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Chapter Author: Anne O. Krueger

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11 Partial Adjustment and Growth in the 1980s in Turkey

Anne O. Krueger

11.1 Introduction

Until 1980, Turkish economic policies were broadly typical of those of most developing countries. A policy of import substitution had been consistently followed at least since the 1950s, with prohibition of imports of commodities for which domestic production was deemed adequate. In part to foster import substitution, but more importantly because foreign exchange was always scarce, those policies were buttressed by quantitative restrictions on imports and tight exchange control, which increased the inner orientation of the economy even beyond that which would have resulted from those policies undertaken to encourage import substitution. State economic enterprises (SEEs) had been established and expanded to process and market agricultural commodities, to extract and export minerals, and to produce a wide variety of manufactured goods. Negative real interest rates enabled the government to direct resources through allocation of rationed credit, as well as through import licensing.

In the course of economic growth in the postwar period, the Turkish authorities had already twice been confronted with mounting balance of payments difficulties and rising inflation. In both instances, there had been fairly typical stabilization programs, which succeeded in improving the foreign exchange situation and, in the earlier crisis in 1958, drastically reducing inflation.

By the late 1970s, Turkey was confronting yet another crisis. Inflation had accelerated throughout the 1970s, and reached an annual rate of over 100% by

Anne O. Krueger is Arts and Sciences Professor of Economics at Duke University and a research associate of the National Bureau of Economic Research.

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late 1979 in a country with relatively few indexation mechanisms and strong sensitivity to it on the part of influential groups (including the civil service and the military).

While the political reaction to inflation would probably in itself have forced policy changes, foreign exchange shortages at an increasingly overvalued exchange rate were also resulting in major difficulties and dislocations. Some economists even estimated that there were negative *gross* foreign exchange reserves by late 1979! Whether true or not, there were certainly long delays in obtaining import licenses and foreign exchange, embassy employees overseas went months without being paid, there was no coffee, and the short supplies of petroleum and other imports resulted in severe dislocations and hardships during the severe Anatolian winter. According to the official statistics, real GNP fell only 5% over the 1977–79 period, but contemporary accounts and observations of those who lived through it suggest a far steeper drop, especially starting in the second half of 1979.

Throughout the latter part of the 1970s, successive coalition governments had attempted unsuccessfully to grapple with economic difficulties. Several IMF-supported programs had been started, only to be abandoned when it proved infeasible to implement them. Governments had changed frequently, in large part in response to dissatisfaction with economic performance. By the beginning of the 1980s, it seemed clear that Turkey was in for yet another round of stabilization following the pattern of 1958 and 1970.

Instead, when policy changes came in early 1980, they were far different both in announcement and in action from the two earlier episodes. Instead of addressing primarily the macroeconomic issues driving inflation and the immediate balance-of-payments difficulties, the authorities announced a program that had two fundamental objectives: to alter underlying economic policies aimed toward growth and to reduce the rate of inflation. While this second objective had been included in both earlier programs (although the Turks were singularly unsuccessful in achieving it in the second), the enunciation and pursuit of the first objective constituted a major departure from past economic policies.

From its initiation, the sectoral reform program was articulated and designed to shift Turkey's entire growth strategy away from import substitution and toward greater integration with the international market. Moreover, it was explicitly stated that the role of the government in the economy was to be greatly diminished and that private enterprise would be relied upon to generate economic growth. From a historical perspective, this was revolutionary indeed! For purposes of this analysis, I shall refer to the entire set of policies designed to achieve this result as being "sectoral" reforms, contrasted with the policies entailed in stabilization that will be termed "macro" reforms.[1]

1. There is, however, at least one important and visible link between macro and sectoral reforms, as defined here. That is, the SEEs were incurring large deficits, financed by Central Bank credits.

After 1980, policy reforms continued. Although macro reforms were initially successful, with the rate of inflation falling from over 100% to a low of about 35% in 1982, the rate of inflation thereafter rose again, and inflation continued as a problem throughout the 1980s. By contrast, the sectoral reforms geared to shifting reliance toward the private sector and integrating the Turkish economy with that of the rest of the world gathered momentum as the decade proceeded. By the early 1990s, it could fairly be said that Turkey's sectoral reforms had been—at least to 1991—successful, while Turkey's macro reforms had largely failed. Important questions focused on the sustainability of the sectoral reforms in light of continuing inflation and macroeconomic difficulties.

It is the purpose of this paper to analyze the Turkish reforms of the 1980s and their relationship to growth. A natural starting point is a brief review of the earlier stabilization programs, the topic of section 11.2. Section 11.3 then covers the economic difficulties and policies immediately preceding the January 1980 reforms. Section 11.4 reviews the initial reform program and the response to it. Section 11.5 covers the second phase of reforms, starting in the fall of 1983. Section 11.6 analyzes the real growth of the economy starting in 1983, while section 11.7 covers the macro reforms and their consequences. Section 11.8 addresses the reasons why the macro reforms were so unsuccessful while the sectoral reforms appear to have delivered such satisfactory growth. Section 11.9 concludes by providing a tentative assessment of the sustainability of the altered policies toward the various sectors of the Turkish economy in light of the overall macroeconomic difficulties.

11.2 Two Preceding Cycles

Turkey became an independent state after the First World War, as the Ottoman Empire disintegrated. With Atatürk as a national charismatic leader, economic policy for raising living standards was already an important national issue in the 1920s and 1930s. After a brief effort to develop through laissez-faire in the 1920s, Atatürk switched to etatism[2] as a philosophy in the 1930s, and the first large SEEs were founded, producing textiles, footwear, and a variety of other manufactured goods.

Atatürk died in 1938 but remained the revered founding father of the nation. In the post war period, economic growth resumed, with SEEs expanding rap-

Those deficits alone exceeded 5% of GNP by the late 1970s. Reforms restructuring the SEEs in ways that prevented the expansion of Central Bank credit were both sectoral insofar as they increased the efficiency of SEEs (or reduced the resources allocated to inefficient activities) and macro insofar as they reduced inflationary pressures.

2. See Okyar (1965) for an analysis. For present purposes, it suffices to say that etatism was articulated as a rationale for state economic activities through SEEs. These activities were supposed to coexist, however, with private economic activity. Etatism clearly grew out of the distrust of markets that was worldwide in the 1930s.

idly into new import substitution activities. The underlying policy of etatism remained the guiding principle of development efforts until 1980. Starting in the late 1940s, Turkey's economy grew rapidly, as the opportunities afforded by postwar recovery, receipt of Point IV and Marshall Plan aid, and a buoyant world economy all conduced to economic growth. Simultaneously, there was a rapid increase in government expenditures, especially on investment projects designed to accelerate economic growth.

Starting in 1953, however, export growth ceased,[3] both because of the end of the Korean War commodity boom and because of the shift of resources to the buoyant domestic market. Simultaneously the rate of inflation accelerated. As in many other countries at that time, the Turkish authorities were committed to maintaining a fixed nominal exchange rate. By 1954, the government introduced import licensing in an effort to restrain the demand for imports in line with the availability of foreign exchange. Over the next several years, inflationary pressures intensified[4] while foreign exchange earnings continued to drop.

By 1957, the situation was by any measure serious. Surcharges had been imposed on imports; even those who received import licenses waited eight to twelve months for foreign exchange permits. Export earnings were dropping rapidly, and the black market premium was more than 100% above the nominal exchange rate. At that time, as in many other countries, the top political leadership (Adnan Menderes) was adamantly opposed to any change in the nominal exchange rate. By then, Turks were financing imports with suppliers' credits and other short-term, high-interest-bearing notes. As the harvest approached in 1958, however, even that source of financing was disappearing, and it became evident that little if any gasoline would be available to enable the trucks to move the harvest to ports, without a change in policies.

Reluctantly, the government of Turkey agreed with the International Monetary Fund (IMF) to a stabilization program, the key elements of which were a major devaluation (from TL2.8 to TL9 per U.S. dollar); immediate import liberalization and rationalization of import licensing schemes;[5] ceilings on

3. Turkey had expanded the area under cultivation for wheat through introduction of tractors and mechanization in the late 1940s and was even the world's largest wheat exporter in the early 1950s. The evidence suggests that this large effort was in fact uneconomic in the long run, and wheat exports peaked in 1953. See Krueger (1974) for a discussion.

4. It is difficult to provide a good estimate of the rate of inflation. The Turkish authorities imposed price controls on most basic consumer goods in an effort to restrain inflation, and it was the official prices of those goods that entered into the official price statistics. According to those statistics, the rate of inflation reached an annual rate of almost 25% by 1958, having exceeded 10% annually since 1954.

5. Until 1958, import licenses had been dealt with on an ad hoc basis. The 1958 program included provisions so that there would be some imports (on a "liberalized list") for which the granting of foreign exchange was more or less automatic, some imports (the "quota list") for which quantitative limits were set and whose allocation was subject to detailed bureaucratic negotiation, and some imports whose origin could only be Turkey's bilateral trading partners. Any commodity not listed was ineligible for importation. This basic system lasted until the early 1980s, with new lists published every six months. See Krueger (1974, chap. 6) for a detailed description of how the system worked.

government expenditures, credit, and the money supply; and an increase in prices of commodities produced by SEEs, with the removal of price controls over most items for the private economy.[6] Import liberalization was financed by IMF and other official credits; official creditors also sponsored and supported debt rescheduling for Turkey's outstanding debt.[7]

Most of the components of this package are fairly standard in IMF-supported programs, and require little comment. A possible exception is the increases in prices of SEEs, which featured prominently in the 1970 and 1980 reforms as well. As already mentioned, efforts to control inflation in the years prior to 1958 consisted largely of the imposition of price controls. Private sector firms responded either by shutting down or by selling in the black market. SEEs, however, sold at official prices and incurred losses. As inflation accelerated, these losses mounted. The losses, in turn, were covered by credits automatically extended by the Central Bank to the various loss-making SEEs. The result was growth in the money supply fueled in significant measure by SEE deficits. Raising the prices of goods produced by SEEs in 1958 naturally resulted in an immediate once-and-for-all increase in the various price indices; after that, however, the reduced rate of expansion of Central Bank credits resulted in a reduced rate of inflation. Indeed, the 1958 Turkish stabilization program was unusual in that real GDP, which had been declining, started growing immediately in response to greater availability of imports, while the rate of inflation dropped dramatically: from 25% (at the understated official measure) in 1958 to less than 5% in 1959.

After the initial stabilization plan in the summer of 1958, export earnings rose, other foreign exchange receipts increased, and the flow of imports returned to more normal levels relative to the level of economic activity. Although there was a temporary setback in 1959 as the expenditure and other ceilings negotiated with the IMF were violated, a military coup in May 1960 was accompanied by a recommitment to the major provisions of the stabilization program. The rate of growth of real GDP accelerated, and Turkey was among the more rapidly growing developing countries for most of the 1960s.

However, Turkey's annual inflation rate in the 1960s was in the 5–10% range, and the nominal exchange rate was held constant after the 1958 devaluation. Public and private investment expenditures had increased rapidly in the early 1960s, financed largely by foreign aid. When, in the later part of the 1960s, foreign aid did not increase, the government nonetheless attempted to maintain the rate of investment. The increased demand for imports, therefore, resulted in lengthening queues at the Central Bank. Delays in obtaining imports needed for spare parts and intermediate goods of a year to eighteen months were common. The resulting excess capacity in newly established im-

6. For an analysis of the program, see Sturc (1968).

7. In order to ascertain the level of indebtedness, the Turkish authorities had to advertise in western European and other newspapers and magazines, asking creditors to notify them as to the amount they were owed: there was no systematic record of debt in Turkey, a situation that did not change until the 1980s. See Krueger (1974, chap. 2) for an account.

port substitution industries, combined with the slowdown in investment projects resulting from delays in obtaining imports, was a visible restraint on economic activity and growth.

Although inflation was accelerating, the chief impetus to the 1970 devaluation was clearly the foreign exchange situation. Although circumstances were by no means as extreme as they had been in 1958, the import substitution activities that had been carried out during the 1960s had left the economy more dependent on imports of intermediate goods and raw materials to continue factory operations than had earlier been the case; inflation was not widely perceived to be a major problem.

The 1970 devaluation had many of the same components as the earlier one, although emphasis was much more on the foreign trade regime and the exchange rate than in 1958. The nominal exchange rate was adjusted from TL9 per U.S. dollar to TL15; the government again received extensive foreign credits, and imports were liberalized, although the "lists" (see note 5) continued to be used in much the same manner as when they were started in 1958.

In contrast to the 1958 devaluation, however, the economy's response to the 1970 devaluation was much more rapid. In particular, export earnings rose sharply, and, at the same time, Turkish workers in Germany and other western European countries remitted sizable amounts of foreign exchange. There was no mechanism readily at hand for the Central Bank to sterilize these inflows, and as a consequence workers' remittances expanded the Turkish money supply sharply. Inflation therefore accelerated, although foreign exchange was plentiful. During the first half of the 1970s, however, real economic growth was rapid, spurred in part by expansionary monetary and fiscal policies, and in part by the increases in investment that the comfortable foreign exchange position permitted.

As of 1975, Turks regarded their real growth rate of around 7% annually almost as an immutable constant: Turkey had been growing rapidly and per capita incomes had been rising steadily since the early 1950s despite population growth well in excess of 2.5% annually.

11.3 Run-up to the Third Crisis

Inflation had already reached an annual rate of 25% by 1973 when the first increase in the world price of oil was effected. Although the nominal exchange rate had been held constant since 1970, foreign exchange receipts from exports and from workers' remittances continued rising sharply, so that there was no immediate foreign exchange problem. Indeed, the Turkish authorities were in the unaccustomed situation of accumulating foreign exchange reserves in 1971 and 1972.

The result was that, when the terms of trade deteriorated sharply because of oil, the authorities failed initially to alter the internal prices of petroleum and its products, letting the SEE handling petroleum instead incur losses and financing the increased cost of imports out of foreign exchange reserves. Fiscal deficits therefore increased in 1974 and 1975, as the overvaluation of the exchange rate associated with accelerating inflation increased, while the fiscal deficit itself and the failure to change the internal price of oil and its derivatives made the situation worse.[8]

Table 11.1 gives data on the economic deterioration between 1975 and 1980. Annual data understate the extent of the difficulties as they mounted late in 1979 and early 1980, as imports increased sharply in 1980 after the January policy changes and the rapid downward spiral in real GDP was reversed. Even by these annual figures, however, it is evident that real GDP grew only 15% between 1975 and 1980, while population increased by almost the same amount. For a country accustomed to rapid growth in per capita incomes, the slowdown was abrupt. Moreover, acceleration of inflation resulted in economic discomfort for the many influential groups—military, civil servants, academics, pensioners—whose incomes were fixed without indexation.[9] In 1976 and 1977, as can be seen in table 11.1, imports continued to grow, albeit slowly. By 1978, however, sources of financing were disappearing, and imports were reduced with consequent dislocations of economic activity.[10]

Several aspects of economic policy had gone badly wrong in the early 1970s. All measures of the price level reflected sharp increases. By 1975, prices are estimated to have been 134% above their 1970 level, yet the nominal exchange rate was still TL 15.15 in 1975—virtually the same as it had been in 1970. Although the nominal exchange rate was altered more frequently after 1975 as inflation accelerated, the GDP deflator increased 258% from 1975 to 1979, while the official price of foreign exchange was increased 165%. The real exchange rate, therefore, had appreciated massively in a situation in which, given the deterioration in Turkey's terms of trade, it should have depreciated.[11]

SEE deficits were large and increasing in the late 1970s. By 1979, transfers to SEEs to cover their deficits accounted for 13.6% of general government expenditures, and the fiscal deficit was equal to more than 4% of GDP (and 16% of government revenues). Meanwhile, nominal interest rates were kept

8. Dervis, De Melo, and Robinson (1982, 346) estimated the separate contributions of each factor to the buildup of the crisis. As of 1977, they estimated that the economic costs of the crisis were equal to about 9.7% of GDP, of which 1.1% was the result of the negative swing in Turkey's terms of trade (primarily but not entirely oil), 5.1% was attributable to reduced foreign resources, 0.9% was due to increased trade distortions, and 2.6% was attributable to the reduction in domestic production necessitated by reduced imports.

9. Despite periodic adjustments, real incomes of persons in these groups fell, as nominal changes were systematically less than the preceding change in the price level, while inflation was accelerating.

10. To be sure, there was considerable smuggling during this period, so that the official statistics may overstate the reduction in imports. Nonetheless, supplies of commodities that are difficult to smuggle, such as oil, were dropping, resulting in severe dislocation.

11. As imperfect as it is, the percentage by which the black market exchange rate exceeds the official rate gives some idea of the extent of distortion in the nominal exchange rate. In 1975, the black market premium is estimated to have been about 10%; by 1978 it was 51.6%; and by early 1979 it reached a level 91.4% above the official exchange rate. See Krueger and Aktan (1992, 27).

Table 11.1 Indicators of Turkish Economic Deterioration, 1975–80

	1975	1976	1977	1978	1979	1980
Real GDP per capita (1975 = 100)	100	109	113	118	116	115
Wholesale prices (1975 = 100)	100	116	142	213	353	761
Current account deficit (millions of US$)	1,648	2,029	3,140	1,265	1,413	3,408
Imports (millions of US$)	4,502	4,872	5,506	4,369	4,815	7,513
Total debt (billions of US$)	3.6	4.3	11.4	14.8	15.9	19.0

Source: Krueger and Aktan (1992), appendix tables for the first four rows; table 6, p. 28, for debt.

low (in part to facilitate financing public debt). The real interest rate, calculated as the difference between the inflation rate and the general nominal interest rate for medium-term credits, was minus 38.5% in April 1978, minus 51.3% in May 1979, and reached minus 100.5% in March 1980.

One other phenomenon of the late 1970s deserves mention. It has already been pointed out that there were weak coalition governments during that period. In part, those weak coalitions reflected underlying divisions within society and societal unrest. This was reflected, inter alia, in the radicalization of labor unions and of student groups, with attendant violence and civil unrest.[12] It is estimated that 8 million man-days were lost to strikes in 1980, compared to 1 million for all of 1979 (Baysan and Blitzer 1991, 359). The impact on the economy of the unions was substantial. On one hand, they demanded, and most got, large wage increases. On the other, once wage increases were granted, unions were frequently reorganized under new leadership and went on strike once again to demand even more. By the late summer of 1979, real wages of factory workers had increased rapidly over the preceding decade, even during the period when real output was declining. From the viewpoint of Turkish industry, however, the strikes and work stoppages were highly disruptive and were at least as damaging as the delays and shortages of imports.

Thus, by any standard, the Turkish economy was in severe disequilibrium by 1980. Inflation had reached triple digits and was still accelerating; imports were more and more constrained, and the premiums on import licenses and on black market foreign exchange were high and rising rapidly; and real output and incomes were falling. The reasons for this are clear in the policy indicators: a highly overvalued and unrealistic nominal exchange rate and interest rate; a large and growing fiscal deficit and rapid expansion of the money supply; and severe restrictions on foreign trade and domestic investment (because of foreign exchange difficulties).

In 1978 and 1979, two stabilization programs were negotiated with the IMF.[13] Both of these were abandoned when the agreed-upon policies were not

12. See Krueger and Turan (1993) for an account.
13. For an excellent account, see Okyar (1983).

enacted, as the coalition governments were simply unable to restrain government expenditures, reduce SEE deficits, or raise taxes.

When Suleyman Demirel became prime minister of yet another coalition government in the fall of 1979, therefore, he inherited an extremely difficult economic situation. He had no more parliamentary support than had the predecessor governments under Bülent Ecevit, but the fact that economic deterioration had been so prolonged perhaps gave him some room for maneuvering. In a sense, the usual political coalitions that had prevented action earlier were rendered ineffective by the severity of the crisis.

11.4 The 1980 Reform Program and Initial Response

By late 1979, there was universal agreement that the economy was once again in crisis. Unlike the earlier episodes, however, there were significant groups (including most prominently the association of Turkish industrialists) that had concluded that the earlier policies of import substitution had failed and would not generate future growth, even if the crisis was overcome. There was active advocacy of an alternative strategy by the Turkish industrialists and others.[14]

When Suleyman Demirel became prime minister, he appointed Turgut Özal to be deputy prime minister in charge of economic policy. Özal and a very small team of bureaucrats (estimated to have been less than ten persons altogether) then drew up a program for reform, which was announced by the prime minister late in January 1980. Even key ministers had been unaware of the scope of the plan outside their own domain; they were asked to sign a variety of decrees on a piecemeal basis and had no advance information as to what other components of the program would be.

There were several key initial measures: (1) devaluation of the Turkish lira from 35 to 70 per U.S. dollar, with an announcement that henceforth the Turkish lira exchange rate would be changed frequently to reflect the differential between domestic and foreign inflation;[15] (2) increases in the prices of almost all goods produced by SEEs, with an announcement that SEEs would in future be free to set their own prices and would not be permitted to borrow from the Central Bank; and (3) a variety of changes in the organization of the various ministries and bureaus that were responsible for economic policy, with the general purpose of reducing the power of some traditional groups and strengthening the hand of the deputy prime minister.

Thereafter, a number of other economic problems were addressed, and additional policy changes were announced at frequent intervals. Turkish debt was rescheduled under the auspices of the London and Paris Clubs, with financial

14. See Krueger and Turan (1993) for an extended discussion.

15. In fact, the Turkish lira was depreciated somewhat more rapidly than the differential in inflation between Turkey and her trading partners; see table 11.2.

support from the European Communities as well as the multilateral institutions. After the January devaluation, the nominal exchange rate was altered frequently, until daily changes became routine starting in mid-1981. In June 1980, ceilings on bank deposit rates were lifted. Throughout the year, conditions under which Turks could hold and use foreign exchange were liberalized, as banks and exporters were authorized to retain sizable fractions of their receipts. Trade in gold had been legalized in January.

It should be noted that the initial January 1980 program was announced and implemented with no IMF program. Although there had been contact between Özal's team and IMF staff prior to January, it was undertaken without waiting for IMF approval and support. An IMF agreement came into effect in June,[16] although its main provisions had already been met ahead of schedule. Throughout the 1980s, the IMF and World Bank[17] continued to provide support for Turkey.

These measures were all initiated under the government of Prime Minister Demirel, as already mentioned. However, civil unrest had been a major problem prior to the outset of the program, and the Demirel government ruled only by coalition. Indeed, it may be said that only the crisis proportions of the economic problem permitted Demirel and Özal to act in January. As they presented tax and other measures to Parliament in the summer of 1980, it became evident that Parliament was unlikely to approve them.

In that atmosphere and with violence increasing, the military intervened in September 1980, ousting the Demirel government. Turgut Özal, however, was retained as deputy prime minister in charge of economic policy. Thereafter, a number of additional measures were undertaken. Perhaps most controversial within Turkey, union activity was forbidden, although the same decree prohibited firms from laying off workers.[18] Other measures included relaxation of restrictions governing direct foreign investment, and liberalization of capital markets as regulations governing bank behavior and trade in securities and other financial instruments were modified.

16. For particulars, see Okyar (1983).

17. There were five World Bank structural adjustment loans in support of Turkish reforms. Turkey was the first country to receive such support. For an account of World Bank lending, see Kirkpatrick and Onis (1991).

18. Not only was this measure controversial politically, but it makes interpretation of the subsequent behavior of employment and real wages difficult. While output was growing fairly rapidly in the years following 1983, industrial employment and real wages did not begin to show any significant increases until about three years later. Whether this was because union power in the late 1970s had driven industrial wages and employment to such levels that a retrenchment was avoided through these measures, or whether instead of freezing of employment encouraged employers to adopt capital-intensive methods of production while the absence of union activity permitted wages to languish remains an open issue. Clearly, some of each occurred. At any event, by the late 1980s, employment and wages were growing more rapidly, and any analysis of the relationship of the macroeconomic failures and sectoral successes of the Turkish reforms does not hinge on resolution of that issue. See Krueger and Aktan (1992) for data on employment and real wage behavior and a more extended discussion. See also Celasun (1986) for a much more critical interpretation of the role of labor repression in the 1980s.

Initially, the foreign trade regime was not overhauled, although increased availability of funds for imports necessarily meant liberalization of the regime. In the next several years, however, quantitative restrictions on imports were almost completely abolished, and reliance instead shifted to the exchange rate and aggregate demand management as a mechanism for maintaining external balance.[19] Removal of quantitative restrictions was in itself a major change in Turkish economic policy and in the structure of incentives confronting Turkish producers. Starting in 1984, tariffs were also lowered. By the mid-1980s, Turkey's protection would have been described as moderate, as contrasted with the earlier extremely protective regime.

The net effect of these measures on some key policy variables can be seen in table 11.2. The rate of inflation, as measured by the GDP deflator, fell from over 100% in 1980 to 42% in 1981 and 28% in 1982. Simultaneously, frequent adjustments of the exchange rate led to a depreciation of the real exchange rate from a level of 327 at the end of 1979 to 432 at the end of 1980 and 488 at the end of 1982, altogether an increase in incentives to exporters of 32%.[20]

As can also be seen in table 11.2, government expenditures and the fiscal deficit fell sharply. SEE financing from the Central Bank virtually ended, while the reduction in central government expenditures also reduced the fiscal deficit.

However, at the same time as that happened, the financial liberalization had induced many new entrants into Turkish credit markets. These financiers were borrowing and lending in the newly liberalized markets on relatively thin margins, and in the summer of 1982, one of the large ones (Banker Kastelli) appeared in imminent danger of bankruptcy. The military government apparently feared a major financial crisis, and reacted by discharging Turgut Özal and replacing him with a politician believed to be much more sympathetic to expansionary monetary and fiscal policy. Shortly thereafter, the military announced that elections would be held in the autumn of 1983.

There followed a year of relaxation of fiscal and monetary policy. In the 1983 elections, Turgut Özal organized a political party, the Motherland Party, which ran against the party supported by the military. The Motherland Party won, and Özal became prime minister. Thereafter, the second stage of reforms began.

Before turning to those reforms, however, it is instructive to assess the reactions of the Turkish economy to the policy changes over the 1980–83 period. Table 11.3 gives some data. As can be seen, real GDP declined for 1980 as a

19. See Baysan and Blitzer (1991) and Krueger and Aktan (1992) for more detailed accounts.

20. In addition to the exchange rate, a number of other measures were adopted to encourage exports. Many, however, had been in place prior to 1980. They certainly contributed to the overall incentive to export, but protection remained sufficient so that at best the export incentives offset a significant proportion of the bias that still remained toward import substitution through the trade regime. That bias began falling significantly after 1984, and the special export incentives were reduced, starting at that time. See Krueger and Aktan (1992, chap. 4) for a detailed discussion. In terms of the *change* in incentives for exporting, the depreciation of the real exchange rate was clearly crucial, and far outweighed the changes in other export incentives.

Table 11.2 Economic Policy Indicators for the 1980s

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990[a]
Nominal exchange rate (TL/US$)	76	111	163	225	367	522	674	857	1,422	2,121	4,168
GDP deflator (% change)	104	42	28	29	51	41	30	39	66	65	59
Real exchange rate[b]	432	432	488	509	527	522	505	499	512	473	473
Nominal interest rate	30	36	36	36	55	62	62	66	87	85	65
Real interest rate	−89	−5	4	1	2	9	18	13	−14	−16	7
Real government expenditures (% of GDP)	25	23	18	23	21	19	21	22	21	23	24
Fiscal deficit (% of GDP)	4.0	2.6	1.7	2.6	5.3	2.8	3.6	4.4	3.8	4.4	4.1

Sources: Krueger and Aktan (1992), rows 1 and 3 from table 9; row 2 from table 12; row 4 from table 16; and row 5 from data appendix, table 10. Rows 6 and 7 from Central Bank of Turkey, *Annual Reports* (1987, 1989, 1991).

[a]Data for 1990 are not always comparable to those for earlier years. Most are derived from International Monetary Fund, *International Financial Statistics,* and the percentage changes from 1989 to 1990 were linked to the data for earlier years.

[b]The real exchange rate was calculated as the nominal exchange rate deflated by the Turkish wholesale price index and adjusted for the price level of Turkey's Group of 7 trading partners.

Table 11.3 Turkish Economic Indicators, 1979–83

	1979	1980	1981	1982	1983
Real GDP (billions of 1968 TL)	208	206	215	224	232
Growth rate	−0.6	−1.1	4.2	4.5	3.3
Real investment (billions of 1988 TL)					
Private	7.6	6.7	6.2	6.5	6.7
Public	9.9	9.5	10.3	10.6	10.2
Index of industrial output (1986 = 100)	N.A.	N.A.	65.1	70.3	76.2
Exports (billions of US$)	2.3	2.9	4.7	5.7	5.7
Imports (billions of US$)	5.1	7.9	8.9	8.8	9.2
Current account deficit	−3.2	−5.6	−4.5	−3.2	−3.7

Source: Krueger and Aktan (1992), appendix tables.

whole, although there is little doubt that quarterly data, if they were available, would show the upturn starting in the second half of the year. Growth was moderate the following three years. Real private investment continued declining in 1981, and did not begin to increase again until 1982; even in 1983 it did not reach its 1980 level, much less the levels of the late 1970s. These data were reflected in the mood of the times: there was considerable anxiety about the policy changes, and uncertainty as to whether reforms would persist. While removal of bottlenecks and disruptions associated with strikes enabled real GNP to begin increasing, the increases were moderate.

The bright spot in the economy during the first three years after the reforms was the behavior of exports. As is evident from table 11.3, exports of goods and services recorded in official statistics were only $2.3 billion in 1979, less than half the level of imports. Imports would, of course, have been greater had foreign exchange been available.[21]

External financing permitted a 50% increase in imports in 1980, so that the current account deficit increased sharply to $5.6 billion in that year, despite an increase in recorded exports of $600 million, or almost 25%. Growth of exports accelerated over the next three years, however, so that export earnings by 1982 were double their 1980 level, and the current account deficit was back to its 1979 level due to the sustained increase in imports.

By 1983, therefore, it could have been claimed that the 1980 program had met its immediate goals: incentives for exports had increased markedly and exports had responded; the program had induced financial support from the international community, which permitted resumption of an enlarged flow of imports necessary to sustain a higher level of real GDP; and the inflation rate had fallen from over 100% to less than 25%.

11.5 The Second Stage of Reforms

Once Prime Minister Özal assumed office in December 1983, an economics team was assembled with the assignment to carry reforms further. There was a flurry of initial measures, including a major realignment of interest rates (which had been recontrolled in the wake of the Banker Kastelli affair), liberalizations of foreign exchange regulations with removal of virtually all restrictions on tourist travel allowances, permission for commercial banks to retain 80% initially and then 100% of their foreign currency receipts, and even permission for capital exports by Turkish residents (with Central Bank approval). Import licensing procedures were greatly liberalized, and the highest tariff rates were reduced in 1984. In the next several years, import licensing was abandoned, and tariffs were further reduced.

The initial moves were followed by a series of major reforms that shifted the Turkish economy still further away from its earlier centralized-control mode. A value-added tax was introduced in 1985. Reopening of the Istanbul stock exchange (in 1986) and a variety of other measures further liberalized the capital market. A foreign exchange market was established, and treasury bonds began to be sold by weekly auction. Efforts were begun to privatize some of the SEEs.

21. There is no doubt that smuggling of imports into the country and means of getting exports out without surrendering foreign exchange meant that actual imports and exports were greater than the officially reported numbers. Nonetheless, there is also no doubt that import shortages were real, and that exports had dropped substantially in the late 1970s.

Meanwhile, earlier controls on SEEs' borrowing had their intended results. Whereas SEEs had required financing from the government budget equivalent to about 14% of total government expenditures in the late 1970s and early 1980s, that percentage fell to 7% in 1984, and then stood in the 2–3% range for several years until it jumped back to 9% in 1991.[22] Meanwhile, a second factor also contributed to reducing recurring government expenditures. That is, expenditures on government personnel dropped, both because government employment was frozen as part of the policy reform package, and because wage adjustments in the public sector lagged significantly behind inflation.

One might have anticipated that these reduced claims on government expenditures would have permitted rapid restoration of fiscal balance. Three factors contributed to offsetting the reductions. First, the Özal government increased expenditures on infrastructure and public works sharply. To a degree, some of these increases reflected deferred maintenance and investment from the 1970s. Roads were widened and extended so that traffic delays and damage to vehicles were reduced; overseas telephone line capacity was greatly increased and domestic service enhanced; decades-long neglect of the city of Istanbul was reversed as public works expenditures changed many aspects of that city; and so on. A second factor was that with increases in the nominal interest rate the costs of servicing the public debt increased, rising from 3% of budgetary expenditures in 1980 to 21% in 1991.

The third factor contributing to increased government expenditures was the "political business cycle." Government expenditures rose markedly prior to each electoral cycle. Table 11.4 gives data on the money supply, its components, and its growth rate from 1979 to 1991. As can be seen, monetary expansion slowed dramatically after 1980, reaching its low point between 1982 and 1983. Thereafter, Central Bank lending accelerated prior to each election in response to the government's borrowing requirements. Those requirements, in turn, were driven in large part by increases in expenditures in the months prior to each election. Toward the end of the decade, as the Motherland Party's percentage of popular votes in the polls fell, these accelerations of expenditures increased. As the data in table 11.2 indicate, government expenditures (which do not include SEE expenditures) increased from their low of 18% of GNP in 1982 to 21% in 1986–88 and to 24% by 1990.

Combined with the increases in overall expenditures, some other practices were instituted that tended to undermine some of the gains that had been achieved. Starting in the mid-1980s, off-budget "special funds" were established for purposes such as "workers' housing," financed largely by import charges that were largely, although not entirely, across the board.[23] In the mid-

22. The SEEs' borrowing requirement rose sharply in 1991, equaling 3.2% of GDP despite a larger transfer from the central government. This latter rose from TL1,265 billion in 1990 to TL12,200 billion in 1991. After allowing for 65% inflation, that constitutes a real increase of 480%!

23. See Krueger and Aktan (1992) for details and estimates of the rates. The rate of tax for the special funds reached 10% in 1990.

Table 11.4 Money Supply and Credit, 1979–91 (end of year; billions of TL)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Money supply (M4)	610	1,074	2,143	3,178	3,984	5,941	9,209	13,152	19,132	29,736	50,054	76,782	123,694
Currency and sight deposits	468	739	1,019	1,407	2,084	2,448	3,420	5,357	8,682	11,312	19,560	31,399	46,793
Time deposits	88	186	690	1,272	1,393	3,045	5,120	6,919	9,020	15,884	27,582	40,173	70,326
Total (M2)	556	924	1,710	2,679	3,477	5,493	8,540	12,276	17,702	27,195	47,142	71,571	117,120
Central bank deposit	144	267	673	866	993	1,279	1,630	1,760	2,371	5,343	8,653	9,947	15,031
Foreign liabilities	199	646	829	1,194	2,129	4,062	6,930	11,955	23,044	38,621	48,564	65,051	113,300
Foreign exchange deposits									1,884	2,926	4,398	5,429	8,034
Central bank lending	382	655	926	911	1,234	880	1,300	1,828	3,439	5,142	6,699	8,294	19,888
Treasury	92	189	262	266	339	528	795	1,052	1,407	2,082	2,565	2,901	13,589
Public enterprise	123	178	233	257	251	37	122	213	763	1,082	1,322	1,565	5,420
Banks	121	240	377	321	569	278	333	479	1,124	1,500	2,200	2,436	3,395
Commercial bank deposits	434	767	1,545	2,384	3,109	5,007	8,038	11,750	17,109	26,209	43,244	66,155	93,219
Commercial bank lending													
Industry	156	283	459	557	526	861	1,722	2,517	3,651	4,233	5,292	8,369	12,815
Agriculture	83	146	266	335	512	530	956	1,782	2,956	4,521	7,404	13,150	18,436
Foreign trade and tourism	28	61	127	440	596	702	985	1,798	2,315	3,432	6,409	10,965	20,748
Housing and construction	17	19	42	71	130	250	594	1,330	2,693	4,127	5,571	8,658	10,255
Domestic trade	47	75	148	284	482	560	910	2,049	3,450	4,961	9,634	19,612	30,759
Unclassified	92	170	213	21	38	64	127	118	240	397	555	1,749	3,308
Total	446	790	1,319	1,806	2,418	3,149	5,568	10,053	16,034	22,771	37,050	65,648	102,240
Annual growth rates													
Money supply (M3)		76	100	48	25	49	55	43	45	55	68	53	61
Total (M2)		66	85	57	30	58	55	44	44	54	73	52	64
Central bank deposit		85	152	29	15	29	27	8	35	125	62	15	51
Central bank lending		71	41	−2	35	−29	48	41	88	50	30	24	140
SEE borrowing													
Commercial bank borrowing		98	57	−15	77	−51	20	44	135	33	47	11	39

Source: Central Bank of turkey, *Quarterly Bulletin*, 1992–1.

Table 11.5 Economic Performance after 1984

	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP (trillions of 1985 TL)	26.4	27.8	30.0	32.3	33.5	34.1	37.3	38.0
Change from preceding year (%)	6.0	5.3	7.9	7.7	3.7	1.8	9.4	1.9
Investment (trillions of TL)	4.8	5.8	7.3	8.7	8.4	8.1	10.3	11.1
Exports of goods and services (billions of US$)	7.4	8.3	7.6	10.3	11.9	11.8	13.0	13.7
Imports of goods and services (billions of US$)	10.3	11.2	10.7	13.6	13.7	16.0	22.6	21.0
Current account balance (billions of US$)	−1.4	−1.0	−1.5	−0.8	1.6	0.9	−2.6	0.3

Sources: Krueger and Aktan (1992), appendix tables; International Monetary Fund, *International Financial Statistics Yearbook 1992;* OECD, *Economic Outlook* (June 1992).

1980s as well, the government undertook a foreign exchange risk insurance scheme (FERIS), under which it lent in domestic currency to investors who financed their activities with loans and assumed the foreign exchange risk. In the 1970s, a similar scheme, the convertible Turkish lira deposit scheme, had resulted in large increases in the money supply when depositors had been insured against foreign exchange risk in the context of rising inflation.[24]

11.6 Real Growth after 1983

After about 1984, the results of the sectoral reforms in the Turkish economy began to show. They were reflected in rising private investment, accelerated growth of real GNP, and continued growth of exports of goods and services. The data in table 11.5 provide an indication of the degree of success.

As can be seen, real GNP growth averaged over 7% annually in the five years starting in 1984. The OECD (1991, 91) estimates that total factor productivity, which had grown at an average annual rate of 1.1% in 1979–85 with output growth of 3.8% and negative growth of capital productivity, grew at an average annual rate of 4.5% in 1987–89, with an 8% rate of growth of output in nongovernment economic activities.

Rapid export growth also continued: exports had constituted only around 5% of GNP in the late 1970s and were 20% of GNP by 1987. This attests to

24. See Celasun and Rodrik (1989) for an account. The 1980 scheme was not as explosive as the 1970 scheme because interest rates were significantly higher relative to the inflation rate, and all interest rates were adjusted every six months. In the 1970s, fixed nominal interest rates, well below the rate of inflation, had persisted for the life of the loan.

the enormous structural changes that were taking place in the Turkish economy in response to the sectoral reforms.

Although imports of goods and services were also growing, the Turkish current account balance, which had been around \$5 billion in 1980 and in the range of \$3–4 billion in 1981–85 (see table 11.3), fell to less than \$1 billion by 1987 and even turned positive in 1988 and 1989, and again in 1991.

11.7 Failure with Macro Reforms

Thus, in real terms, there was every reason to believe that the Turkish policy changes of the 1980s had been successful. Whereas in 1980 it was believed that further growth possibilities through import substitution had probably been exhausted, by the late 1980s, it was evident that Turkey's potential for growth through integrating with the world economy was substantial. Moreover, the earlier suspicion of private business that had accompanied etatism had been replaced by recognition that Turkish industry could perform when provided with appropriate incentives and adequate infrastructure.

Despite these successes, however, the macro reforms were in difficulty. As already indicated, the major problem was that government expenditures increased beyond the ability of the government to increase tax collections. Government expenditures were growing more rapidly than GNP, despite its rapid growth. This is reflected in the rising share of government expenditures in GNP shown in table 11.6. This increase in expenditures took place despite the repression of civil servant salaries and the virtual elimination of SEE deficits as a budgetary drain (at least until the 1990s). The major increases in expenditures were on infrastructure and interest on the debt, on a fairly sustained basis, and on transfer payments prior to each round of elections. This is reflected in table 11.6, which gives data on government expenditures and their composition. As can be seen, interest payments constituted only 4% of government expenditures in 1981 and had risen to more than 20% by the late 1980s. Investment expenditures rose absolutely and as a share of total expenditures until 1987, and fell thereafter, while transfers fluctuated with the proximity to elections. Simultaneously, tax revenues were growing more slowly than income.[25]

There is no mystery as to why inflation persisted. Throughout the 1980s, monetary expansion continued and by all estimates was the crucial determining factor in the inflation rate. To be sure, financial liberalization, and in particular the moves toward full convertibility of the Turkish lira, led to some currency substitution: whereas the ratio of M2 to GNP fell from .224 to .203 over the

25. The imposition of the value-added tax in 1985 was judged a great success and yielded more revenue initially than had been anticipated. However, in order to improve incentives, the Özal government had reduced very high marginal tax rates and corporate tax rates. The net result was that tax revenues did not rise even proportionately with income. Gokcekus and Kipici (1992) ran a logarithmic regression of tax revenues on GNP for the period from 1980 to 1991. Their estimated elasticity of tax revenues with respect to real GNP growth for the entire period is .84.

Table 11.6 **Consolidated Budget, 1979–91 (billions of TL)**

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991[a]
Expenditures	613	1,110	1,503	1,575	2,613	3,785	5,263	8,160	13,043	21,447	38,871	68,527	129,345
Current	262	497	645	720	1,069	1,488	2,086	3,051	4,538	7,460	16,660	33,452	60,900
Investment	95	170	310	344	503	677	989	1,619	2,642	3,564	5,818	10,055	16,600
Transfers	256	443	481	434	831	1,179	1,514	2,159	3,598	5,445	8,134	11,054	27,723
SEEs	83	153	214	233	292	275	181	138	446	1,025	1,223	1,257	11,200
Interest	N.A.	N.A.	67	87	210	441	674	1,330	2,266	4,978	8,259	13,966	24,122
Revenues	526	933	1,330	1,424	2,314	2,806	4,476	6,754	10,445	17,587	31,369	56,753	97,000
Taxes	406	750	1,191	1,305	1,934	2,372	3,829	5,972	9,051	14,232	25,550	45,399	78,650
Nontaxes	120	183	139	119	380	434	647	782	1,394	3,355	5,819	11,354	18,350
Deficits	87	177	173	151	299	979	787	1,406	2,598	3,860	7,502	11,774	32,345
Net domestic borrowing	31	17	50	28	167	137	498	476	896	2,433	5,982	7,942	1,812
GNP	2,200	4,435	6,555	8,722	11,552	18,375	27,789	39,310	58,565	100,582	170,412	287,254	454,838
% of total expenditures													
Current	43	45	43	46	41	39	40	37	35	35	43	49	47
Investment	15	15	21	22	19	18	19	20	20	17	15	15	13
Transfers	42	40	32	28	32	31	29	26	28	25	21	16	21
SEEs	14	14	14	15	11	7	3	2	3	5	3	2	9
Interest	N.A.	N.A.	4	6	8	12	13	16	17	23	21	20	19
% of total revenues													
Taxes	77	80	90	92	84	85	86	88	87	81	81	80	81
Nontaxes	23	20	10	8	16	15	14	12	13	19	19	20	19
Ratios													
Government expenditures/GNP	28	25	23	18	23	21	19	21	22	21	23	24	28
Deficit/revenue	17	19	13	11	13	35	18	21	25	22	24	21	33
Deficit/GNP	4.0	4.0	2.6	1.7	2.6	5.3	2.8	3.6	4.4	3.8	4.4	4.1	7.1

Sources: for 1979–80, State Planning Organization, *The Developments before the 5th Development Plan;* for 1981–82, Central Bank of Turkey Annual Report, 1985; for 1983, Central Bank of Turkey Annual Report, 1987; for 1984–86, Central Bank of Turkey Annual Report, 1989; for 1987–91, Central Bank of Turkey Annual Report, 1991. The numbers in Central Bank of Turkey annual reports are based on Undersecretariat of Treasury and Foreign Trade provisional numbers.

[a]Provisional numbers.

1984–90 period, the ratio of M2 plus foreign exchange holdings of Turkish nationals rose from .231 to .253 (having been as high as .275 in 1986) over that period.[26] The Central Bank tried to use a variety of instruments to curb inflation, but was essentially powerless to do so in the face of the financing needs of the government budget.[27] In 1991, the OECD provided reduced form econometric estimates of the inflation rate and the difference between the government deficit and the effect of output growth on base-money demand. According to those estimates, over 70% of the variability in underlying inflation in Turkey could be explained by the monetization of public sector deficits.[28]

Until the late 1980s, the association of prospective elections with successive bouts of inflation (which are much more evident in quarterly data than in annual) was evident to all, and there was some credibility to the notion that government expenditures would be contained "after the election." By the late 1980s, however, it was apparent to all that the support for Prime Minister Özal and the Motherland Party was weakening, and that there was little prospect that government budgetary discipline could be relied upon to bring about a significant reduction in the rate of inflation.

When in 1991 new elections returned Suleyman Demirel to the prime minister's office leading a coalition government, the earlier problems intensified. As can be seen from table 11.6, the fiscal deficit increased sharply, as, among other things, the SEE drain on the government budget increased sharply.

11.8 Reasons for Successful Sectoral and Failed Macro Reforms

There is little mystery remaining in why there was Turkish inflation. The interesting questions center on how the sectoral reforms could have succeeded, at least initially, while the macro reforms were unable to stabilize the economy, and how macroeconomic instability has affected and will affect the sustainability of the sectoral reforms. The first question is tackled here. The second question must await analysis of the first.

Three major factors probably account for the success and durability of the sectoral reforms during the 1980s. First, there was the evident failure of earlier economic policies. Second, there was the personality, determination, and con-

26. From the background paper by Gokcekus and Kipici (1992), based on data presented in Atiyas and Ersel (1992).

27. In 1983–84, there was an effort to curb inflationary expectations by setting the short-term interest rate above the long-term interest rate. When the inflation rate did not decline, however, people shifted to holding short-term accounts, and the policy was abandoned. The Central Bank began auctioning treasury bills in 1985, which drove up the cost of borrowing. Politically, however, there seems to have been no way to curb government expenditures.

In order to investigate whether inflation caused money creation or conversely, Gokcekus and Kipici (1992, 3) used quarterly data for first quarter 1983 through fourth quarter 1991. They used the Schwartz criterion and used a two-quarter lag structure. They found very strong causality between the quarterly inflation rate and changes in reserve money, in both directions, but with stronger causation from money to inflation and the price level than conversely.

28. See also Rodrik (1990), who provides a rationale for such an estimation procedure.

trol of Prime Minister Özal. Third, there was the initial success of the sectoral reforms in bringing about evident changes.

Before addressing these three factors individually, however, one other feature of the Turkish experience must be noted. That is, at least until 1988, the rate of inflation *had* come down, and the argument put forward by Prime Minister Özal and the Motherland Party—that inflation would be reduced after the election—had some credibility. Equally, in the early 1980s, stabilization had initially succeeded, and provided scope for the sectoral reforms within a macroeconomic framework that appeared to offer promise of stability. The gains for the economy that resulted from both the early sectoral reforms and from stabilization provided a momentum that permitted accelerating economic growth at least through the 1986–88 period.

The first factor that permitted the reforms, especially the sectoral reforms, to continue was the evident failure of earlier policies. The fact that the economy had been in crisis, and that the government of Bülent Ecevit had tried the old remedies with little success, had convinced many Turks that there was no alternative to change. In effect, opposition to change had been defeated by the failure of the earlier policies.

The second factor, the personality and commitment of Prime Minister Özal, cannot be doubted. Not only did he believe in changing the role of the government in the economy, he believed it was the achievement for which history would remember him. In that sense, it was at the top of his agenda, and received his personal attention. After the military takeover in September 1980, he had the support of the military for the continuation of the reform program. That gave him, and the technocrats who worked with him, considerable latitude in the short run. Although he lost that authority in 1983, he regained it with the election late in that year, and was again able to appoint and support technocrats who shared his vision of a changed Turkish economy.

During the 1980–83 period, it may be noted, Turkish economic growth was modest, albeit considerably more satisfactory than it had been in the late 1970s.[29] Considerable opposition to the reforms emerged in 1984–85, as military rule had ended and opposition became more vocal. However, by that time, economic growth was accelerating, and that helped to mute it. It is arguable that if growth had not accelerated when it did, the opposition would have been able to reverse some of the sectoral reforms, especially in the import regime.

If those factors account for the sustainability of the sectoral reforms, at least through the late 1980s, why were the macro reforms less successful? Proximately, of course, the reason is that the government was unable to increase revenues or reduce expenditures in ways that would permit the Central Bank

29. Most countries during 1980–83 were in deep recession, and it may be argued that Turkish economic growth was sluggish for that reason. The fact that Turkey was doing so much better than other countries, however, was little noted in the domestic policy debate.

to brake the growth of the money supply more than it in fact did. The question, then, is why the government fiscal posture remained so expansionary.

That answer, too, has several parts. First, there is the personality of Özal. Second, there were some genuine infrastructural problems that needed to be addressed if the private sector was to be able to expand in accordance with Özal's blueprint. Third, and most important, however, were the political constraints imposed on the Motherland Party in its attempt to maintain power.

There seems to be little doubt that, committed as Özal was to shifting toward more reliance on the private sector for economic growth, he was also an engineer and, perhaps because of that, a builder. He believed that better telephones, roads, port facilities, and other infrastructure would pay for themselves in accelerated growth. In that sense, he attached less weight to the goal of combatting inflation than he did to the goal of resuming and accelerating growth with more efficient allocation of resources and reliance on the private sector. Belief in the role of incentives led him to support reductions in the earlier very high marginal rates of corporate and income taxation. Despite the success of the value-added tax, tax revenues simply did not rise as rapidly as real income, which contributed to the difficulties. Özal also almost certainly underestimated the risk of inflation, and the ease with which monetary expansion before various elections could be reversed afterward.

The need for improved infrastructure clearly fed into Özal's perceptions. There is little doubt that Turkish exports could not have expanded as much as they did if telephone connections had not been improved, if port and domestic carrying capacity had not been expanded, and if power facilities had not been greatly increased.

But the third factor, the political imperatives of remaining in office, was clearly compelling. In fact, if one observes the explosion in government expenditures attendant upon the shift in power in 1991, one might conclude that Özal had been remarkably successful in containing demands from various political constituencies for greater expenditures. The fact is that Özal's support was weakening, and in an effort to retain power, he apparently perceived little option but to increase expenditures in the hope of gaining support. In the end, he was unsuccessful, but the coalition government that followed found the imperative to increase government expenditures even more compelling, and inflationary pressures intensified.

11.9 Can Sectoral Reforms Succeed while Macro Reforms Fail?

The more difficult question is the impact that failed macro reforms will ultimately have on Turkish economic growth and the sustainability of the sectoral reforms. To date, the evidence is mixed. By the late 1980s, when the inflation rate was remaining stubbornly in the 60–70% range, there was an interval when changes in the nominal exchange rate lagged far behind those in the rate

Table 11.7 **Inflation Rates and the Real Exchange Rate, late 1986–92**

	1986	1987	1988	1989	1990	1991
Rate of inflation (%)[a]	30	32	68	70	53	55
Nominal exchange rate	674	857	1422	2121	2608	5079
Real exchange rate (1985 = 100)[b]	99	95	94	82	59	74

[a]Rate of inflation is percentage change in the wholesale price index, from SIS, *Statistical Yearbook of Turkey* for 1988 and earlier; from Central Bank of Turkey, *Annual Report* (1991) for later years.

[b]Real exchange rate is the nominal exchange rate deflated by the Turkish wholesale price index. An increase in the index indicates a depreciation in the real exchange rate.

of inflation. The result was a major real appreciation of the Turkish lira. Table 11.7 gives the relevant data.

As can be seen, the nominal exchange rate increased by less than the Turkish rate of inflation in each year after 1985. At first, the real appreciation was modest, and arguably was within the range that may well have been appropriate, given rates of inflation in Turkey's major trading partners (at most 4% annually), and the decline in the price of oil in 1986. By 1989, however, the real appreciation was much larger, and in 1990, the nominal exchange rate changed by less than two-thirds the rate of inflation.

By late 1989, the real appreciation of the Turkish lira was already having a visible effect on export earnings and the demand for imports (see table 11.5). By 1991, however, the Turkish lira was depreciating in nominal terms by more than the rate of inflation. Clearly, had the real appreciation of the Turkish lira continued, it would not have been possible to maintain the open trade regime: import licensing would have had to be reimposed, which in itself would have represented a major setback for the credibility of the entire set of sector reforms.[30]

Since 1988, however, the rate of economic growth has fluctuated sharply (see table 11.5). Much of the fluctuation may be attributed to alternative tightening and easing of monetary policy and credit in response to the fluctuations in aggregate demand resulting from expansionary fiscal policies, especially prior to elections.

Those fluctuations in themselves would appear to constitute something of a damper on the potential for economic growth. Real rates of interest have been as high as 50% in periods when the authorities were attempting to reduce aggregate demand. Those rates in themselves, as well as uncertainty as to their future levels, must also be somewhat growth retarding.

Even more problematic, however, is the fact that there is little prospect for

30. There was some concern in the late 1980s that real private investment in manufacturing, necessary to support a continued increase in exports, might not be increasing. Data for the early 1990s, however, indicate that this phenomenon was reversed in 1990. See OECD (1992).

significantly reduced fiscal expansion in the near future. The present government, a coalition, does not appear to have the political ability to withstand expansionary measures. The public borrowing requirement, equal to 12.5% of GNP in 1991, was forecast at 8.8% of GNP for 1992, but by August it seemed evident that that target would not likely be achieved (*Financial Times,* August 3, 1992, 3).

However, if the authorities maintain an open trade and payments regime, it would appear that prospects are for inflation itself to become the "crisis" problem that must somehow be resolved. Given past political sensitivities to inflation, it is perhaps surprising that there has not already been more political protest against it. Yet given a weak coalition government, accelerating inflation and macroeconomic difficulties seem very likely.

The important question is probably not whether there will need to be a period of tight fiscal and monetary policy. The question is how inflation rates of at least 60–70%, if not more, culminating in a period of austerity, will affect the sectoral reforms which so far have succeeded in the Turkish economy.

It is not possible to provide a definitive answer. On one hand, it is possible that the present coalition government, in response to increasing political discontent over inflation, may respond with reimposition of controls over various sectors of the economy, including price controls, credit rationing, import licensing, fixation of the nominal exchange rate to attempt to contain inflation, and other measures. If this should happen, it would of course imply that failure to have achieved macroeconomic stability would have undermined the sectoral economic reforms. Turkey would then presumably undergo a period of stabilization followed by another period of sectoral reform at some time in the future, with poor growth prospect in the interim.

On the other hand, there are some grounds for being somewhat more optimistic. First, the performance of private producers, both in bringing better-quality items to the Turkish market and in competing abroad, has greatly reduced the suspicion with which private economic activity was viewed by the majority of Turks. Because of the greater confidence of the public in the business community, its political positions and influence on the political process are more important than they were prior to 1980.

Second, the earlier import substitution policies seem to have been greatly discredited in the crisis of the late 1970s. While it is imaginable that import restrictions might be reimposed in reaction to accelerating triple-digit inflation, it is not imaginable that Turks would believe that these controls were supporting economic growth as they earlier did. As such, the basis for removing them would be greater.

Third, and perhaps most important, however, is that Turks, especially the middle- and upper-income groups whose desire for modernization and whose views on economic development strategy were so important in support of etatism and government intervention, have benefited enormously from the reforms. Restrictions on currency have been largely removed, and Turks can travel freely. Imported goods are available in the shops, including items such as pharmaceuticals and books that earlier had been more readily obtainable in the black market. And the quality of goods produced domestically has improved, in many cases dramatically. The likelihood that the intellectuals who exercise leadership roles in shaping public opinion could be persuaded of the virtues of the ancien régime seems fairly remote.

The questions then are probably two. The first is whether the Turkish economy can continue to function moderately satisfactorily in the context of rapid inflation. If it can, the next question, and probably the most important one, is whether a macroeconomic stabilization program can be adopted and implemented at some future date in ways that do not seriously distort private sector incentives. If so, the sectoral reforms of the 1980s will have been an important stepping stone toward further growth of the Turkish economy. Even if not, Turkish economic performance and productivity improved significantly in the 1980s. While there would be considerable waste in having to repeat the sectoral reform process, there has been a great deal of learning, and future Turkish efforts would start from a considerably higher base because of the experience of the 1980s.

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