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9 Turkish Experience with Debt: Macroeconomic Policy and Performance

Merih Celâsun and Dani Rodrik

9.1 Policy Phases and Adjustment Patterns

Turkey was the first major developing country (LDC) debtor to face a payments crisis after 1973. Turkey's debt debacle began in mid-1977, before the second oil shock of the late 1970s. Indeed, Turkey's debt reschedulings prior to 1982 were the largest ever undertaken, and accounted for nearly 70 percent of the total volume of debt renegotiated by all LDCs in the 1978–80 period. Despite this massive restructuring of debt, Turkey experienced an agonizing foreign exchange crisis from 1978 to 1980. In early 1980, in an unexpectedly bold fashion, Turkey launched an outward-oriented adjustment program which produced an export-led recovery and an acceptable degree of creditworthiness by 1982–83, just as the LDC debt crisis started to dominate the headlines.

Against the backdrop of such anomalous characteristics, Turkey has been informally referred to as "the Baker Plan country before the Baker Plan." The Baker Plan (in October 1985) called for intensive, market-based micro-level domestic adjustments in return for expanded international lending to the problem debtors. In recent years, the multilateral lending institutions have increasingly stressed trade and financial liberalization in their programs for LDCs with debt-servicing difficulties. Together with the well-known cases of the export-oriented East Asian economies, Turkey's recent adjustment experience is often cited by the international financial community as a successful reference case for the approach currently promoted in the management of the LDC crisis.

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In the design of adjustment programs for major debtors, a set of common questions arise as to the appropriate timing and magnitude of external financing, the proper mix and sequencing of domestic policies, and the nature of social costs likely to be faced in the transition process. Our forthcoming monograph on the Turkish experience (see the country studies volumes of this project), on which the present chapter draws, aims to provide a balanced account, intended for generalized assessments as well as for policy evaluations specific to Turkey.

Our approach is essentially ex post and empirical, and we do not offer economic projections or explicit recommendations for future policy actions. The underlying objective of the study is to contribute to an improved understanding of foreign borrowing and of policy-performance linkages in the Turkish economy in the face of the external disturbances of the post-1973 period.

9.1.1 Background

In its recent history, Turkey faced foreign exchange stringency at three junctures: in 1957–58, 1969–70, and 1978–80. Each episode involved IMF-supported programs involving stabilization with devaluation. Domestic political difficulties and unrest were heightened at each instance, paving the way for military interventions in 1960, 1971, and 1980, mainly on grounds of restoring law and order. The payments difficulties were relatively mild in 1969–70, as was the partial military intervention in 1971, which did not result in the dissolution of the existing Parliament. The military takeovers of 1960 and 1980 were more complete, however, resulting in the adoption of new constitutions (in 1961 and 1982). At each stage, the military interventions were transitional and brief. They were terminated with multiparty parliamentary elections and the formation of civilian governments.

With the institutionalization of formal planning in the early 1960s, Turkey pursued its development efforts in the context of five-year plans, which gradually lost their policy effectiveness in the post-1973 period. During the initial two plans (1963–67 and 1968–72), GNP growth averaged around 6.8 percent per year with relative price stability and moderate reliance on external assistance (amounting to about 1.5 percent of GNP per year). The planning techniques in this period made heavy use of a restrictive trade regime, state enterprise investments, and financial repression as key institutional tools in achieving the import-substituting industrialization objectives.

9.1.2 The 1970s: Debt Crisis and Lack of Adjustment

For the Turkish economy, the 1970s were the best of times and the worst of times. The decade witnessed an unprecedented spurt of investment and growth until about 1977, accompanied by what looked like a steady improvement in income distribution. This was followed by a crash that was equally unprecedented. From mid-1977 on, Turkey found itself in a monumental debt crisis which took several years of intricate negotiations with creditors and a long series of rescheduling agreements to resolve. Growth suffered heavily, with two years of real contraction at the end of the decade; income distribution began to turn against urban workers and the peasantry.

With hindsight, it is not too difficult to provide a broad interpretation of the Turkish experience prior to 1977. The early years of the decade had been a time of great optimism as the perennial external constraint appeared to have been permanently relaxed, thanks largely to a rapid rise in workers' remittances. As table 9.1 shows, the current account was actually in surplus for two years in a row in 1972 and 1973. Partly as a consequence, the public sector went on an investment binge shortly thereafter, and encouraged the private sector to follow suit. As the share of investment rose from 18.1 percent of GDP (in 1973) to 25.0 percent (in 1977), the real growth rate of the economy reached its zenith at 8.9 percent (in 1975 and 1976).

There were two problems, however. First, all of this was taking place in the context of the fourfold rise in world oil prices. Second, the government succumbed to all of the usual policy pitfalls: price distortions including overvalued exchange rates, large public sector deficits, and an accommodating monetary stance. These helped swing the current account sharply into deficit, moving it from a surplus of $534 million in 1973 to a deficit of $3,431 million in 1977. The current deficits were financed by external borrowing, much of it short term.

Table 9.1 Macroeconomic Performance of Turkey During the 1970s

	Real GDP Growth (%)	Inflation Rate (WPI) (%)	Current Account Balance ($ mill.)	Investment (% of GDP)
1972	6.0	18.0	47	20.1
1973	4.1	20.5	534	18.1
1974	8.8	29.9	−662	20.7
1975	8.9	10.1	−1,889	22.5
1976	8.9	15.6	−2,286	24.7
1977	4.9	24.1	−3,431	25.0
1974–77	7.3	19.9	−2,067	23.2
1978	4.3	52.6	−1,595	18.5
1979	−0.6	63.9	−1,203	18.3
1980	−1.0	107.2	−3,304	21.4
1978–80	0.9	74.6	−2,034	19.4

Sources: State Institute of Statistics, State Planning Organization, and the Central Bank.

As foreign lenders started getting jittery at the beginning of 1977, the stage was set for a debt crisis. New flows slowed down to a trickle, and the Central Bank's depleted reserves forced it into arrears on payments to foreign banks, governments, and export suppliers. The consequent foreign exchange shortages led to a forced reduction of the current account deficit by administrative means, the collapse of investment and growth, and an upsurge of inflation (see table 9.1). The next few years witnessed a series of debt renegotiations with creditors.

What were the sources of this debt debacle? Conventional wisdom stresses the adverse external environment, misguided exchange rate and fiscal policies, and the short-term nature of the liabilities incurred during the 1973–77 period. But there must have been more at work. Until the debt crisis of 1982, Turkey's debt problems were among the most severe experienced by the postwar international system. Unlike practically all of the other newly industrializing countries experiencing debt difficulties, Turkey got into trouble after the first oil shock, rather than the second one. This suggests, prima facie, that the usual explanations of the crisis—in terms of a combination of external shocks with a number of key inappropriate domestic policies such as overvalued exchange rates and a lax monetary and fiscal stance—at best will go only part of the way in explaining its origins. In comparative perspective, the external shocks experienced by Turkey were not particularly severe; nor were the Turkish macroeconomic policies excessively distorted. It is likely that these policies would have gotten Turkey into trouble eventually. But we have to look for additional reasons why Turkey's crisis occurred sooner rather than later.

The precocious nature of Turkey's debt crisis is best explained by reference to the borrowing "strategy" in place. Between 1975 and 1977 Turkey relied on a form of foreign borrowing with intrinsically destabilizing features. To attract capital inflows, the authorities depended disproportionately on the so-called convertible Turkish lira deposit (CTLD) scheme, whose key feature was that it protected domestic borrowers from all exchange risk. This exchange guarantee acted as a subsidy on foreign borrowing by the private sector, as the domestic currency was already perceived to be overvalued by the beginning of 1975. More important, it rendered the implicit subsidy an increasing function of the expected depreciation of the Turkish lira.

The resulting borrowing was heavily biased toward the "strong" currencies (predominantly the deutsche-mark and the Swiss franc) with low nominal interest rates. As borrowing increased and the current account deteriorated, there was increased anticipation of further depreciation of the domestic currency. That in turn raised the implicit subsidy on foreign borrowing, giving rise to even greater incentives to borrow. Hence the CTLD scheme had the fatal flaw of engendering an ever-expanding spiral of over-borrowing by the private sector. According to our calculations, the marginal cost of foreign funds (denominated in D-marks) was at least 20–25 percent towards the end of 1976, implying a real interest-rate burden of around 16–21 percent. Borrowing went on, since domestic borrowers paid only a fraction of this cost, with the rest effectively socialized under the exchange guarantee.

Consequently, even though the counterpart to the current deficits of the period was, in an accounting sense, an investment boom by the public sector (see table 9.2), it is hard to envisage that this could have justified foreign borrowing at such terms. The boom was sustainable only to the extent that foreign banks were willing to increase their exposure to Turkey at an ever-increasing pace. Once foreign banks slowed their lending, the edifice collapsed.

The crisis developing in mid-1977 threw Turkey into a period of forced adjustment. As foreign exchange sources dried up, external balance for the first time in many years became a genuinely binding constraint, requiring an adjustment in the relationship between income and absorption in the economy. How was this adjustment achieved? Policy itself was of little help. The IMF was called on to administer a series of stabilization programs, and two sets of adjustment measures were announced, one in early 1978 and the other in 1979. But both

Table 9.2 Investment-Saving Balance and Growth of Real Expenditures, 1973–77

	1973	1974	1975	1976	1977
			(percent of GNP)		
Investment	18.1	20.7	22.5	24.7	25.0
Private	11.1	10.0	10.3	13.1	11.9
Public	7.0	10.8	12.2	11.6	13.1
Domestic Savings	20.3	18.4	17.4	19.3	18.0
Private	11.6	11.0	8.5	11.2	11.7
Public	8.8	7.4	9.0	8.1	6.4
Foreign Savings	2.2	2.3	5.0	5.4	6.9
Sectoral savings – Investment balances					
Private	0.5	1.0	−1.8	−1.9	−0.2
Public	1.8	−3.4	−3.2	−3.5	−6.7
Total	2.3	−2.4	−5.0	−5.4	−6.9
			(percent)		
Growth of real expenditures[a]					
Private	3.7	7.3	7.4	9.6	2.7
Public	7.4	10.3	20.2	12.5	9.0
Total	4.5	7.9	10.0	10.2	4.2

Sources: State Planning Organization.

[a]Excluding expenditures on inventories.

programs, as well as the two corresponding IMF standby arrangements, proved unsuccessful. Until January 1980, the various adjustment measures undertaken by the authorities can be described as "too little, too late." The reduction in government spending was only half-hearted, and exchange rate policy, albeit more active, lagged behind rising inflation. The policymakers were too conscious of political support to administer radical shock treatment, and too divided to implement any feasible alternative.

The burden of achieving the requisite adjustment fell on investment and inflation (see table 9.1). Between mid-1977 and early 1980, a collapse in investment and an inflationary spiral were the key mechanisms for ensuring that the external constraint was met. In the absence of sufficient reduction in nominal expenditures, and of real exchange rate depreciations, absorption could be brought in line with the available resources only by engineering inflation. It was inflation that equilibrated the open-economy income identity by closing the gap between ex ante demand and supply.

9.1.3 The 1980s: Adjustment Policies and Stabilization

In conjunction with inner-oriented expansionary macroeconomic policies, the largely unnoticed buildup of price distortions in 1973–77 had produced not only a stagnation in exports, but also a rapid rise in the intensity of imports in production, resulting in a negative import-substitution as a source of growth at the aggregate level. Against the background of import and output contraction, commodity shortages and hoarding, and strained relations with the international financial community during 1978–79, the newly installed minority government of Süleyman Demirel was persuaded to introduce a comprehensive package of policy measures in January 1980. The policy package was unexpectedly bold in terms of its anti-inflationary measures as well as its qualitative aspects, which gave clear signals of a greater export- and market-orientation in the development strategy.

As shown in table 9.3, the macroeconomic and trade performance has been quite remarkable since then, especially in a generally unfavorable world economic environment. Following the contraction of output in the first year of the policy package, GNP growth has averaged around 4.6 percent per year (in 1981–85), accompanied by sharp rises in trade ratios. In value terms, merchandise exports have increased from around \$2.3 billion in 1979 to \$8.3 billion in 1985 with the share of manufactured products going from 35 to 75 percent in the same period.

The reduction in the rate of inflation from about 105 percent in 1980 to 28 percent in 1983 was a substantial one, even though inflationary pressures intensified in 1984–85. After declining 20 percent in 1977–

Table 9.3 **Macroeconomic Performance, 1980–86**

	1980	1981	1982	1983	1984	1985	1986[a]
A. % Annual Increase							
1. Real value added GNP	−1.1	4.1	4.5	3.3	5.9	5.1	7.8
Agriculture	1.7	0.1	6.4	−0.1	3.5	2.4	7.1
Manufacturing	−6.4	9.5	5.4	8.7	10.2	5.5	10.2
2. Real expenditure[b]							
Private	−6.3	−0.3	4.3	4.7	5.9	4.0	8.4
Public	2.0	5.2	2.1	1.5	2.3	8.9	9.0
Total	−4.7	0.8	3.8	4.0	5.2	5.0	8.6
3. Employment	−0.1	0.9	0.9	0.7	1.3	1.1	2.1
4. GNP deflator	103.9	41.9	27.4	28.0	49.8	43.6	32.8
5. Terms of foreign trade ($)	−22.8	−9.4	−4.6	−1.4	12.9	1.1	
B. Trade Ratios (% of GNP, current prices)							
1. Exports of goods (fob)[c]	5.0	8.0	11.0	11.6	14.7	15.6	12.9
2. Exports of goods and services (XGS)[d]	6.3	10.2	14.8	15.6	19.4	21.5	18.4
3. Imports of goods (cif)	13.6	15.2	16.5	18.1	21.4	21.9	19.1
Oil	6.6	6.6	7.0	7.2	7.3	6.8	3.9
Nonoil	7.0	8.6	9.5	10.9	14.1	15.1	15.2
4. Current deficit (after debt relief)	5.5	3.5	2.2	4.1	2.8	1.9	2.2
C. Monetary Parameters							
M1/MB (money base)	1.5	1.2	1.1	1.2	0.8	0.7	
M2/MB	1.8	2.0	2.2	2.1	1.9	1.9	
GNP/MB	9.3	8.0	7.4	7.3	6.7	6.4	
GNP/M1	6.3	6.7	6.5	5.9	8.1	8.6	
GNP/M2	5.0	4.0	3.4	3.5	3.5	3.4	
M2/Domestic credits	0.7	0.8	1.0	1.0	1.2	1.2	

(continued)

Table 9.3 (continued)

	1980	1981	1982	1983	1984	1985	1986[a]
D. Domestic Credits (%)[e]		100	100	100	100	100	100
by: Deposit money banks		59	64	66	70	72	77
Investment banks		13	12	13	13	11	8
Central bank		28	24	21	17	17	15
to: Public sector		48	40	37	32	28	29
Treasury		14	13	12	10	12	11
Public enterprises		34	27	25	22	16	18
Private sector		52	60	63	68	72	71
E. External Debt							
Debt stock ($ billion)		16.9	17.9	18.4	21.3	25.3	31.2
Of which short-term		2.2	1.8	2.3	3.2	4.8	6.9
Debt/GNP		0.29	0.33	0.36	0.42	0.48	0.53
Debt/XGS		2.80	2.22	2.31	2.18	2.22	2.79
Debt service/XGS		0.30	0.31	0.32	0.28	0.32	0.38
Net resource transfer/GNP		0.01	−0.007	0.003	−0.007	−0.02	−0.007

Sources: State Planning Organization and Central Bank of Turkey.

[a]Provisional estimates (March 1987).

[b]Real domestic final expenditures, excluding inventory changes.

[c]Includes transit trade.

[d]Excludes workers' remittances.

[e]Net of Central Bank advances to the banks.

79, private fixed investment further dropped around 26 percent in real terms during 1980–1982. Thus, the output increase came essentially from the existing productive capacity, which responded to the increased availability of the imported inputs, and from expenditure-switching policies of the new program.

A number of special factors have played an important role in Turkey's economic recovery since 1980. Among these, the most salient ones were (i) the transitional military rule from 1980 to 1983, which provided continuity and added political clout in the policy process; (ii) sizable debt relief and new lending; (iii) special market conditions in the Middle East affected by the Iran-Iraq conflict in the Persian Gulf; and (iv) substantial downward flexibility of real wages and agricultural prices, which made it possible to attain a new set of equilibrium prices and conditions more compatible with macroeconomic stability and increased trade-orientation in the economy. As shown in table 9.4, debt relief and new external credits were very sizable, obviating the need to generate surpluses in the noninterest current account in the earlier years of the program (unlike the situations faced by the Latin American debtors in the post-1982 period). An effective policy dialogue with the IMF (initially involving a three-year standby agreement of SDR 1,200 million) and the World Bank (providing five SAL's totaling $1.6 billion in addition to regular project lending) facilitated debt relief agreements, concessional bilateral lending, and all-around creditor support during the 1980–85 period.

Policy Sequence

The adjustment program of the 1980s proceeded in discernible stages. The immediate policy objectives of the first stage (1980–81) were to restore an acceptable degree of macroeconomic stability, to relieve shortages of essential commodities, and to induce an export-oriented recovery in output. Regaining public confidence by eliminating hoarding and parallel markets was perceived as a prerequisite for the subsequent structural components of the program.

The initial policy package of January 1980 contained a steep devaluation (exceeding IMF expectations), deregulation of private-sector industrial prices, and huge price hikes for the state economic enterprise (SEE) products and services (ranging from 45 percent for gasoline to 300 percent for paper and 400 percent for fertilizer against the backdrop of 70 percent inflation). The package contained supplementary incentives for export promotion and simplified administrative procedures for imports. The first significant but still partial change in the import regime came in January 1981 with the elimination of the quota list (with all items not shown in the liberalized lists for imports remaining prohibited). In June 1980, bank interest rates were substantially

Table 9.4 **Financing the Current Account, 1980–86 ($ million)**

	1980	1981	1982	1983	1984	1985	1986 (provisional)	1980–85 ($ billion)	%
Part A: After Debt Relief									
Interest payments	−668	−1,184	−1,465	−1,441	−1,586	−1,753	−2,134	−8.1	
Noninterest current account	−2,270	−485	630	−387	179	740	606	−1.6	
Current account balance	−2,938	−1,669	−835	−1,828	−1,407	−1,013	−1,528	−9.7	
Part B: Before Debt Relief									
Current account balance	−3,408	−1,919	−935	−1,898	−1,407	−1,013	−1,528	−10.6	−100.0
Nondebt financing	−475	−100	−229	−62	150	298	−169	−0.4	−4.0
Direct foreign investment	18	95	55	46	113	95	125	0.4	4.0
Changes in reserves	−512	−263	−297	−269	208	−20	−545	−1.2	−10.9
Counterpart to valuation changes	19	68	13	161	−171	223	251	0.3	3.0
Net foreign borrowing	3,883	2,019	1,164	1,960	1,257	715	1,697	11.0	104.0
Long-term (LT)	2,194	1,165	1,030	303	1,046	−20	525	5.7	54.1
Debt relief (interest + principal)	1,450	850	750	1,000	580			4.6	43.8
Other LT (net)	744	315	280	−697	466	−20	525	1.1	10.3
IMF (net use)	422	268	129	117	−142	−103	−241	0.7	6.5
Implied short-term	1,267	586	5	1,540	353	838	1,413	4.6	43.4
Memo items									
Debt repayment (LT, after relief)	−586	−620	−952	−1,066	−1,104	−1,858	−2,145	−6.2	
Debt service (after relief)	−1,254	−1,804	−2,417	−2,507	−2,690	−3,611	−4,279	−14.3	
Net resource transfer	2,745	577	−401	139	−329	−1,038	−437	1.7	

Sources: Central Bank of Turkey, IMF, and OECD. The present data partly reflect the latest available figures provided in the 1986 Annual Report of the Central Bank.

Note: Based on the revised presentation of the balance of payments.

deregulated, resulting in sharp rises in rates for time deposits and nonpreferential credit to borrowers. A firm signal for the maintenance of a realistic exchange rate policy was given initially through frequent mini-devaluations, and from May 1981 on by daily adjustments. By the end of 1981, an export-driven output recovery had begun, accompanied by a substantially depreciated currency and a sizable reduction in the rate of domestic inflation.

The second stage of the program (in 1982–83) strove to consolidate the conditions for macroeconomic stability, and to maintain the relative price realignment as of the end of 1981. During this stage of policy consolidation, no major moves were made towards the further liberalization of domestic and external markets. Institutional measures produced some helpful results in areas such as external debt management, establishment of a new framework for the small and ineffective securities market, and income tax changes aiming at supply-side responses. However, the tax reform resulted in the reduction of the tax/GNP ratio from 19 percent in 1981 to 17 percent in 1983 as it offset the bracket creep of the previous inflationary period.

The financial liberalization process initiated by the flexible interest rate policy was not followed up with sufficient care and expertise. Turkey faced a major crisis in mid-1982 with the collapse of brokerage firms that had been involved in highly risky credit transactions and corporate bond trading. The crisis led to the replacement of the top economic team, a relaxed monetary stance, and a somewhat reduced official enthusiasm for outward orientation.

The third stage (from November 1983 on), under the civilian government of Turgut Ozal, featured a deeper liberalization of the current and capital accounts of the balance of payments. Although far from being a neutral trade regime, the new trade policy framework provides an unprecedented openness to the Turkish economy on merchandise trade and invisible transactions. A novel feature of the import component of the new trade regime is the presence of a negative list, which explicitly indicates the prohibited import items. The pre-1984 import regimes had contained only positive lists (subject to varying degrees of liberalization), beyond which all imported items were prohibited. Thus, the removal of the quantitative restrictions (QRs) was significant in the trade reform moves of early 1984. Tariffs and other levies on imports have also been reduced, but they have been subject to frequent revisions by the authorities.

The post-1983 government introduced additional policy changes, mainly in the area of fiscal management. Further measures also have been taken to strengthen the bank supervision system and to allow foreign commercial banks to enter Turkey's financial market. Following the reactivation of syndicated borrowing from the international market in 1982, local commercial banks have been increasingly allowed by the authorities to utilize short-term credits and foreign exchange deposits in their trade-financing operations. The external debt stock has climbed from $18 billion in 1983 to $31 billion in 1986, reflecting in part the appreciation of the major European currencies against the U.S. dollar since early 1985. As a result, and with the termination of debt relief in 1984, Turkey's debt servicing burden has increased substantially in the last few years (see section E in table 9.3)

Interpreting the Post-1980 Adjustment

How do we interpret the relatively successful adjustment of the Turkish economy in the post-1980 period? It seems clear that the radical changes in the structure of relative prices, and the attendant shifts in patterns of income distribution, were the key internal mechanism for reducing inflation and initiating export-led recovery. Figure 9.1 displays the drastic transformation in the relative price structure after 1978. While the prereform period (1978–79) had already set some of these changes in motion, particularly the decline in real wages and in agriculture's terms of trade, the policies of the 1980s consolidated and accentuated them. The net effect was a substantial increase in the profitability of the traded manufactures sector, and a sharp reduction in labor and farmers' incomes. On the whole, these also implied an improvement in the terms of trade of the public sector vis-à-vis the private sector, which proved to be the key to the reduction of real private expenditures. Hence, these relative price changes not only

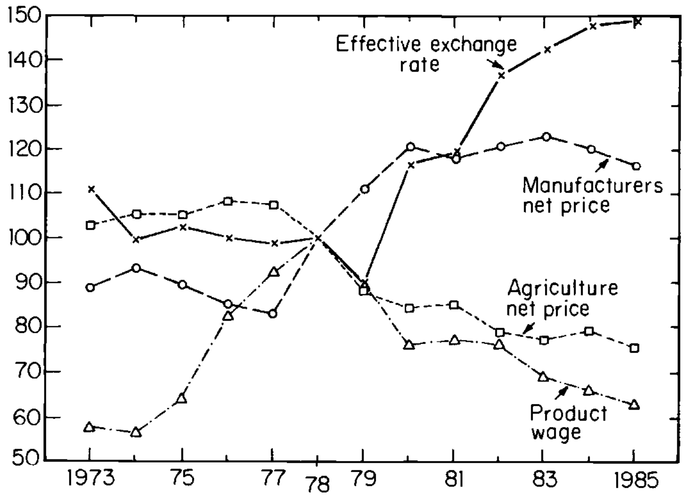

Fig. 9.1 Selected real prices (1978 = 100)

resulted in expenditure switching, in the conventional manner, but were also instrumental in reducing absorption.

In combination with wage repression and lower support prices for agriculture, these relative price changes have been engineered mainly by SEE price increases, exchange rate depreciation, and switching to positive rates on bank deposits. The restructured price system sharply favored the public sector, increased the share of SEEs in public savings, and lowered the dependence on Central Bank financing. In turn, the share of private disposable income in GNP declined at constant prices. Besides promoting expenditure-switching towards exports, the relative price and income shifts thus contributed to reductions in current absorption and public sector deficits, particularly during the 1980–82 period. In the absence of a significant additional tax effort, the burden of adjustment in the public sector fell mainly on subsidies, employee salaries, and current social expenditures as the government strove to sustain public employment and fixed investments in infrastructure sectors.

With the adoption of the policy of positive real rates on time deposits, the income velocity of broad money (M2) was gradually lowered from 5.0 in 1980 to 3.4 in 1985. Besides favorably affecting the expansion of financial intermediation in the economy, the positive deposit rates have served to increase the availability of bank credit to finance working capital, albeit at sharply increased bank-loan risks and real user costs. In the presence of reduced but still large public sector deficits, the high interest rates have contributed to private net savings mainly through lower private business investment rather than through higher savings rates in the private sector.

That these sharp changes in relative prices could be maintained is in no small measure due to the special political circumstances of the period. The military regime of 1980–83 was in the comparatively rare position of enjoying broad popular support as it restored law and order, which had been severely lacking before September 1980. In addition, debt relief and capital inflows reduced the magnitude of the requisite fiscal retrenchment.

9.2 Aspects of Debt and Adjustment

9.2.1 External Borrowing, Wage Flexibility, and Trade-Liberalizing Devaluations: A General Equilibrium Analysis (1978–83)

A comparative study of the Turkish adjustment efforts in 1978–79 and 1980–83 brings out the important roles of the trade adjustment mechanism and of the macroeconomic context in a semi-industrial country facing disturbances from the external environment. The 1978–

79 episode reveals that import compression by means of quantity rationing (serving as the trade adjustment mechanism) has a limited effectiveness in maintaining a modicum of growth in a heavily import-dependent and structurally rigid economy, especially under lax demand management.

In turn, the post-1980 experience shows the feasibility of resuming outward-oriented expansion under a gradually liberalized trade regime supported by timely external assistance, an improved macroeconomic setting, and adequate shifts in relative prices and incomes. The Turkish case also suggests, however, that the required changes in relative prices and income distribution may be quite pronounced in an economy characterized by structural rigidities and distortions. In the context of such policy concerns and research issues, our longer monograph summarizes the findings of a general equilibrium analysis with a computable multisectoral model calibrated to observed 1978–83 data.

Our counterfactual simulations explore the economy-wide effects of trade-liberalizing devaluations (which aim at reduced levels of quantity rationing of nonoil imports) under varying sets of urban wage policies and predetermined limits on external borrowing. The simulations demonstrate and quantify the high marginal productivity of external borrowing and the growth-supporting role of the downward flexibility of real wages under the economic conditions of Turkey prevailing in the early 1980s.

9.2.2 Trade Regime and Export Performance

It is possible to recast the Turkish experience with external debt in terms of a narrative exclusively involving trade flows. In such a case, the rapid accumulation of debt in 1973–77 would be seen as the consequence of rising imports with stagnant exports. In 1978–79, the economy could be seen as in a tailspin with imports collapsing. The recovery after 1980 would be the result of a phenomenal increase in exports, which allowed a revival in imports. To be sure, such a perspective is seriously misleading, since it focuses on trade alone. The accumulation of external debt and its servicing are both clearly macroeconomic phenomena. These two are fundamentally linked to the relationship between aggregate expenditures and national income. As such, the various microeconomic measures comprising a country's trade regime play a somewhat secondary role. Nonetheless, Turkey's case demonstrates that the kind of import dependence and structural rigidity fostered by import-substitution policies render adjustment to a payments crisis much more painful. The extent to which an economy is export oriented makes a big difference to the ease with which a given stock of foreign debt can be serviced, and is therefore an important indicator of creditworthiness. Here too, the post-1980 Turkish experience is exemplary.

In view of the rather miraculous export performance since 1980, it is important to gauge the relative contributions of the various factors at work. A rough statistical decomposition of the increase in the volume of exports between 1979 and 1984 yields some interesting results. The bulk of the increase turns out to be accounted for by a dummy variable for 1981:II, which alone "explains" 58 percent of the difference between the actual and counterfactual levels of exports in 1984. The real exchange rate depreciations since 1979 "explain" 30 percent of the increase in exports, and the reduction in exchange rate volatility another 7 percent, bringing the total contribution of exchange rate policy to 37 percent. The slowdown in industrial countries, on the other hand, has made a negative contribution of 12 percent.

It is rather surprising that exchange rate policy has played such a moderate role in view of the vast real depreciations achieved since 1980. Also, the predominant role of the dummy variable points to a significant upwards shift in export supply or export demand (or both) during 1981. It is tempting to ascribe this effect to the Iran-Iraq war, as a boom in exports to these two countries started during 1981. In addition, a non-negligible share of the increase in exports after 1980 turns out to have been the result of a statistical fiction: To take advantage of generous export subsidies, domestic entrepreneurs appear to have changed their invoicing practices from mild underinvoicing to substantial overinvoicing (at an average rate of 13 percent during 1981–85 in exports to the OECD). Finally, the depressed state of private investment throughout the first half of the 1980s suggests that very little export-oriented structural change has taken place in fact, with the bulk of exports coming from increased capacity utilization.

9.2.3 Public-Sector Financial Management

In comparative perspective, two aspects of Turkish fiscal policy stand out. First, as argued above, large fiscal deficits were not the ultimate cause of the debt crisis of 1977. In an accounting sense, of course, the growing current account deficits had their counterpart in a deteriorating fiscal balance. Whatever danger that may have implied over the longer run, the timing of the crisis was determined instead by the dynamics of debt itself. Under the convertible lira scheme, the capital account was set on an unsustainable course of ever-increasing foreign borrowing. Hence, the Turkish case may represent one instance where it may make sense to reverse the usual causality, and to ascribe the fiscal deficits to increasing debt rather than the reverse. The public sector acted as a vacuum; foreign inflows kept coming in.

The second important aspect is that fiscal policy has played only a moderate role in the adjustment process of the 1980s. While the reform in pricing policies in agriculture and state enterprises has served to enhance public savings, foreign official assistance in the early years of the recovery obviated the need for a dramatic retrenchment. Indeed, the public sector borrowing requirement (PSBR) stood at 10 percent in the first year of the adjustment program (1980), not too far from its level at the height of the crisis in 1977 (see figure 9.2). Since 1980, the public sector borrowing requirement has averaged around 5 percent of GNP, a large number in new of the growing debt-servicing burden and the consequent need to maintain the current account deficits at reasonable levels.

The continuing burden of fiscal deficits has produced two crucial dilemmas. First, it has increased the cost of maintaining external competitiveness, as real exchange rate depreciations tend to increase the debt-servicing burden on the budget. Second, it has forced the government to rely increasingly on short-term domestic borrowing at real interest rates far exceeding the rate of growth of the economy, raising severe questions about longer-term stability.

9.2.4 External Financial Relations and Debt Management

Turkey's important geopolitical role in the Middle East and as a NATO member bordering on the Soviet Union was critical after 1979 in mobilizing Western support—in terms of both debt relief and new flows—of a magnitude not experienced in any other recent case. A widespread feeling around official circles, as expressed in a *New York Times* editorial on 3 January 1979, was that "[t]he strategic importance of Turkey . . . is too great for Ankara's fate to be left to the [International] Monetary Fund and commercial banks abroad." Official lenders' enthusiasm has also affected the policies of the IMF and the World Bank which showered Turkey with generous amounts of program lending. During the first four years after the crisis of 1977 (1978–81), ex-

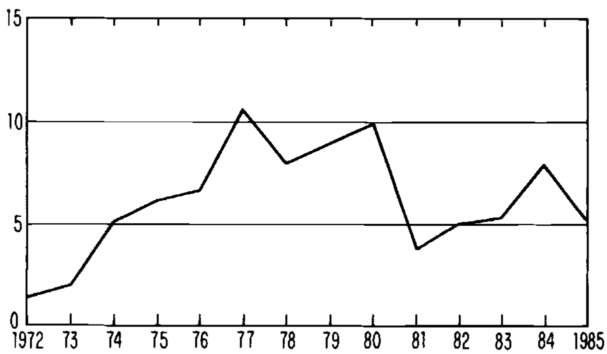

Fig. 9.2 Evolution of the PSBR, 1972–85 (percent of GNP)

ternal flows allowed the Turkish economy to run an average current account deficit of 3.4 percent (of GNP), and an average noninterest current account deficit of 2.3 percent. In fact, net resource transfers to Turkey turned negative for the first time only in 1982, a comfortable five years after the original crisis. The contrast with the post-1982 experience of other heavily-indebted countries could not be starker.

The absence of an intense squeeze on the current account, as was the case in most other countries, has greatly facilitated the implementation of the reforms after 1980, as well as setting the stage for a recovery. It is largely because of capital inflows that the Turkish stabilization took place *alongside* an economic expansion. In this key respect, Turkey's adjustment experience provides an obvious lesson for the current strategy in the global debt crisis.

Since 1982, Turkey's reliance on official inflows has diminished. Such inflows have been replaced by syndicated loans, and, to a much greater extent, by renewed short-term borrowing on the part of domestic banks and the Central Bank. The borrowing experience of the last few years has brought to the fore the recurring penchant of policymakers for rather exotic borrowing arrangements with relatively short-term maturities and high premia over international rates (e.g., the CTLDs in the 1970s, the Dresdner Bank scheme in the 1980s). These have not served Turkey well in the past, and there are some questions as to whether they will do so in the future.

9.3 Conclusions and Prospects

Turkey has managed to transform itself from the problem country of the 1970s to the model debtor of the 1980s. Our account stresses the role both of the domestic policy changes and of the external environment in this accomplishment. While a remarkable amount of adjustment has clearly taken place, some problem areas continue to cloud the horizon.

First, the problems of fiscal adjustment are, if anything, likely to become accentuated in an era of growing debt-service burden. The fiscal retrenchment that has taken place since 1980 has not been a remarkable one, and the public-sector budget remains the Achilles' heel of the Turkish macroeconomy. Second, the Turkish economy still lacks a well-founded "debt strategy." Ever since the mid-1970s, the debt accumulation process has been marked by recourse to rather exotic arrangements whose long-term stability is problematic. Third, the extent to which the real economy and growth process have adjusted to the changes in the structure of relative prices since 1980 is unclear. Most disappointing in this respect is the apparent lack of buoyancy of private investment in tradables. Finally, the Turkish economy continues to be plagued by the consequences for income distribution of the debt crisis of the late 1970s. Any attempt to reverse these consequences will likely put strains on macro balances that are already somewhat shaky.

Appendix

Table 9.5 **External Debt, 1978–86**

(mill. US $)	1978	1979	1980	1981	1982	1983	1984	1985	1986
Total external debt	14,399	14,223	16,315	16,861	17,619	18,391	21,288	25,012	31,228
Medium and long-term debt	7,223	10,667	13,835	14,667	15,455	15,352	16,782	18,395	21,837
Multilateral organizations (incl. IMF)	2,168	2,474	3,398	3,857	4,531	4,916	5,434	6,103	6,588
Bilateral credits[a]	4,212	4,370	5,983	6,712	7,115	6,566	7,305	8,013	10,187
OECD	3,871	3,976	5,253	5,901	6,146	5,613	6,168	6,776	8,270
Commercial Banks[b]	487	3,464	3,436	3,257	3,229	3,262	3,693	4,014	4,833
Private lenders	356	359	1,018	841	580	608	350	265	229
Short-term Debt	7,176	3,556	2,480	2,194	2,164	3,039	4,506	6,617	9,391
Public sector[a]	1,894	1,104	1,448	1,161	1,104	1,737	2,663	3,755	5,406
Dresdner Bank[c]	363	344	365	473	817	1,251	1,778	2,678	3,788
Bankers' credits	333	18	10	—	—	65	195	432	944
overdrafts	341	244	254	69	48	164	417	376	77
Private Sector[a]	5,282	2,452	1,032	1,033	1,060	1,302	1,843	2,862	3,985
CTLDs[d]	2,860	617	543	473	585	647	61	18	6
Suppliers' Credits (cash against goods)	1,560	1,400	—	—	—	—	—	—	—
Acceptance credits	862	435	377	230	276	318	703	1,093	1,061
Pre-Export financing	—	—	112	330	199	254	414	609	629
FX deposit accounts	—	—	—	—	—	83	544	724	1,250

Source: Central Bank.

[a]The subcategory or subcategories shown represent only a partial list of this kind of debt, with the exception of the years 1978–83 in the private sector in which the list of subcategories is complete.

[b]Includes rescheduled convertible Turkish lira deposits (CTLDs) from 1979 on.

[c]These include deposits with maturity longer than one year.

[d]Nonrescheduled CTLDs.