions (M&A) volume in the last five years reached to USD 75 billion while number of transactions was more than 650. Foreign investors’ transactions constituted more than 70% of the last three years’ volume and 80% of the last two years’ volume. Volume of transactions by private equity firms reached to USD 6.5 billion in the last three years. Popular sectors have been financial services (more than 85 deals) energy (around 50 deals) and food and beverage (more than 50 deals). Number of deals in 2007 was 162 whereas the total volume was USD 20.6 billion.

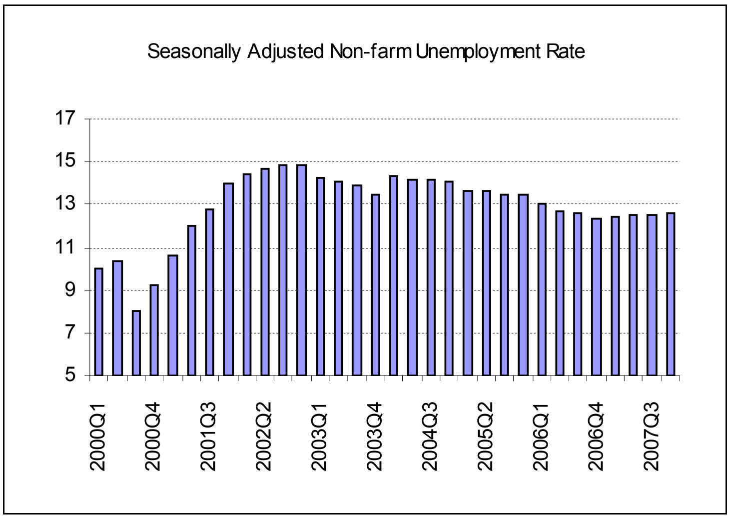
5.2. Costs of Virtue

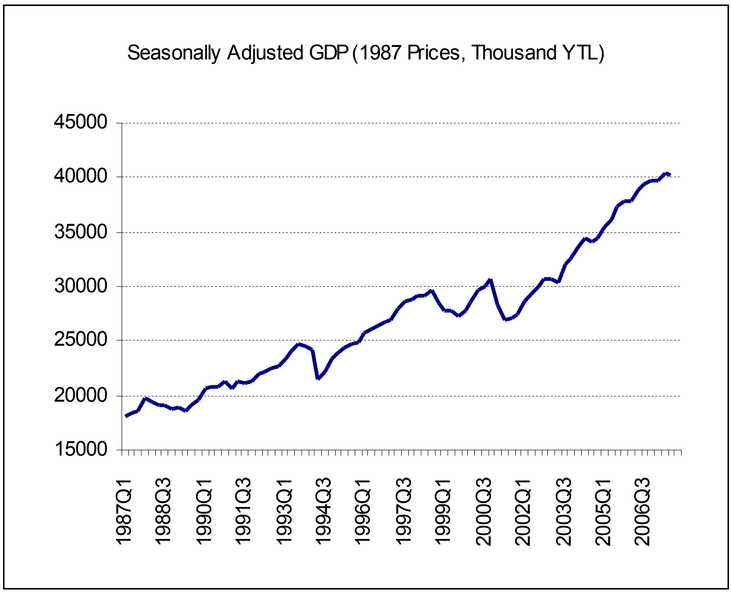
Turkey’s astonishing economic boom has been disappointing in terms of job creation. The extraordinary increase in real GDP reaching almost 50 percent in the last six years was not enough to absorb labour supply. Unemployment rate has been fluctuating around 10 percent, which is very high in every measure. The unusually prolonged period without sufficient job creation has caused a large number of young and mostly female workers to abstain from actively looking for work, and therefore to be excluded from the official unemployment measurement. When the fact that actual unemployment statistics fails to account such a “missing” labor force, the situation becomes more threatening. The reason of such a high unemployment is paradoxically nothing but the beneficial transformation of the economy.

Structural adjustments have inevitably caused that factors of production, including labor resources, have shifted from shrinking sectors to expanding businesses, which has been a costly and painful process for the workers whose skills have no longer been in demand. The agriculture sector, which was accounting for one third of the labor force, but only one eighth of GDP has been undergoing such a comprehensive restructuring. In order to achieve fiscal consolidation, agricultural subsidies, which used to play an important role in maintaining low productivity small-scale farms and curbing rural-urban migration, were cut. In turn, the reduction in subsidies has increased rural unemployment and triggered a movement of surplus labour from rural to urban areas, while the proportion of agriculture in the GDP came down from 18.0 percent in 1998 to 9.7 percent as of 2006. Another factor, which has a share in so-called “jobless growth”, has been public sector reform. The rule to replace no more than 50 percent of civil servants leaving through attrition and 10 percent of employees leaving state economic enterprises have led to a significant employment reduction in the public sector. Privatization and outsourcing efforts contributed to this downsizing further. Similarly, as the composition of manufacturing industry has shifted towards a more capital-intensive structure (Figure 8) and as productivity has become an indispensable element for success, some of the excess capacity sectors e.g. textile and clothing, whose labour absorption capacity was relatively high have lost their position. The competition arising from the global integration worsened the situation. As a result, not only the economy faced with a jobless growth, but also in such a prosperous period, Turkey could not improve its income inequality problem (Figure 11).

Figure 11: Unemployment Developments vs. Growth





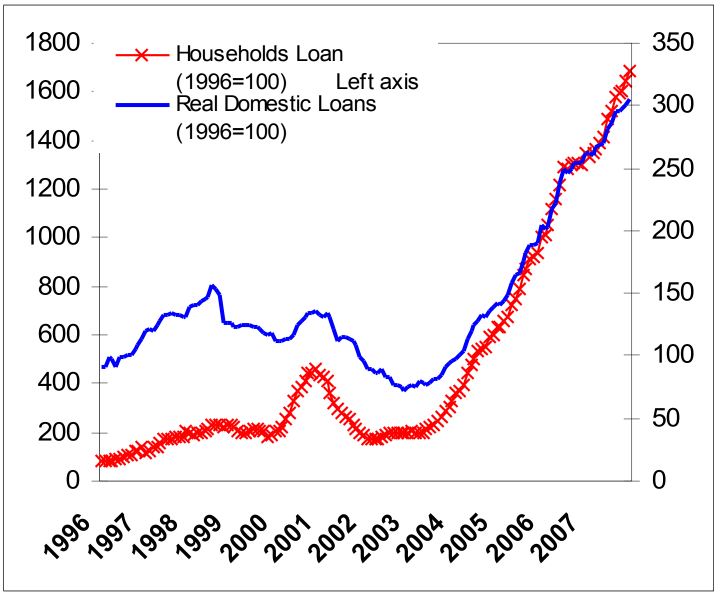


Firms, which had been operating under a high chronic inflation environment lost sensibility for productivity and adapted themselves according to unstable economic conditions. They developed a business model assuring their survival: lengthen the average turnover of payments, shorten the average turnover of receivables, and invest the residual into inventories. In addition even non-financial corporations became highly involved in foreign exchange and interest arbitrage. This business model was covering inefficiencies and leading to build excess capacities. As disinflation crystallized, economies of scales and cost efficiency became key factors to business success. However many firms, especially small and medium sized ones have found themselves in a very difficult situation since they were unable to reorient according to the new rules of the game. On the other hand, stabilization was increasing global integration as well, and this off course was heightening burden over again the same firms through the competition. With already diminished margins, traditional businesses neither could cope with global pressures nor could they find enough extra resources to invest for reformation of their firm.

Although floating exchange rate regime was supposed to make necessary adjustment in balance of payments, a real appreciation of domestic currency was observed for the period 2003- 2007 mainly due to increasing amount of foreign capital inflows attracted by the stabilization. As a result the deterioration of trade balance could not be prevented. There are several secular reasons for this deterioration, including substantial oil price hikes, which increased energy bill and very rapidly elevating commodity prices in global markets. Nevertheless, the stabilization program itself included a series of dilemma that worsened the situation. The combination of tight monetary policy and fiscal austerity offered significant rate of return while risk perception was reducing. During previous decades, borrowing for longer maturities was out of question. As stabilization was restored, and financial sector regained the function of intermediation, and volume of the loans to the real sector started to rise. Similarly, consumer loans, which were previously at very low levels compared with the international figures, rose drastically (Figure 12).

While foreign capital inflows were abundant, firms and households exploited this new opportunity to finance investment and consumption expenditures. Although interest rates were relatively reduced, the CBRT, whose main concern was the price stability, could not decrease interest rates further to limit capital inflows. As a consequence, on the one hand amount of loanable funds has risen and, on the other hand excess supply of foreign exchange has put an upward pressure on the value of Turkish lira against foreign currencies. Appreciation of Turkish lira in turn, was enlarging interest arbitrage opportunities to foreign investors and hence attracted more capital. This cycle, while stimulating import demand, has also caused private indebtedness to increase. Turkey has become "trapped by success" as this "virtuous cycle", which has made balance of payments vulnerable for sudden stops.

Figure 12: Credit Boom after the Crisis



Source: CBRT

6. Conclusion

Turkish economy has lived through three and a half decades of high and volatile chronic inflation, high degree of currency substitution, and low and unstable growth rates. Living with such weaknesses for such a long period of time has created a strong inertia in inflation dynamics, deteriorated financial system and caused to misallocations and misalignments. Previous attempts to reform the economy were lacking at least one of the two indispensable principles: providing public sector discipline and building a transparent and accountable institutional governance framework. Furthermore the celerity and agility needed for success of reforms could not have been attained. As a consequence, even if a relative improvement attained at the beginning in some cases, policy- makers could (or did) not resist to opposition and preferred to compromise. Hence although reforms started with ambitious targets, every failure left a negative mark in the collective memory of the Turkish society.

Table 3: Comparative Analysis of Reform Programs

	Structural Changes	Public Sector Discipline	Institutional Framework	Velocity
1980- 84 Program	•Opening of the economy •Liberalization	Missing	Poor	First rapid, then gradual
1994 Program	•Stabilization	Some, but not sustained	Poor	Gradual
1999 Program	•Stabilization •Banking reform	Aimed but not realized	Quite enough	Rapid (exchange rate, banking)
2002 Program	•Transformation of economy as a whole	Achieved	Comprehensive	Rapid

The stabilization program implemented in the aftermath of 2001 crisis included these principles and was brought into life very rapidly due to the urgency of the situation. In other words, for the first time both the horizontal (coverage, ingredients) and vertical (timing, velocity) dimensions of a program were appropriately fulfilled. All economic indicators show that the period after 2001 is structurally and significantly different compared with the previous decades. Productivity driven growth, the measure of fiscal consolidation, relative improvement in disinflation, changing composition of economic activity and integration of Turkish economy to the global markets should be considered as benchmarks of this successful transformation.

Turkish case provides evidence in favour of rapid reforms. As economic systems, thanks to the information and communication technologies, which make information available to all parties without much cost, are getting more sophisticated and dynamic and global integration is deepening at a growing pace, the expectations channel becomes the most effective one among all transmission mechanisms everywhere. The absence of trade-off between inflation and growth during the stabilization episode, even in the short term (in fact the contrary seems to be the case in Turkish example), should be considered as another evidence of the role played by expectations cannel. In order to achieve stabilization programs, policies should be design to manage expectations of economic units correspondingly. If the time interval is too long and the reform does not become effective rapidly, an asymmetry will emerge between those who can find a way to waive the costs of stabilization by adjusting their position easily and those who cannot. Some real costs are incurred on the agents who assumed the program's targets would be attained. Thus due to the free-rider problem, confidence will be totally lost, and consequently the program will fail. Moreover, once expectations have deteriorated, even if fundamentals are strengthened later, it will be not possible to convince economic units once again to behave appropriate to the program goals. Similarly, if there is an inconsistency in the program due to the probability of future discretionary policies, this fact will be taken into consideration by economic units during expectation building. After the 2001 crisis, the reforms were brought to full fruition very rapidly (e.g. fifteen legislation in fifteen days) and rule based policies assured confidence through transparent surveillance. In addition, floating exchange rate did not tolerate any incompliance with the promised schedule. So the program was implemented without compromise, excuses or delays, and the transformation worked successfully.

However, the success is not costless. Economic units, which have taken positions according to the parameters of old economic construction, are facing difficulties. Especially traditional businesses, small and medium size enterprises, and agriculture have been suffering from the adjustment. Normalization of the economy caused profit margins to shrink, real wage per unit of production to fall, competition to increase, and economies of scale to become key determinant of sustainability of businesses. In addition, real appreciation of domestic currency and increasing private indebtedness caused by the success of stabilization paradoxically generate vulnerability for sudden stops. Nevertheless compared with the costs of the instability reigned over for more than two decades and came very expensive, those are negligible and Turkish case provides evidence in favor of disinflation programs combined with sound fiscal policies in spite of some adverse effects in the short run.

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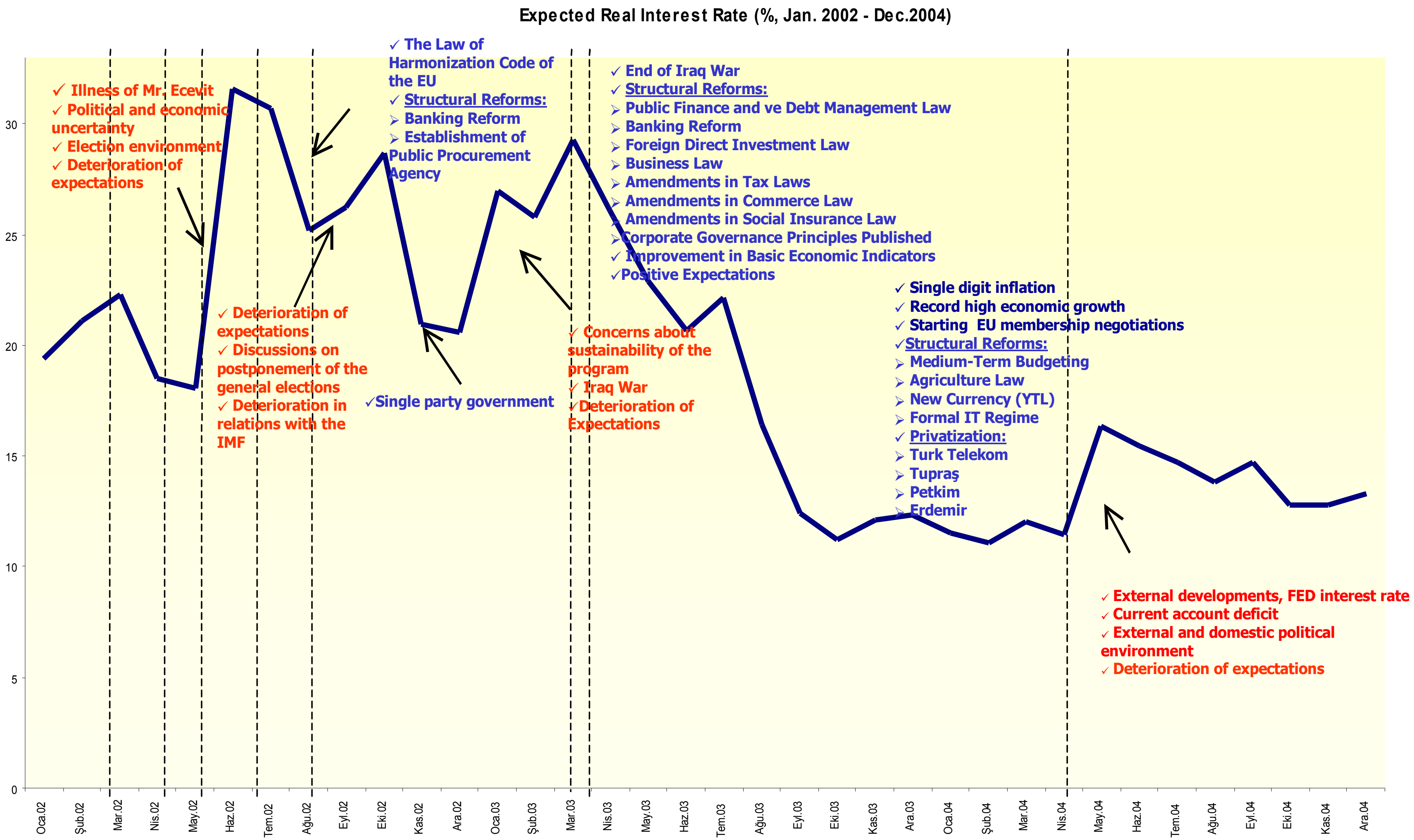
8. Appendix



Expected Real Interest Rate (%, Jan. 2002 - Dec.2004)
✓ Illness of Mr. Ecevit
✓ Political and economic uncertainty
✓ Election environment
✓ Deterioration of expectations
✓ Deterioration of expectations
✓ Discussions on postponement of the general elections
✓ Deterioration in relations with the IMF
✓ The Law of Harmonization Code of the EU
✓ Structural Reforms:
➢ Banking Reform
➢ Establishment of Public Procurement Agency
✓Single party government
✓ Concerns about sustainability of the program
✓ Iraq War
✓Deterioration of Expectations
✓ End of Iraq War
✓ Structural Reforms:
➢ Public Finance and ve Debt Management Law
➢ Banking Reform
➢ Foreign Direct Investment Law
➢ Business Law
➢ Amendments in Tax Laws
➢ Amendments in Commerce Law
➢ Amendments in Social Insurance Law
➢Corporate Governance Principles Published
✓ Improvement in Basic Economic Indicators
✓Positive Expectations
✓ Single digit inflation
✓ Record high economic growth
✓ Starting EU membership negotiations
✓Structural Reforms:
➢ Medium-Term Budgeting
➢ Agriculture Law
➢ New Currency (YTL)
➢ Formal IT Regime
✓ Privatization:
➢ Turk Telekom
➢ Tupraş
➢ Petkim
➢ Erdemir
✓ External developments, FED interest rate
✓ Current account deficit
✓ External and domestic political environment
✓ Deterioration of expectations
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