



Stabilising Stabilisation

**Marco Airaudo, Kemal Derviş, Daniel Gros, Faik Öztrak,
Fırat Bayar and Yusuf Işık**

Abstract

Recurrent severe macroeconomic crises have not allowed the Turkish economy to realise its growth potential over the last two decades. The stabilisation programme launched after the latest crisis in the spring of 2001 has so far been successful in the sense that inflation has fallen from over 70% to less than 10% and public debt is declining slowly as a % of GDP. The key task now is to transform this hard won stability into a normal state of affairs, i.e. to stabilise stabilisation.

This paper addresses several aspects of this overall task. Section 1 gives a brief overview of what has been achieved so far. It then turns to the key variable that determines Turkey's vulnerability to shocks, namely the debt-to-GDP ratio and its dynamics. Section 3 then deals with external vulnerability: How can Turkey import capital to accelerate its convergence with the EU without accumulating a crippling foreign debt burden? FDI might play a crucial role here (as it did, and still does, for the new member countries). Section 4 then deals with the quality of the institutions that determine the performance of the Turkish economy in a European context. Section 5 concludes.

Marco Airaudo is LUISS Research Fellow at CEPS. Kemal Derviş is former Minister for Economic Affairs, Member of Parliament and, Member of the Coordination Board, EDP. Daniel Gros is Director at CEPS. Faik Öztrak is former Undersecretary of the Treasury and Visiting Professor at Middle East Technical University. Fırat Bayar is former Associate of the Treasury and Ph.D. candidate at Middle East Technical University. Yusuf Işık is Advisor to Mr. Derviş and former Head of the Strategic Research Department of the State Planning Organisation.

EU-Turkey Working Papers are the product of a joint project of the Centre for European Policy Studies (CEPS), Brussels, and the Economics and Foreign Policy Forum, Istanbul, entitled:

Strategy for the EU and Turkey in the Pre-Accession Period

Launched in August 2004, this new publication series covers both political themes (democracy and domestic governance, justice and home affairs, foreign and security policies) and economic policy (macroeconomics, banking, energy, agriculture and the EU budget). The working papers will form the basis of a book, integrating all these aspects of Turkey's EU candidacy. These materials will be presented for public debate at conferences to be held in Brussels on 27 September and in Istanbul on 8 November. CEPS is also electronically publishing a monthly *Turkey in Europe Monitor*, which is freely accessible at www.ceps.be.

CEPS and EFPF gratefully acknowledge financial support for this project from the Open Society Institute of Istanbul, Akbank, Coca Cola, Dogus Holding, Finansbank and LUISS.



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ISBN 92-9079-518-2

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Introduction

One of the key reasons explaining why Turkey failed to realise its growth potential in the past and lost relative ground to countries in southern and eastern Europe has been the recurrence of quite severe macroeconomic crises, erasing in one year what had been achieved in two or three preceding years, and lowering Turkey's growth average. In the more distant past, these crises were triggered by chronic balance of payments difficulties. More recently, the key problem has become total public sector debt, which rose from about 28% of GDP at the beginning of the 1990s, a modest ratio, to about 90% of GDP at the peak of the 2001 crisis. What led to the 2001 crisis was the coming together of a banking crisis, which forced the state to recognise its contingent liabilities in the banking sector, with a risky attempt to disinflate by using a nominal anchor exchange rate policy. The ensuing collapse of the exchange rate and the surge in the stock of public debt resulting from the Turkish government's recapitalising the de facto bankrupt state banks and important segments of the private banking system that were nationalised because they had lost their capital, led to a surge of the public debt ratio to more than 90% of GDP at the end of 2001.

The new Economic Programme launched in the spring of 2001 embarked on a set of structural reforms and a macroeconomic policy with the objective of both stabilising and strengthening the growth process in Turkey so as to realise an acceleration in the long-term growth rate and protecting the country from recurring crises. So far, the assessment of both private market actors as well as of the international institutions is that the programme has been successful in re-establishing macroeconomic stability, reducing the debt ratio and transforming expectations about debt-sustainability, as well as laying the ground for a durable acceleration of growth in an environment of drastically reduced inflation and much lower real interest rates.

The key task that now remains is to transform this hard-won stability into a normal state of affairs, i.e. to stabilise stabilisation. In the following we discuss several aspects of this overall task. We start in Section 1 with a brief overview of what has been achieved so far. We then turn to the key variable that determines Turkey's vulnerability to shocks, namely the debt-to-GDP ratio and its dynamics. Section 3 then deals with external vulnerability: How can Turkey import capital to accelerate its convergence with the EU without accumulating a crippling foreign debt burden? FDI might play a crucial role here (as it did, and still does, for the new member countries). Section 4 then deals with the quality of the institutions that determine the performance of the Turkish economy in a European context. Section 5 concludes.¹

1. Macroeconomic Policy Achievements

Let's start with the good news. Table 1 summarises the short-term success of the programme launched in 2001. The economy recovered strongly in 2002 and 2003 and the macroeconomic performance targets of the Economic Programme linked to the Stand-By Agreement with the IMF were generally exceeded. After a decline of 7.5% in 2001, GDP growth rates jumped to 7.8% and 5.8% in 2002 and 2003, respectively. This was achieved despite a very tight fiscal stance. On a three-year average basis, the primary surplus of the public sector was 5%. In 2001, at the peak of the crisis, the target of 5.5% was exactly met. In 2002, partly due to relaxation during the months leading to the November general

¹ A companion working paper (No. 8) looks at Turkey's long-term growth potential and prospects for real income convergence. See Dervis et al. (2004).

elections, the primary surplus declined to 4%. In 2003, final estimates are likely to show that the primary surplus approached the strengthened target of 6.5%. Clearly fiscal policy in Turkey has succeeded in impressing markets and restored short-term confidence without preventing a strong recovery in output thanks to an exceptionally flexible economic structure and a great deal of social cohesion. Preliminary estimates for 2004 indicate that GDP growth will be close to 7 percent, well above the 5 percent original program target, which the international institutions and market observers agree will be exceeded.

Table 1. Macroeconomic policy achievements

	2001	2002	2003	2004*
GNP per capita (€)	2360	2770	3000	3290
GDP growth (%)	-7.5	7.8	5.8	>5.0
Inflation (CPI annual, %)	68.5	29.7	18.4	12.0
Real effective exchange rate (CPI, end 2003=100)	82.4	91.8	100	
Central Bank reserves (\$ billion)	18.741	26.725	33.639	
Bank regulatory capital to risk weighted assets (%)	15.3	25.3	31.8	
Net public debt/ GNP (%)	90.9	78.6	70.5	67.7
Primary surplus/GNP	5.5	4.0	6.5	6.5
PSBR/GNP	-21.1	-12.3	-9.3	-6.8
Spreads on Turkish dollar Eurobonds (basis points)	707	693	309	
Average real interest on domestic debt, ex-ante	35,5	30,3	28,6	11,2
Unemployment (%)	8.4	10.3	10.5	
Current account (%of GDP)	3.4	-1.5	-2.9	-3.5 to-4.0

* Economic Programme magnitudes

Sources: Eurostat, IMF Staff Report, IFS, Turkish Treasury and Central Bank estimates.

Two qualifiers must be added to this positive evaluation, however: a good part of the fiscal adjustment, particularly in 2003, has been due to one-off measures, including a tax amnesty and draconian cuts in public investment which are not sustainable. Looking towards the future, fiscal policy will have to be much more concerned with the quality of the adjustment and long-term sustainability. The second qualifier concerns the current account deficit which has been widened and will exceed 4 percent of GDP. While this may not cause an immediate cause for concern given the high level of foreign exchange reserves and the flexible exchange rate regime, it does indicate the need for some correction in the medium-term.

On the inflation front, there has been very good progress. Turkey had suffered from chronically high inflation for more than two decades. In the 1990s, inflation averaged about 70%. With the exchange rate-based stabilisation programme in 2000, CPI inflation declined to 37%. The 2001 collapse led to another surge: annual CPI inflation was 68.5% in 2001. Thanks to the new Economic Programme taking hold, it declined to 29.7% in 2002 and to 18.4% in 2003. The target set for 2004 was 12% and the final outcome is likely to be close to that figure.

While developments have so far been encouraging on the inflation front, basically because the newly independent central bank was left to pursue its prime target of price stability thanks to a tight fiscal policy, the question remains whether this can be taken for granted for the future as well. The next section will deal extensively with fiscal policy, but one should also not forget that monetary policy has to take into account some special factors as well. As shown in more detail in the annex on dollarisation, the Central Bank of Turkey faces a very complex task. Special care is needed in applying

simple rules, e.g. “if inflation is above target, increase interest rates by the amount of the overshoot”. Such simple rules (sometimes called Taylor rules) have to be modified in an economy in which 40% of bank deposits are still in foreign currency. (Whether the public holds dollars or euros does not matter in this context.) Any depreciation of the currency automatically increases the local currency value of the public’s holdings of money and implies an immediate increase in the local currency value of their dollar or euro holdings, increasing the propensity to spend, which in turn increases the pressure on prices. Under these circumstances it becomes difficult to control inflation. If the exchange rate falls for some exogenous reason (e.g. the crisis in Iraq, internal political difficulties or a crisis in other emerging markets), inflation could increase even though the central bank has not changed its policy stance. In an economy such as Turkey, in which the public holds such a large share of its liquid assets in foreign currency, it thus becomes important for the central bank to be particularly tight in its control over inflation and to react when the exchange rate moves.

Following a sharp depreciation in 2001, the real effective exchange rate appreciated by 11.4% and 8.9% in the following two years and reached its pre-crisis level by the end of 2003.

In the 2002-03 period, gross reserves of the Central Bank have recorded a \$15 billion increase, reflecting a comfortable overall balance of payments situation, although it should be stressed that the combination of a widening current account deficit compensated by short-term capital inflows, means that the economy will remain vulnerable to a sudden capital flow reversal and significant exchange rate depreciation. This could re-ignite inflation and constitute a major setback on the road to lasting stability. Some volatility is, of course, unavoidable and some of it will be due to developments in international markets beyond the control of Turkish policy-makers. The challenge is to keep volatility within limits that will not upset the overall trend towards stability that Turkey has been able to establish since the end of 2001.

2. Macroeconomic Policy Prospects and Debt Dynamics

Turkey’s attempt to stabilise stabilization will depend critically on Turkey’s ability to ensure that fears about a ‘debt event’, such as any involuntary restructuring, do not resurface in the future, that inflation remains on a steady downward trend and that the risk premia leading to high real interest rates steadily decline. Taking into account what has been achieved by 2004, can one safely assume that Turkey has indeed overcome the chronic high inflation and macroeconomic instability that was experienced in the past? Under what conditions could Turkey’s debt-to-GDP ratio converge to the 60% Maastricht criterion and how does it compare to debt burdens in the rest of Europe? Is 60% low enough given the memories of instability that must be overcome for interest rates to decline to levels compatible with the 5% per capita growth that we assume in the convergence scenario presented in our companion paper? What are plausible debt dynamics projected by international institutions and private sector analysts for the period ahead? What is the likely path for the real interest rate and is that path consistent with the convergence scenario? These are the issues that we will discuss in this section.

The strength of the recovery observed in 2002 and 2003 largely reflected the rebound after a deep recession. But, continued rapid growth in 2004 and the rapid increase in labour productivity, together with a more than 20% real increase in private investments in 2003 further accelerating in the first half of 2004, also give an early indication of an improvement in longer-term growth prospects. Turkey would not be the only country to experience more than a rebound after a financial crisis. Russia, which was hit by an even stronger speculative attack in 1998 (two and a half years before the crisis broke in Turkey) has since experienced a period of sustained growth which initially surprised many observers. One important element in keeping Russian growth rates high has certainly been the high oil price. What has been more surprising to some is that the government has kept its accounts in good order, continuing to run small surpluses. This is another indication of how a tight fiscal policy can foster growth.

The decline in inflation continues for the third consecutive year with annual CPI inflation now close to 10%, for the first time in three decades. Turkey appears to be able to achieve both disinflation and growth under the auspices of the programme launched in 2001.

The credibility of the stabilisation programme has also been strengthened by the decisive moves designed to facilitate the beginning of negotiations towards EU membership. By breaking past nominal rigidities, the structural reforms have started to enable the economy to avoid the trade-off between growth and disinflation that had characterised the past.

As Europe and Turkey contemplate the beginning of membership negotiations, the foundations exist for continued stable and quite rapid growth. At the same time it should be stressed that the existence of the foundations is not enough to ensure success. Both the size and the nature of Turkey's public debt as well as the level of real interest rates on domestic debt continue to make Turkey vulnerable to external or internal shocks. To stabilise stabilization and to accelerate growth in a sustainable fashion, future economic policies must have four essential components:

1. Fiscal policy must continue to be able to generate a sizable primary surplus.
2. The 'quality' of fiscal policy must improve in a way that is 'growth supporting'.
3. Structural reforms must ensure that no new 'contingent liabilities' are allowed to undermine the overall fiscal effort (municipalities, pensions, energy).
4. Social policies must ensure that inequalities and inequities do not undermine the social cohesion and social peace without which sustained growth would not be possible.

These four dimensions of good policy must be implemented simultaneously throughout the years ahead. The burden of debt and the weight of the past are such that Turkey cannot afford to make new mistakes. We shall turn, briefly, to each of the four areas that condition success.

2.1 A strong primary surplus

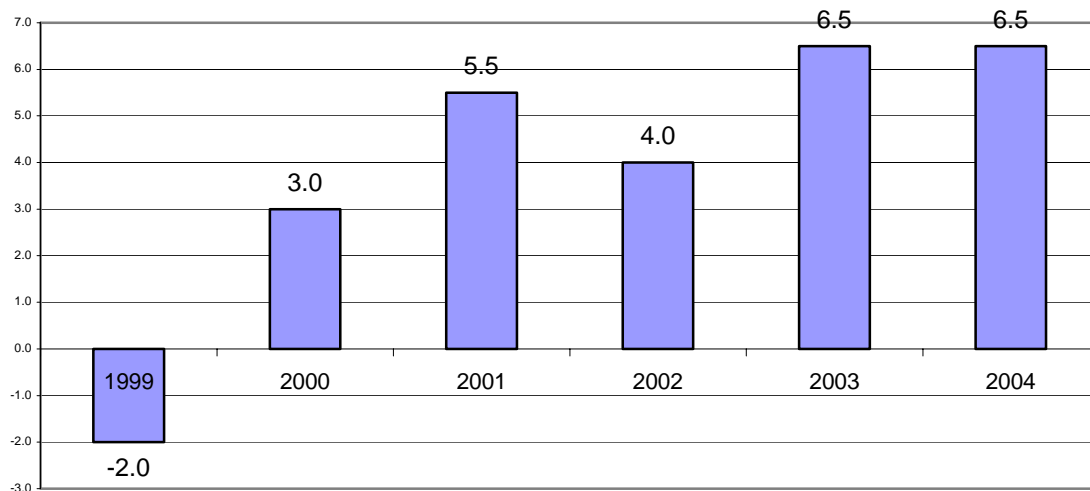
Together with GDP growth, the real exchange rate and the real rate of interest on the stock of public debt, the primary surplus of the public sector is one of the four determinants of debt dynamics. It is also the only one of these variables that can be considered to be a policy variable in that it is broadly under the control of the government authorities.² There is no doubt that the strong fiscal adjustment Turkey was able to implement over the last three years has been one of the key factors leading to the restoration of confidence and the rather rapid reduction in the debt ratio. Figure 1 below depicts the extent of the fiscal adjustment and the strength of fiscal policy.

As can be seen in Figure 1, Turkey was able to achieve a large primary surplus in the crisis management (2001) and post-crisis period (2002-03). The target of 5.5% was exactly met in 2001, the crisis year. 2002 was an election year and the primary surplus fell short by a substantial 2.4 percentage points from the target which had been set at 6.5%. Nonetheless, it should be stressed that 4.0% is in itself quite a surplus, and it is better than what most EU member countries have achieved over the last decade!³ In 2003, the target of 6.5% was broadly met which sent a very strong positive signal to markets. The outlook for 2004 suggests that Turkey is likely to come close to meeting the same ambitious target. In the crisis and immediate post-crisis period, strong fiscal policy had three mutually reinforcing positive effects. First, it made resources available to finance the roll-over of debt. Second, by restoring confidence it led to a decline in real interest rates which had skyrocketed at the time of the crisis. Third, the restoration of confidence which increased the risk appetite of international investors in 2003 also led to a significant appreciation of the Turkish currency causing an immediate reduction in the debt-to-GDP ratio as a significant portion of the debt was either foreign debt or domestic debt denominated in or indexed to foreign exchange.

² The basic debt dynamics equation is $d = -p + (r - g) D$, where d is the rate of growth of the debt to GDP ratio, p is the primary surplus, r is the real rate of interest (adjusted for real exchange rate changes), g is the rate of GDP growth and D is the ratio of the stock of net debt to GDP.

³ For example, in Mexico the primary surplus was 2.35% in the year following the 1994 crisis; it was 0.53% in Argentina in 2001 and 3.5% in 2000 in Brazil. A primary surplus in the 3 to 4% range is usually considered a major achievement.

Figure 1. Public sector primary balance/GNP, Turkey



Source: Turkish Treasury and IMF.

Turkey will have to continue to run a significant primary surplus in order to drive the debt ratio to 60% and below. In the coming years, however, it will be equally important to focus on the *quality of fiscal policy*. It is also becoming increasingly important to remember that government expenditures have two components: current expenditures which do not, directly at least, add to the public sector's net worth, and public sector capital formation, which does add to the net worth of the public sector. To quote Buiter & Grafe (2001), "when public sector capital earns a net financial return equal to the government's cost of borrowing, capital formation is, from a fiscal point of view, exactly the opposite of government borrowing; it amounts to government debt repayment." When public investment does not produce a direct financial return but adds to the economy's capital stock leading to more rapid growth, the story is more complicated but it remains true that a medium-term fiscal framework should not lump together current and capital expenditures.

With these arguments in mind, Turkey must be careful that the primary surpluses it generates do not come at the expense of essential amounts of public investment which may be needed to break key infrastructural bottlenecks or which are needed to provide essential public goods without which the process of growth will be endangered. Running a very high primary surplus should not take the form of accumulating a new set of contingent liabilities in the form of essential expenditures that cannot be indefinitely postponed. A 6.5% primary surplus constitutes a maximum by world standards and cannot be expected to continue for much longer. Provided the favourable evolution of debt indicators continues and the current account deficit starts to narrow, a reduction of the primary surplus will become possible. When it is reduced, this needs to be done in an effective way, i.e. by relying on strong structural policies to free resources for a package of growth-supporting expenditures and/or growth-friendly and careful reductions in those taxes that constitute serious disincentives for growth.

2.2 The quality of fiscal adjustment

For the Economic Programme launched in 2001 to be successful in achieving the transition to a sustained rapid growth rate, this *quality of fiscal policy* referred to above is as important as the overall level of the primary surplus. The projection of a continuation of very tight fiscal policy, with a primary surplus maintained at close to 6.5% of GDP combined with quite rapid growth is a key feature of the 'base case' scenario adopted by both the Turkish authorities and the IMF. Modest variations in the real growth rate of the economy or in the real interest rate do not lead to unsustainable outcomes. If, however, one or two years of slower growth and higher real interest rates were to be combined with a significant (say 2 percentage points) decline in the primary fiscal surplus, the debt ratio would start increasing again and the danger of another vicious cycle of increasing real interest rates, falling growth

rates and increases in debt indicators would reappear. These considerations highlight the critical importance of fiscal policy.

As noted above, however, it is not only the aggregate magnitudes but also the ‘quality’ of fiscal policy that matters. If, for example, the primary surplus is lowered by one percentage point to make space for growth-promoting measures, such as high-priority and high-return public investments, the effect on debt dynamics will be different than if fiscal policy is relaxed for the sake of pure public consumption.

The quality of the tax system, especially ensuring that it is sufficiently broad-based, is also very important.

The continuation for 3 or 4 years of a 6.5% primary surplus is going to be extremely difficult. What is needed and politically feasible is a gradual and careful reduction of the surplus *in favour of highly growth-promoting measures* so that debt dynamics will not deteriorate. An increase in growth will compensate for a lower primary surplus in the equation governing the evolution of the debt-to-GDP ratio. A relaxation of fiscal policy, even if it is modest, *without* such growth-promoting improvements in the composition of revenues and expenditures is dangerous. It will be important, therefore, to go more deeply into the analysis of the quality of fiscal policy in the medium term.

2.2.1 Public debt in Turkey: A brief history

Turkey has entered the 1990s with liberalised capital account. Similar to the experience of many emerging countries, this was done against a background of a poorly regulated financial sector. The financing of the growing public deficits was based on an arbitration mechanism carried by private banks. This led to the build-up of maturity and exchange rate risks in the banking sector.

Figure 2. Public net debt/GNP



Source: World Bank, Turkish Treasury.

Turkey’s public net debt share in GNP remained fairly constant between 1994 and 1998. Despite the increase in the overall borrowing requirement, the primary balance appeared to be in surplus. High inflation, i.e. the monetisation of some of the debt, prevented a large increase in the debt ratio. Turkey remained vulnerable, however, throughout that period. In 1999 the rapid depreciation of the TL and the slump in economic activity, together with some easing in the fiscal stance resulting partly from the terrible August earthquake, disturbed this relative stability and led to a rise in the ratio of net debt to

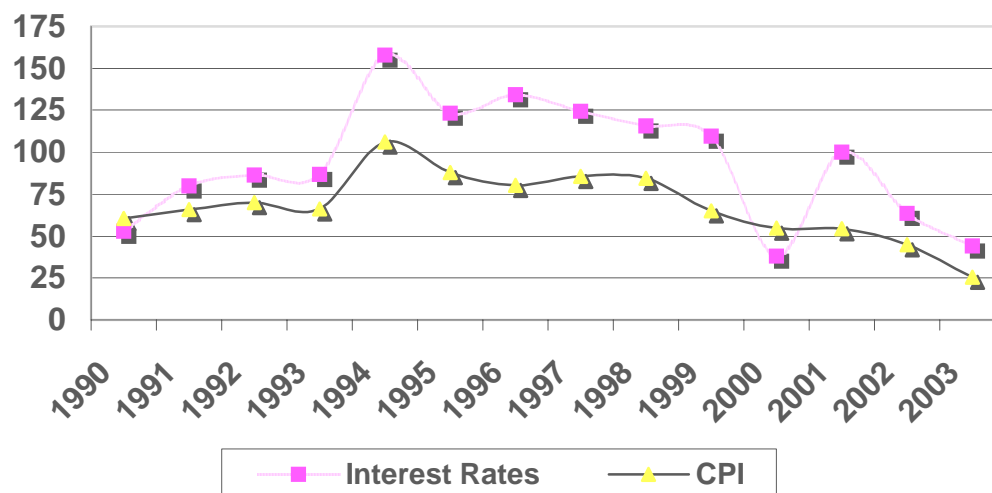
GNP to 61%. Parallel to these developments, there had been a steady increase in the contingent liabilities of the state mainly in the financial sector. A disaster was waiting to happen and it finally happened in early 2001 triggered by a minor political dispute.

2.2.2 The need to reduce the PSBR

Turkey's public sector deficit as a share of GNP has increased by more than 50% during 1990-2001. Between 1990 and 1994, the increase was mainly due to the increase in the primary deficit. Following the 1994 currency crisis, the primary balance remained mostly in surplus, but the overall public sector borrowing requirement (PSBR) continued to increase. This was due to the increase in interest payments. During the 1990s, factors such as the currency crisis in 1994, natural disasters in 1999 and external developments such as the Asian and Russian crises have negatively affected the economy.

Turkey could be considered a key witness in the case for delaying capital account liberalisation until a strong supervisory and regulatory framework is in place. The strategy that started to be implemented at the end of the 1980s, namely to facilitate government finance via liberalisation of the capital account, led to an extremely vulnerable structure. It could only be maintained through a rapid increase of domestic interest rates as higher premia were required with increased risk perception. Figure 3 below shows the widening gap between treasury borrowing rates and CPI increases indicating a very high risk premium.

Figure 3. Nominal interest rates* and consumer price index, Turkey

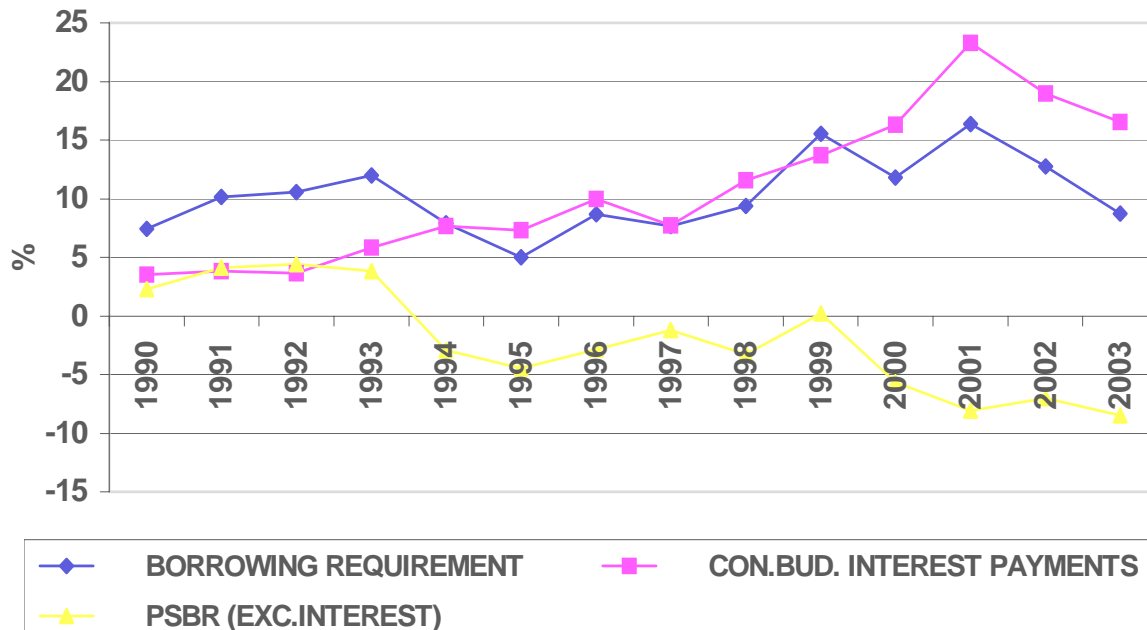


*Annual Average Compounded Interest Rates of Treasury Discounted Auctions

Source: Turkish Treasury

The consolidated budget interest bill peaked in 2001 after the currency and banking crisis. The realisation of the contingent liabilities related to the banking sector, the slump in economic activity and the depreciation of the currency were the main factors behind this development. Consequently despite a major improvement in the primary surplus, the PSBR increased dramatically as a share of GDP compared with the previous year. The Economic Programme which was adopted after the crisis in 2001 was based on radical fiscal retrenchment. The record-high primary surpluses, external finance provided by the IMF, together with the implementation of a radical structural reform agenda boosted confidence and led to a rapid reduction in interest payments and public deficits during the two years following the crisis.

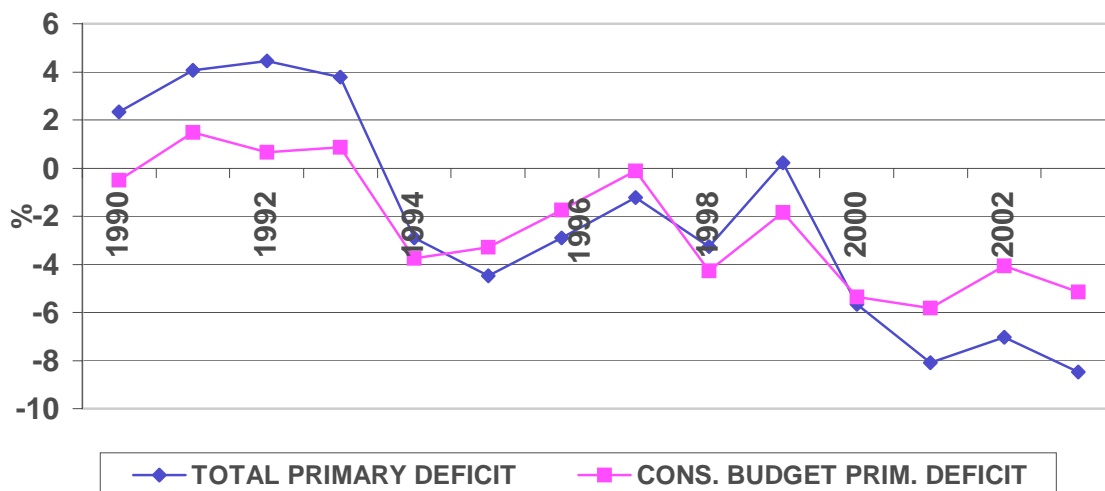
Figure 4. Public Service Borrowing Requirement/GNP



Source: SPO.

During the first half of the 1990s, the primary deficit generated by the non-budget institutions was the main determinant of the overall primary deficit. Non-budget institutions are state economic enterprises (SEEs), local governments, social security institutions and extra budgetary funds. Between 1995 and 1999, these institutions registered primary surpluses. The data do not include arrears accumulated by the central government to public banks due to the duty losses of the SEEs. Their surpluses have increased substantially after 2001. Removal of a large number of extra budgetary funds to increase budgetary control, reduction of the subsidies provided through SEEs and labour rationalisation in SEEs realised after 2001, contributed to this development.

Figure 5. Primary deficit/GNP

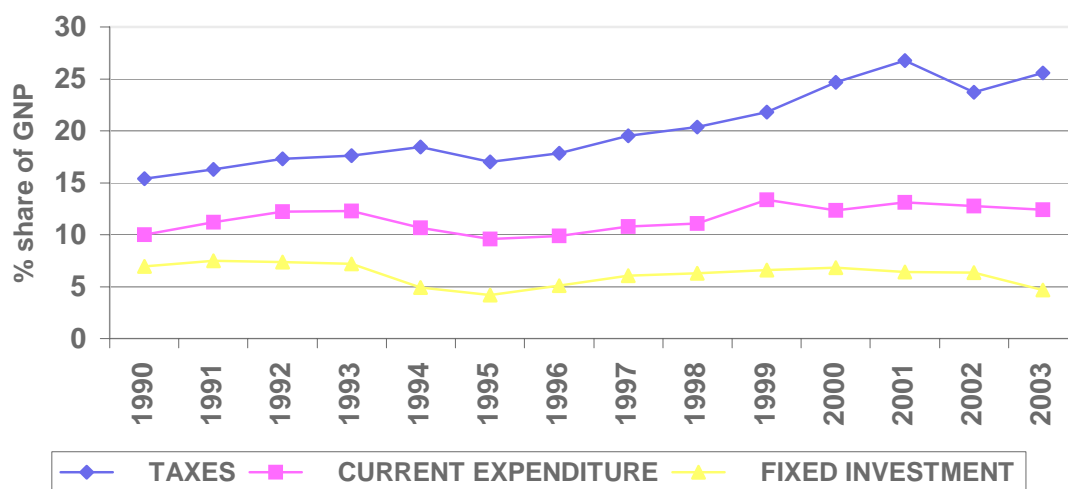


Source: SPO

2.2.3 The nature of the adjustment in the public sector

In order to analyse the nature of the fiscal adjustment, we focus on the major determinants of the primary balance. Figure 6 below shows that during 1990-2003, fiscal policy relied heavily on tax increases. Other current expenditures of the public sector as a share of GNP (also covering personnel expenditures) after a decline during the 1994 crisis exceeded their pre-crisis levels in 1999 and remained more or less at that level in the following years. The resilience of other current expenditures is mainly related to personnel expenditures. Although the civil service wage bill was limited during the 1994 crisis through below-inflation salary increases and hiring freezes, these were reversed after a few years. A radical reform of the civil service is needed to increase efficiency through rationalisation in human resources comprising also increases in the remuneration of skilled personnel.

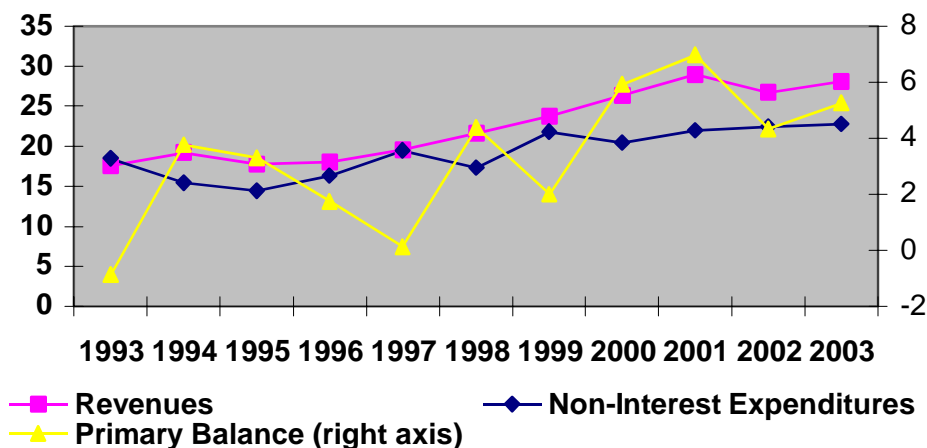
Figure 6. Public sector adjustment



Source: SPO

Public sector capital investment expenditures were exceeding 7% of GNP before 1994. Following the 1994 crisis they were cut to below 5% of GNP. After 1997 they increased to around 6% of GNP. During the course of the 2001 Economic Programme, the share of public investments in GNP was first kept over 6%. But in 2003 as a result of indiscriminate expenditure cuts to finance salary and pension increases, the share of public investments in GNP declined to below 5% for the first time since 1995.

Figure 7: Consolidated Budget Balance (share of GNP)



Source: Turkish Treasury

Having a better understanding of the fiscal stances adopted during the 1990s and early 2000 requires a closer look at budgetary policies. During the 1994 crisis, the initial adjustment relied mainly on one off primary expenditure cuts. But since these were not supported by sufficiently strong structural reforms, they were not sustainable and the level of expenditures rapidly returned to pre-1994 crisis levels. Revenue increases were more modest.

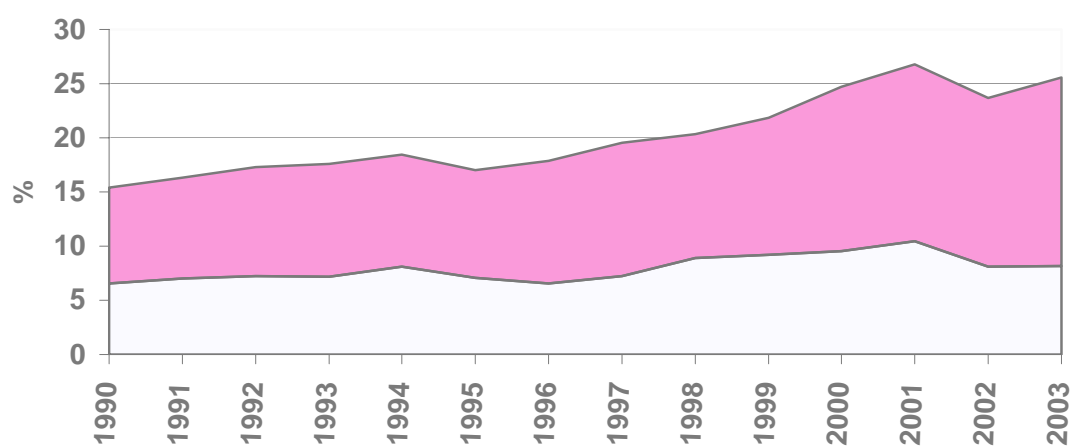
The programme adopted after the 2001 crisis mostly relied on revenue increases. But the higher increase in budgetary non-interest expenditures as compared to public sector expenditures as a whole reflects the budgetisation of some expenditures, e.g. extra budgetary funds and agricultural subsidies treated previously outside the budget to improve fiscal management. Improving the control of public expenditures and structural reforms with longer-term fiscal impacts were given higher priority as opposed to one-off cuts.

Although the central government budget represents the major portion of public sector activity, in the Turkish case consolidated public sector accounts provide a better understanding of the fiscal stance. Accordingly, the following two sections take a closer look at revenues and expenditures.

2.2.4 Revenues

The composition of taxes has shifted considerably towards indirect taxes. This was mainly due to the ad hoc introduction and increases of excises. The economic efficiency of these taxes is not high. They also have negative distributional effects on low-income groups. At the early adjustment stage following a severe crisis, the recourse to such taxes is inevitable. But after the crisis, a rationalisation of the tax system on economic and distributional grounds is required to promote growth. Although a comprehensive medium-term tax reform strategy has been adopted within the 2001 Economic Programme and major reforms have been realised, there is still a need to improve the organisational structure of tax administration to achieve better compliance.

Figure 8. Total taxes/GNP



Source: SPO.

Turkey's tax effort concerning indirect taxes on goods and services is comparable to that of countries in the eurozone. But the share of direct taxes, including social security taxes, are considerably lower than in the monetary union, despite the fact that tax *rates* are comparable.⁵ This is mainly due to the lower level of per capita income, the large population in agriculture and the size of the informal sector. During the convergence phase there is scope to increase revenues from direct taxes. On the other hand, the large share of basically untaxed agricultural employment, the large share of labour at minimum wage (about 45%) and the large informal employment, increase the tax burden on labour in the formal,

⁵ World Bank (2003a).

tax-paying sector. This high level of taxes on labour negatively affects the flexibility of the labour market. One also has to bear in mind that high nominal interest rates have a positive impact on direct taxes. With a decline in inflation, revenues from taxes on interest earnings will decrease. This will further increase the required tax effort to converge to EMU levels in direct taxes. The ongoing measures related to the modernisation of the tax administration will be the major contributors to the required effort.

Table 2. Central government tax revenues, 2000 (share of goods & expenditures, %)

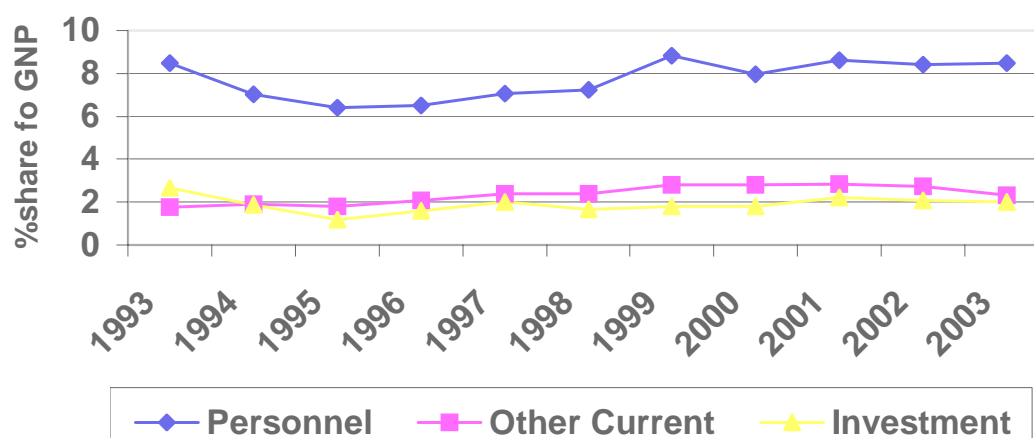
	Current Revenues	Taxes on Income	Social Security	Taxes on goods and services
Turkey	26.7	8.3	5.6	10.3
EMU	34.2	9.2	12.5	9.1

Source: World Bank (2003a)

2.2.5 Expenditures

Budget expenditures on investment, personnel and current expenditures give an idea on the adjustment patterns. Although a substantial reduction was realised in the civil service wage bill and investments in 1994, they were not sustainable. During the implementation of the 2001 programme these expenditures as a share of GNP proved to be resilient despite declines in real terms.

Figure 9. Budget expenditures



Source: Turkish Treasury.

On the other hand, the overall level of public expenditures as a share of GDP in 2000 is higher in Turkey compared with EMU. This is due to the high interest outlays. Non-interest expenditures are considerably lower than EMU average. With the decline in interest outlays due to increased confidence during the accession period, an important room for manoeuvre to somewhat increase growth-supporting expenditures will be created.

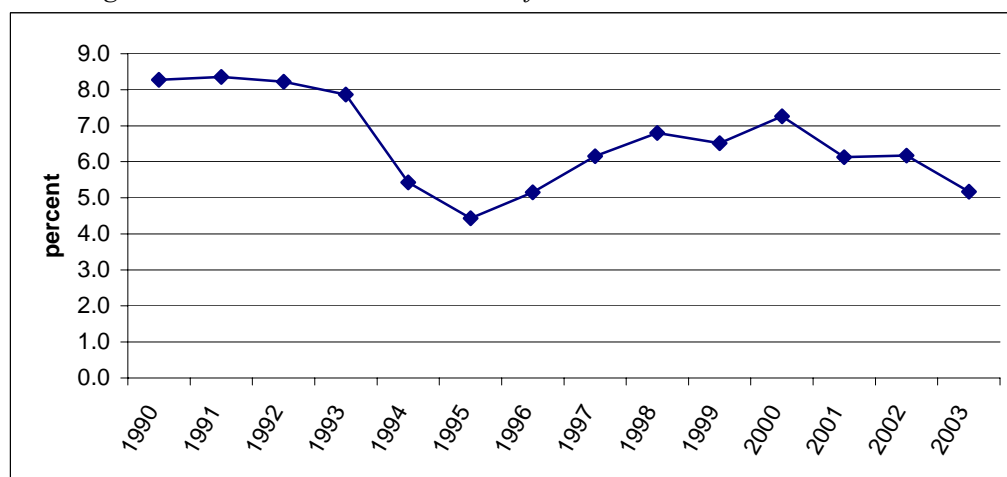
Table 3. Interest and non-interest expenditures, 2000 (share of GDP, %)

	EMU	Turkey
Interest	3.7	17.0
Non-interest	41.1	33.4
TOTAL	44.8	51.4

Source: SPO, European Commission (2003b).

Public investments as a percentage of GDP are shown in Figure 10. There has been a strong decline in this ratio in the years following the 1994 crisis. The subsequent recovery was gradual and broken by a renewed decline due to the 2001 crisis.

Figure 10. Public investment as a % of GDP, 1990-2003



Source: Turkish Treasury.

The sectoral distribution of public investment is also important for assessing the growth-friendliness of public investment expenditures. Education, health and basic infrastructure are the sectors for the public sector to promote growth. The share of education in public investments stood at around 7.1% during 1991-96. After the introduction of 8 years of compulsory education, the share of investments in this sector has jumped to 11.7% during 1997-2000. After the 2001 crisis, this figure increased to 13.4%. The corresponding figures for health are 3.9%, 4.4% and 5.6%. In 2001, a rationalisation of the public investment programme was implemented. In the 2002 investment programme, 353 projects and 649 sub-projects were cancelled and the average completion time for public investment program was reduced by 32%. As shown by the table below, investment in social sectors has been given priority.

Table 4. Gross fixed investments by sectors (public) (at current prices, percentage share)

	1997	1998	1999	2000	2001	2002	2003
Agriculture	10.8	8.1	8.4	8.7	10	9.2	7.4
Mining	1.6	1.5	1.5	1.2	1.5	0.7	1.3
Manufacturing	2.5	2.7	2.6	2.9	4	3.2	3
Energy	12.4	16.8	15.4	15.2	13.7	20.8	15.1
Transport % commu.	34.8	34.1	36.9	35.2	27.1	27.5	27.3
Tourism	0.6	0.5	0.5	0.5	0.6	0.8	0.7
Housing	1.2	1.1	1.3	0.8	0.9	0.8	1
Education	12.4	10.8	11.8	11.9	13.7	12.1	14.5
Health	4.8	4.5	3.8	4.5	5.9	5.1	5.8
Other services	18.9	20	17.9	19.2	22.5	19.8	23.9
Total	100	100	100	100	100	100	100

Source: Turkish State Planning Organisation.

Finally, one should not forget that achieving price stability has fiscal implications. Gros (2004) shows that the central bank (and thus ultimately the Treasury) should have benefited from the high inflation and high (real and nominal) interest rate environment, earning perhaps until recently as much as 1.5-2% of GDP. Most of this will disappear once price stability has been established on a credible basis so that both real and nominal interest rates can fall to below double-digit levels.

At that point the independence of the CBT will have to be carefully safeguarded because it has a large amount of foreign assets and liabilities on its accounts. Given the large country risk premium for Turkey on international financial markets, it is likely that the CBT has to pay a higher interest rate on its liabilities than it receives on its foreign currency assets (which it also has to keep in a liquid form so that they can be readily mobilised). With foreign assets and liabilities on the balance sheet of the CBT amounting to about 20% of GDP, an interest differential of 2-3 percentage points could easily lead to losses worth 0.4-0.6% of GDP, i.e. more than the remaining seigniorage revenues the CBT could expect under price stability. If the CBT were to run sustained losses because of its overblown balance sheet, its independence might in the end be put in danger.

Price stability leads to a loss of the inflation tax, but it might also bring considerable benefits. There is the well-known ‘Oliviera-Tanzi effect which operates when taxes are paid after incomes have been earned. With high inflation, the government was thus getting a somewhat devalued tax revenue. This is why most countries emerging from a longer period of high or hyper-inflation usually find that the real value of tax revenues increases as price stability is re-established.

As mentioned above, the instability of the domestic currency has led Turkish households to extensively use foreign currencies, which implies a cost for the economy as a whole. The ‘dollarisation’ of bank deposits can be easily measured, it is now around 40% of total banking deposits, depending of course on the exchange rate. It is impossible to provide an equivalent measure for currency in circulation, but some estimates exist. Considerable amounts of dollars are reported to be in circulation in Turkey. The total cash in circulation in TRL amounts, in USD, to about \$4.5 billion. In Turkey the euro is as widely used as the USD; it is thus likely that an equivalent amount of euros is also in circulation. Accordingly, the total (foreign) currency in circulation in Turkey could be around 18-20 billion euros or dollars, equivalent to close to 10% of GDP. With an interest rate on Turkish foreign debt around 7-8%, this would imply that the cost to the Turkish economy of this high degree of dollarisation must be close to 1% of GDP. It is likely that once price stability has been really established, currency holdings change to a pattern like that of Bulgaria where the (domestic) cash to GDP ratio is now close 8% of GDP. This implies that achieving price stability could save the Turkish economy foreign debt service equivalent to around 0.5-0.8% of GDP in flow terms (8-10% of GDP in stock or present value terms).

2.3 Protecting the economy against new contingent liabilities

2.3.1 Fiscal risks ahead

Efforts to rationalise the tax system, a reduction of quasi-fiscal deficits, measures to increase the control of public liabilities and steps towards a more efficient public expenditure management are major moves towards a sustainable fiscal stance. The major risk in the fiscal area would be the reversal of this structural reform process. The start of the negotiations with the EU will be an important external anchor to guarantee the continuation of reforms.

Despite the radical reform agenda implemented over the last few years, vulnerabilities still exist. Further risks may arise during the harmonisation period with the greater liberalisation of several markets. Explicit and implicit contingent liabilities exist in several areas. Guarantees extended to local governments, contingent supports extended to enterprises in the energy sector, future deficits of social security institutions and government guarantees to the liabilities of the financial sector are among the risk factors.

Under certain conditions local governments can borrow for their investments. In the past, political pressures led to the accumulation of guaranteed credits of local governments. The payment discipline was low at the local level and the Treasury had to pay on their behalf. Accumulated arrears of local governments to the Treasury stood at around \$5 billion. Although the newly adopted legal framework explicitly defines the sovereign debt and guaranteed debt, municipalities are institutions that cannot go bankrupt. Explicitly guaranteed or not, creditors could implicitly assume a Treasury guarantee while

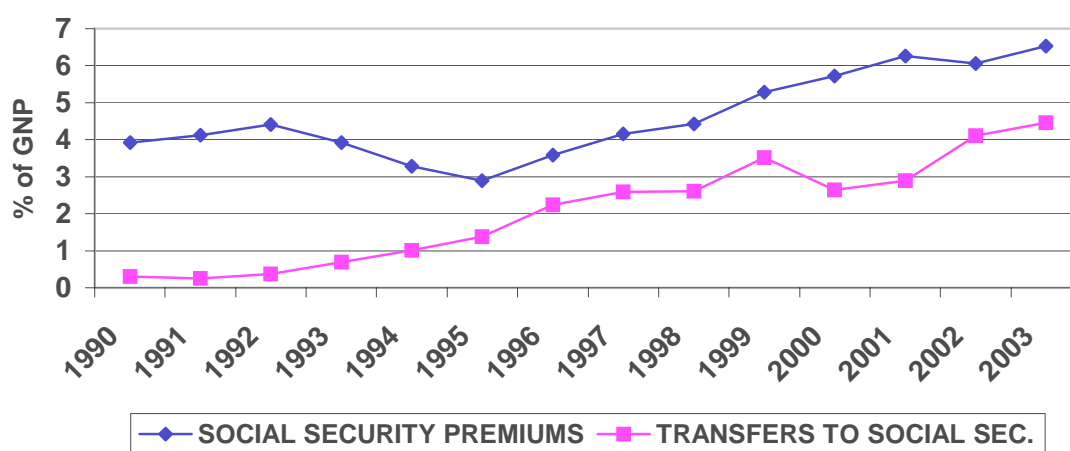
extending credits to municipalities. Without central control over their borrowing activities, this will be a major risk for government finances.

Similar developments exist for the borrowing of the state economic enterprises. The government recently removed the stringent control on their borrowing activities. These companies belong to the state. Within the existing legal framework they cannot go bankrupt. The creditors can easily assume that they are lending under the Treasury's guarantee. Due to the lack of understanding of the importance of the contingent liabilities, a large amount of guarantees also had been extended to private projects in the energy sector. The face value of guaranteed power purchase contracts is about \$3-3.5 billion yearly. In the gas sector, the state-owned gas company has signed contracts for large volumes of gas imports on a take-or-pay basis. The face value of these contracts is about \$3 billion per year.⁶

Because of the guarantee schemes, which had been introduced in the 1990s, and extended in 2000, all the creditors of the failed banks (not including off-shore deposits) had to be bailed out by the Treasury as part of the takeover of these banks during the 2001 crisis. Although, beginning from July 2004, there has been a return to a limited deposit guarantee scheme in line with practices in the EU, the experience of the recent past is bound to continue to have some effect on the risk perception of creditors and tight supervision will continue to be very important.

Another area of concern for the sustainability of public finances is the situation in the pension system. Turkey still has vastly better demographic dynamics than most EU member countries, but it seems that a significant part of this advantage has already been consumed in the domestic political process. Figure 11 below shows a sustained increase in budgetary transfers to these institutions despite an increase in premium collections since 1995. Parametric reform realised in 2000 reversed this trend, but it was short lived.

Figure 11. Social security premiums and budgetary transfers



Source: SPO.

To conclude, the structure of adjustment in the fiscal area observed during the 1990s cannot be classified as pro-growth. This was mainly due to the ad-hoc nature of adjustments in dealing with disturbances. With the start of the 2001 Economic Programme, several steps in the field of structural reform were taken. Undoubtedly the impact of the reforms on the growth potential will be realised in the medium term. But there are still risks and there is ample room for further improvement in the quality of public finances, which is a necessary condition for a path of successful and sustained income convergence to the European Union.

⁶ World Bank (2003a).

2.4 The need for effective social policies

The macroeconomic parameters pertaining to the period following the 2001 crisis and the start of the Economic Programme are largely positive. The picture needs to be complemented with a careful look at what has been happening in the social domain.

In Turkey extreme poverty, i.e. income of \$1/day, is confined to around 2% of the population and is therefore small by international standards (World Bank, 2002). However, urban food poverty and economic vulnerability are at much higher scales and a significant part of the population is poor. Despite some new schemes to help the very poor through income support announced by the government, the mechanism for alleviating poverty remains patchy and lacks effectiveness. Apart from needing a major restructuring, the size of the Social Solidarity Fund is estimated to remain equal to or below 0.30% of GNP while the figure for corresponding mechanisms is 1% of GNP in Western Europe and 0.7% in Romania and Bulgaria. The worrying poverty situation in rural areas has been somewhat alleviated by the continuation, after a slowdown at the end of 2002, of the disbursements foreseen in the Direct Income Support scheme started in 2001. But overcoming rural poverty requires further steps including modernisation in agriculture and new infrastructures.

The income distribution statistics show a slight improvement in 2002 compared to 1994 in terms of the shares of quantiles. According to the Turkish State Institute of Statistics, the share of the richest quantile decreased from 54.9% in 1994 to 50.1% in 2002 while the share of the poorest quantile increased from 4.9 to 5.3%. However, serious questions have been raised about the comparability of the two surveys because of methodological differences and inconsistencies with national accounts.⁷ Moreover, the deterioration in 2001 cannot be measured in the 2002 survey as the only available previous survey is for 1994. It is also necessary to look at smaller percentage shares. In fact, however, even if the 2002 survey's results are taken as the basis of evaluation, poverty is still at a serious scale. Also, its incidence among large families, children and women is particularly critical.

Poverty is obviously also connected to the employment and unemployment situation. The summary of the overall picture in this domain is given in Table 5 below.

Table 5. Labour force, employment, unemployment and underemployment, 2000-03

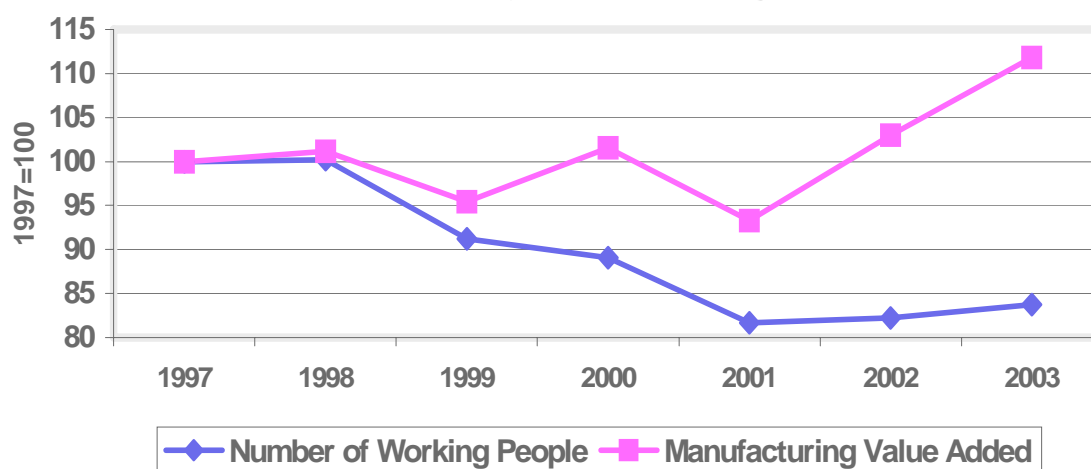
	2000	2001	2002	2003
Labour force (000's)	23,078	23,491	23,818	23,640
Employment (000's)	21,581	21,524	21,354	21,147
Unemployment (%)	6.5	8.4	10.3	10.5
Underemployment (%)	6.9	6.0	5.4	4.8

Source: State Institute of Statistics.

Although 2002 and 2003 were consecutive years of relatively high growth, total employment shows a slight decrease and the unemployment rate has increased. Urban employment shows an increase while rural employment decreases but a growth without employment phenomenon is nevertheless a cause for concern even though productivity growth is measured to have occurred. The employment rate has also decreased from 44.2% in 2002 to 43.2% in 2003. Although the unemployment rate of educated youth has shown a decrease in 2003, the situation of women is worrying because their participation rates and employment figures have decreased noticeably.

⁷ See Yükseler (2004).

Figure 12. Growth without employment and increasing productivity in manufacturing



Source: State Institute of Statistics

The unemployment problem is closely linked to skill deficiency. Around 45% of the unemployed are workers with only a primary school education. The average period of schooling in the adult work force is around 5 years while the corresponding figure is 10 years for the average of OECD. Education constitutes one of the most critical factors in Turkey's employment and growth prospects. Problems in the context of education include quality, relevance to the labour market, transformation into a knowledge economy and pre-school education. The extension of secondary education alone, i.e. 3 million additional places in the education system requires \$12 billion of supplementary resources according to World Bank estimates. Table 6 presents the share of education as a percent of total public expenditure in the 2000-03 period.

Table 6. Total public expenditure on education (% of GNP)

2000	2001	2002	2003
4.0	4.3	4.5	4.0

Source: Emil & Yılmaz (2003).

The need to increase enrolment rates is particularly critical for girls and the poor, especially in poorer regions.

In the domain of health, despite the relative improvements and progress realised in recent years, several serious problems and deficiencies remain. To improve life expectancy, infant and maternal mortality figures, which are still significantly below the OECD average, and to realise general progress in health care, the restructuring and increase of efficiency of health service and institutions have a higher priority than increasing the share of health expenditure in GNP. The latter figure is given below.

Table 7. Total public expenditure on health (% of GNP)

2000	2001	2002	2003
3.8	4.2	5.2	4.4

Source: Emil & Yılmaz (2003).

However, the efficiency increases in question require considerable effort, including an adequate level of expenditure. The most critical aspects of the necessary improvements in the health situation include raising the share and role of preventive medicine, institutional restructuring based on specialisation,

extending health services to all rural and urban parts of the country and not breaking away from the general technology-linked trend of progress in world medicine. These and the other EU-related specific measures need further steps to be taken within the next few years. One of the immediate steps for improvement is to increase the ratio of the population with some form of health insurance, which in 2002 was still only 83.8% on average.

Other measures, such as providing sanitary drinking water in urban and rural areas and sewage construction in urban areas, affect the health situation as well. Since 2001, investment in real terms in all these domains has decreased, significantly in some cases. This includes municipalities' investments.

Housing construction too has decreased significantly. The total number of occupancy permits, which was around 245,000, is estimated to have fallen to 150,000 in 2003.

The social security system in Turkey comprises most of the main components of a modern system in this field but lacks institutional and operational efficiency above all. Although the average rate of insured population is relatively high, (88.1% in 2002), it is not evenly distributed, the scope is not homogeneous and some of the social security schemes, like the one for mainly small traders, Bag-Kur, is rather ineffective because of unpaid debts. The total transfer from the budget to the social security system has been increasing towards and beyond 4% of GNP at a rate warranting great attention. The recent start of a more extensive optional private pension mechanism could grow unlike the previous ones which had to operate under very high inflation and a vulnerable financial system.

The situation of women requires special attention. Apart from a worsening of the employment situation mentioned above and the critical education situation, a general strengthening of women's position in all areas of social, political and economic life is needed. Awareness on this issue is increasing though this is not yet sufficiently translated into implementation.

To conclude this subsection, Turkey faces a double challenge in the area of social policy: to remedy evident shortcomings such as persistent poverty, insufficient health care and education services while at the same time taking the steps necessary for gaining full access to the global knowledge economy. One of the factors restricting the progress required on both accounts seems to be the excessive curtailment of public investment in the last two years.

3. The Critical Role of Foreign Direct Investment

If Turkey is to start a convergence process, its growth rates will have to stay around the 5-7% range achieved over the last few years. But experience has shown that Turkey does not generate enough domestic savings to finance the investment needed to keep growth at this level. This is why in the past growth has often been aborted when the external deficit became too large and a balance of payments crisis ensued. The new and future member countries also faced (and still face) the problem of how to finance a huge need for new capital that cannot all be met from domestic savings. The solution in almost all cases has been that the current account deficit was financed by foreign direct investment as FDI inflows are different from other capital inflows in that this type of capital cannot typically be repatriated at short notice so that it does not lead to the potential for crises that result especially from short-term flows.

Moreover, as discussed below, FDI might sometimes have a stronger productivity-enhancing effect than domestic investment.

For a country with a domestic savings shortfall and a limited technological base, a high rate of FDI inflows would be desirable. But reality has been disappointing in view of the fact that Turkey had initiated a far-reaching liberalisation and structural adjustment programme in the early 1980s and has made a considerable effort to integrate with the global economy since then.

The main factor that has deterred foreign investment in Turkey has been the lack of political and macroeconomic stability. A high degree of economic uncertainty and bureaucratic barriers inhibiting business hindered the inflow of foreign direct investment to the country. The inadequacy of these

flows impeded the modernisation process of the capital stock and hampered access to international export markets; and, at the end, emerged as a major obstacle preventing Turkey from realising its economic potential.⁸

Therefore, one of the main objectives of the Economic Programme launched in 2001 has been to take decisive steps to improve investment and business conditions in the country. In this context, a new foreign direct investment law has been enacted in July 2003. The new law has been designed as an integral part of the ambitious structural reform programme. It aimed at improving the investment climate by creating a more transparent marketplace fully integrated with the world supported by a more rationally structured, leaner and more effective state. In that direction, the concepts of foreign direct investment and foreign investors have been redefined within international standards and the rights of investors have been enhanced via making amendments with respect to issues such as national treatment, guarantee of transfers, access to real estate, international arbitration, employment of expatriates, etc.

Besides this new law, the government has established the Coordination Committee for the Improvement of the Investment Climate (YOIKK). This body, composed of high-level representatives of relevant ministries, the private sector and NGOs, was formed to identify and remove regulatory and administrative barriers in front of investment.

With these steps, backed by the amendments concerning the simplification and streamlining of company registration, Turkey has become, at least in terms of legislation, one of the countries with the shortest and simplest process to set up a business. Together with prospects of EU membership in less than 10 years this should lead to much greater FDI inflows. As seen in the table below, FDI as a percent of GDP is significantly lower in Turkey compared to the new members of the EU as well as Bulgaria and Romania. The experience of Central and Eastern European countries during the 1990s has shown that FDI has been an influential factor in economic restructuring and modernisation. In particular, by bringing capital, technology, expertise and know-how, foreign investments have been very effective in increasing productivity and innovation in these economies.⁹

Table 8. Foreign direct investment (% of GDP)

	1998	1999	2000	2001
Bulgaria	4.2	6.2	7.9	5.1
Cyprus	0.8	1.3	1.8	1.8
Czech Republic	6.5	11.5	9.7	8.6
Estonia	10.9	5.8	7.6	9.7
Hungary	4.3	4.2	3.6	4.7
Latvia	5.9	5.2	5.7	2.3
Lithuania	8.5	4.6	3.4	3.7
Malta	7.7	22.6	18.1	8.5
Poland	4.0	4.7	5.8	3.1
Romania	4.8	2.9	2.8	3.2
Slovakia	2.6	1.6	1.5	7.2
Slovenia	1.1	0.5	0.7	2.6
Turkey	0.5	0.4	0.5	2.3

Source: Calculated from EUROSTAT data.

Therefore with the start of accession negotiations in the near future, Turkey will acquire the strong political anchor provided by the EU, which should contribute to a substantial increase in foreign

⁸ European Commission (2003a).

⁹ OECD (2002).

investment inflows. This, in turn, while contributing to employment creation, will further improve debt dynamics and hence, advance Turkey on its way to realising its economic potential.

A recent survey on the determinants and growth effects of FDI emphasises that the positive spillover effects of FDI become stronger only if the host environment is able to absorb advanced technology. In practical terms, this means a well-educated work force and at least a small high-productivity sector. As emphasised elsewhere, Turkey scores rather badly in terms of the level of qualification of its work force, but there are also sectors in the Turkish economy that are quite advanced in terms of technology and value added per employee. Compared to the transition countries, Turkey thus starts with one handicap and one advantage. And the handicap is likely to be felt only after FDI inflows reach a significant level.¹⁰

Another widely-recognised determinant of FDI is the overall quality of domestic governance. For example, Kinoshita & Campos (2004) show that for the CEECs, variables such as external liberalisation, rule of law and the quality of bureaucracy are the most potent predictors of FDI inflows. At present, the indicators for Turkey on the last two items are rather low as documented further below. In technical terms, the values for Turkey are two standard deviations below the EU-27 average. What would be the impact of bringing Turkey up to the EU-27 standard? By using the estimates for the new member countries, one can arrive at an approximate answer: The improvement in the rule of law and the quality of the bureaucracy should lead to an increase in FDI of about \$200 per capita and in constant purchasing power terms in the short run and about three times this value in the long run. This is an additional effect that would come on top of other improvements to the investment climate. This effect alone would mean that a drastic improvement in domestic governance might lead to an increase in FDI flows in the long run worth cumulatively i.e. over a decade or so about \$600 per capita or close to 20% of GDP, leading to a total that should be on a similar scale as the inflows experienced by the new member countries.¹¹

4. Medium-Term Debt Scenarios

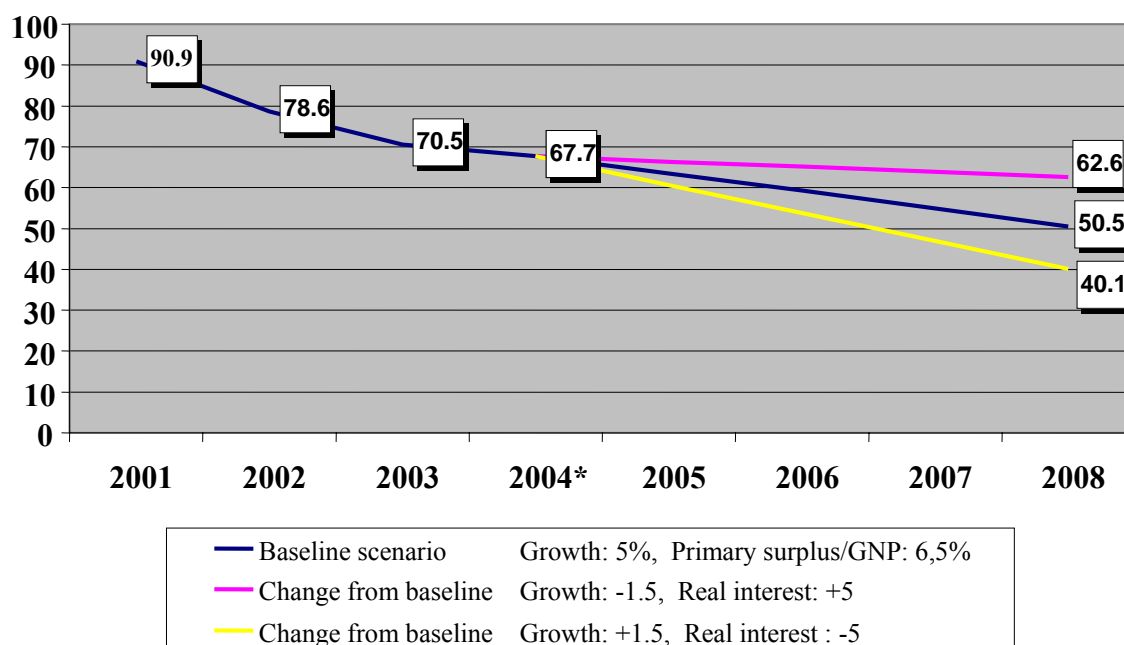
Looking towards the future, will Turkey be able to reduce the burden of public debt and thereby become much less vulnerable to sudden changes in market sentiment and the kind of volatility that unfortunately characterises international capital markets? Will Turkey be able to grow out of the debt trap in which it got caught in the late 1990s?

Figure 13 below shows the most recent growth and debt scenarios drawn up by the Turkish Treasury. According to this scenario, the net debt-to-GNP ratio, falling by more than 20 percentage points under the assumption of an average GNP growth rate of 5% and a primary surplus continuing at 6.5% of GNP, will reach 50% by 2008. A decline of 1.5 percentage points in the assumed growth rates and an increase of 5 percentage points in the assumed real interest rates results in a net debt-to-GNP ratio of 62.6% instead of 50%, a more pessimistic scenario which, still, however, leads to an improvement in debt indicators. A 1.5 percentage point increase in the growth rate, on the other hand, coupled with a decline in real interest rates of 5 percentage points leads to a decline of the net debt to GNP ratio to about 40% by 2008. These scenarios suggest that Turkey may indeed overcome the debt burden and has good prospects of reaching robust debt sustainability well before EU membership.

¹⁰ See Uppenberg & Riess (2004).

¹¹ See Kinoshita & Campos (2004).

Figure 13. Alternative debt indicator scenarios (total net debt, % GNP)



*2004 Programme, 2005-08 projections as of 8 April 2004.

Source: Turkish Treasury.

Nevertheless, Table 9 below shows that the domestic debt stock is highly sensitive to changes in interest rates because of its short-term and heavily-indexed nature. While the weight of floating rates in total domestic debt reaches 42% the maturity of the debt to be redeemed in cash raised from the market is around one year. Non-cash debt is mainly in the form of securities issued to public banks and to the Saving Deposits Insurance Fund for nationalised banks. The debt ratio is also sensitive to the real exchange rate fluctuations although at a lesser extent compared to the interest rate.

Table 9. Domestic provisional debt stock composition, by instruments

	May 2004 (trillion TL)	Duration (months)	(%)
Cash	147,285	12.2	70%
Fixed	81,789	7.4	39%
Floating	35,656	20.4	17%
Fx	17,854	14.6	9%
Fx	11,986	16.7	6%
Imf	6,700	14.8	3%
Swap	5,286	19.1	3%
Other	-	-	0%
Non-cash	62,524	46.9	30%
Fixed	-	-	0%
Floating	5,3171	51.6	25%
Fx	7,722	12.7	4%
Fx	1,631	53.7	1%
Total	209,809	22.5	100%

Source: Turkish Treasury.

These figures show that the start of the accession talks with EU and the consolidation of policy and institutional reforms will, *inter alia*, via their impact on financial markets provide strong support for the stability and the continuation of positive debt dynamics.

Table 10. Comparison of debt indicators (gross debt/GDP)

	2002	2004
EU-15	62.7	63.2
Poland	43.3	46.0
Bulgaria	59.2	50.2
Romania	24.6	26.4
Turkey	99.6	79.6

Source: European Commission (2003b).

Table 10 above compares *gross* debt-to-GDP ratios in Turkey with other EU or candidate countries in the last two years. According to the table, Turkey's public gross debt as a share of GDP is considerably higher than in some accession countries and higher than the EU-15 averages.¹² Although debt scenarios related to the Turkish economy presented above use the concept of net debt which is a better indicator of a country's indebtedness, the gross debt which is used to assess the compliance with the Maastricht criteria, also shows a drastic decline during the years following the crisis in 2001. The ratio of public gross debt jumped to 108% at the end of 2001. This was largely due to the losses related to banking crises borne by the Treasury. At the end of 2003, this ratio has declined to 83.5%. The rapid decline in the gross debt ratio is partially a result of the rapid revaluation of the Turkish lira. But the level of the debt also indicates the need for continued efforts to maintain the positive debt dynamics that started over the last three years to free Turkey from the excessive burden of public debt that accumulated during the 1990s and which became apparent at the time of the 2000-01 crisis.

5. Economic Governance and Turkish Institutions in the European Context

Over the last three decades, Turkey's economic history has been driven by two fundamental forces pulling the country in opposite directions. On the one hand, there has been an extremely dynamic private sector and a social structure supportive of both entrepreneurship and solidarity. Joan Robinson's 'animal spirits' are definitely playing a positive role in Turkey and have allowed the country to defy odds on many occasions. On the other hand, there has been a rent-seeking political-economic system, with governments promising to distribute more resources than they were able to raise and with the private sector spending much time and resources trying to capture rents, resources which could have been spent on real production and the development of markets and technology.

The 2001 crisis inflicted great damage on the Turkish economy but it also created an opportunity for deep structural reforms because of the psychological shock triggered by the crisis. Turkey, as a society, realised in 2001 that the rent-seeking political-economic system had to change and that something fundamentally different was required for the country to continue to progress. The old system had reached its limits when the debt-to-GDP ratio rose above 90%!¹³

It is this psychological shock and transformation that explains the speed with which structural reforms have been adopted during 2001 and 2002. The objective of these reforms has been to build the legal and institutional infrastructure of a modern competitive market economy, where transparency reduces

¹² There are countries within the EU such as, for example, Belgium and Italy, which have much higher debt rates than Turkey. These countries enjoy much deeper capital markets and longer maturities and can therefore sustain such debt levels. For an analysis of sustainable public debt in emerging and advanced economies, see the IMF's *World Economic Outlook*, 2003.

¹³ See Derviş (2004) for an account of the political-economy of crisis management in 2001.

the scope for rent seeking and corruption and where entrepreneurial spirit can be devoted to production rather than securing privileged access to monopoly positions or state contracts. The reforms also aimed at creating a leaner and more efficient state while strengthening the regulatory capacity of state institutions and the quality of the social safety net. Their breadth and number are impressive, as shown in Box 1.

Box 1. Reforms adopted as part of the Economic Programme of 2001

The following reforms were adopted as part of the new Economic Programme launched in 2001:

- Independence of the Central Bank
- Creation of a truly independent agency to regulate the banking system
- A new debt management and public finance law providing a comparative framework for risk management and limiting discretion of the executive branch of government in exceeding debt limits set in the annual budget law passed by Parliament
- Closure of the multiplicity of extra-budgetary funds which had rendered transparent fiscal policy impossible
- A new public procurement law based on UNICITRAL and establishing a new independent public procurement authority
- A new public financial management and control law
- Some simplification of the task system
- New banking laws aiming at much greater transparency and better risk management
- A thorough reorganisation of the public banks and an end to their non-transparent quasi-fiscal law
- A new law regulating the telecommunications sector and opening it up to competition
- A far-reaching reform of the agricultural policies moving them from price support driven by political pressures of higher income farmers lobbies to direct income support attempting to target the poorer farmers
- A new electricity market law aiming at establishing a competitive energy market regulated by the state but open to the private sector
- A new law regulating the natural gas sector
- A new law for the sugar sector
- A new law for the tobacco sector
- A new law simplifying procedures relating to private foreign investment, putting it on a completely equal footing with domestic investment.

Looking at what has been achieved over a three-year period, one can say that the speed of structural and institutional change in Turkey is impressive in the context of worldwide experience. There is hardly another country where so much has been achieved in economic reforms in such a short period.

The quality of the domestic institutions is a key determinant of growth. Despite the impressive progress realised in many aspects of the structural and institutional framework, a lot needs to be done. The starting point is measured by data that reflect the situation at the turn of the century and shows the distance between Turkey and the EU in the field of quality of governance. Table 11 shows the data on six different indicators of the quality of domestic economic governance obtained from data from the World Bank -World Bank (2003b) and World Bank (2003c). The scores broadly reflect the level of development. Turkey comes out well below the EU-15 average (higher values mean a better performance, i.e. more control of corruption, a more effective government, etc.) and also below the new member states in all of the indicators used here. Romania and Bulgaria have similar values to Turkey.

Table 11. Indicators of the quality of governance

Country	Country2	Control of corruption	Government effectiveness	Political stability	Regulatory quality	Rule of law	Voice & accountability
EU-15	Mean	1.70	1.67	1.15	1.57	1.58	1.42
	STDEV	0.52	0.43	0.31	0.26	0.42	0.20
EU-27							
Bulgaria	BGR	-0.17	-0.06	0.56	0.62	0.05	0.56
Estonia	EST	0.66	0.78	0.98	1.35	0.8	1.05
Hungary	HUN	0.6	0.78	1.08	1.21	0.9	1.17
Poland	POL	0.39	0.61	0.71	0.67	0.65	1.11
Romania	ROM	-0.34	-0.33	0.42	0.04	-0.12	0.38
Turkey	TUR	-0.38	-0.2	-0.61	0.08	0	-0.47

Source: Own calculations based data in World Bank (2003b and c).

Table 12 provides a brief statistical analysis of the same data by normalising each variable to make the range comparable and then comparing Turkey to the EU-15 and the EU-27 (the present EU-25 plus Romania and Bulgaria). For example, the value of minus 4 in the column ‘control of corruption’ means that if one compares Turkey to the EU-15, its value is exactly four standard deviations below the EU-15 mean. In statistical terms this would be called an outlier, i.e. a value that is so far from the average that should be considered belonging to a different set. In general, any entry above 2 in the lower part of Table 12 should be considered as showing that the country, or group of countries, is far away from the norm. Thus Table 12 shows that the average value of the new members from Central and Eastern Europe is far away from the EU-15 values in all categories except political stability (where the value is only 0.9). If one compares Turkey to the EU-27, one sees that the distance separating Turkey from the EU-27 was about as large as the distance that separates the CEECs from the EU-15. This implies that when compared to averages of the enlarged EU Turkey before the reforms of the last three years was in a class of its own with respect to the low quality of indicators measuring the quality of governance that have been quantified.

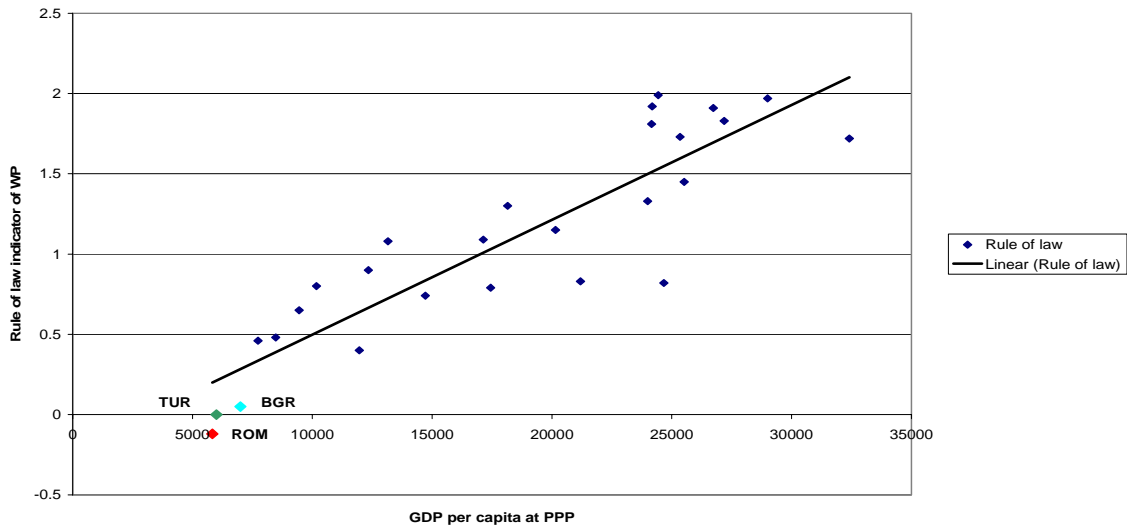
Table 12. Summary statistics for indicators of the quality of governance

Country	Country2	Control of corruption	Government effectiveness	Political stability	Regulatory quality	Rule of law	Voice & accountability
EU-27	Mean	1.1	1.2	1.0	1.3	1.2	1.2
	STDEV	0.8	0.7	0.3	0.5	0.6	0.3
Average CEEC normalised EU-15		-2.7	-2.7	-0.9	-2.8	-2.5	-2.5
Turkey normalised EU-27		-1.9	-2.0	-4.8	-2.6	-1.8	-5.1
Turkey normalised EU-15		-4.0	-4.3	-5.8	-5.8	-3.8	-9.3

Source: Own calculations based on data in World Bank (2003b and c)

While the quality of domestic governance is undoubtedly low, one might ask whether this does not represent simply the level of development of the country. Poorer countries in general have weaker institutions. Maybe these institutions will improve as income grows and the country develops. Figure 14 below shows that if one measures the indicator concerning the ‘rule of law’ relative to GDP per capita, the performance of Turkey appears to be closer to the general ranking of the Turkish economy. Turkey is clustered together with Romania and Bulgaria at the lower end of the scale. Its value is, however, clearly below the regression line. This implies that Turkey performs even worse on the ‘rule of law’ indicator than one would expect given its present low GDP per capita.

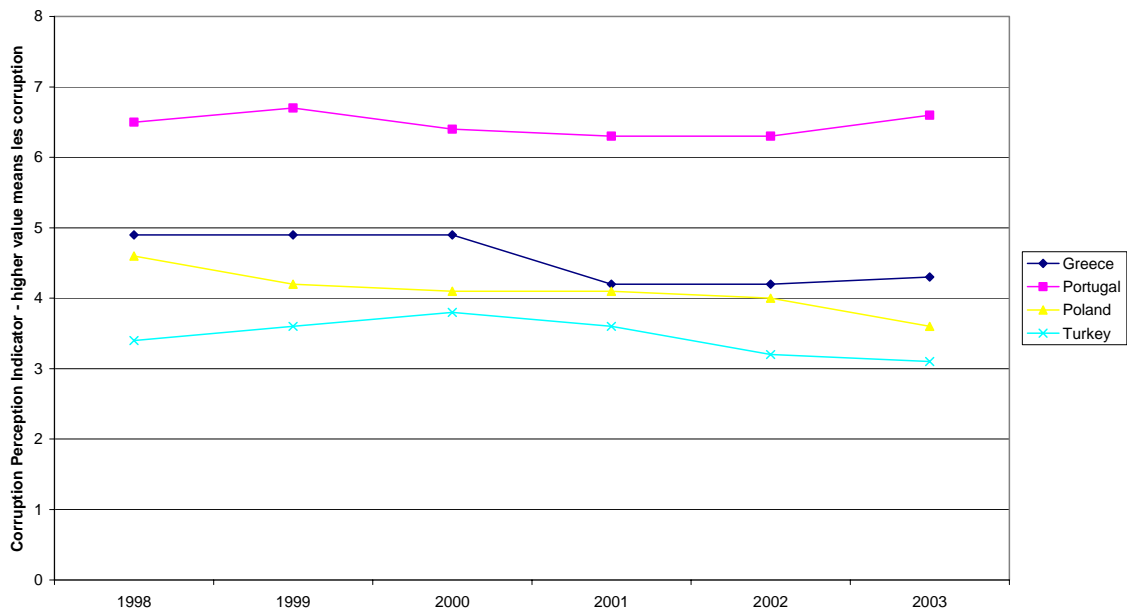
Figure 14. Rule of law and income among EU-27



Source: World Bank (2003, b and c).

Has the problem of poor governance become less severe over time? Unfortunately the indicators used so far are not available for a longer time period. The only comparison over time that is possible has to be based on the widely used ‘corruption perception index’ published regularly by Transparency International. This indicator of the perception of corruption is obtained from an annual survey carried out by Transparency International in a large number of countries. Figure 15 below shows the evolution of the scores for Turkey as well as the member countries for which the survey has been available since 1998. It is apparent that in all the four countries considered here (the perception of) corruption has changed little over time. Turkey consistently has the lowest value (meaning the most corruption), but the distance to some of worst performing member states (e.g. Poland) has not increased over time.

Figure 15. Corruption perception overtime



Source: www.transparency.org

It is also true, however, that institutional change is a complex process that requires not only new laws and regulations but also new behavior.¹⁴ The new legal and institutional infrastructure that the reforms have created provides the basis for new behaviour by public and private agents, compatible with a competitive modern economy. For the institutional change to be consolidated, for any possibility of policy reversal to be forestalled and for learning to take place rapidly, the ‘anchor’ of the negotiations towards full membership in the EU will play a critical positive role. This ‘anchor’ will stabilise expectations and provide a calendar for new achievements in terms of macroeconomic targets and institutional performance that will help Turkey in the process of convergence.

The difficulties experienced by some of the new member countries and those of the ‘class of 2007’ shows that membership negotiations provide an anchor, but do not protect against domestic policy mistakes. The combined currency and banking crisis that hit the Czech Republic in the mid-1990s and the near collapse of the Bulgarian economy into hyperinflation towards the end of that decade show that two items require continuous attention: the budget and the banking system.

In Turkey, as in some other emerging market economies, a third area that deserves attention is municipal finance. Here too, decentralisation and liberalisation, desirable as such, should not be allowed to generate new fiscal problems.

5. Conclusion

Turkey has made impressive progress towards macroeconomic stability since the last financial crisis hit in 2001. With inflation now in single digits, price stability is within reach. However, interest rates remain very high (lower than in the past, but very high by EU standards), which shows that financial markets are not yet fully convinced that stabilisation will be permanent. These high real interest rates make it harder to balance the budget despite a record primary surplus (more than 6% of GDP). Stabilisation has thus not yet been fully ‘stabilised’. Turkey will need to continue to make major efforts consolidating the structural reforms undertaken over the last few years to be able to join the EU in the medium term. The same has been true for the new accession countries.

The beginning of negotiations would provide an invaluable anchor for the consolidation of the economic reforms and would be a significant ‘accelerator’ of Turkish growth through multiple channels. The decision to start negotiations will have an immediate positive effect on expectations leading to a reduction in real interest rates. This will consolidate the positive debt dynamics experienced over the last three years and may well lead to a virtuous cycle with lower interest rates, more investment, more rapid growth, lower debt ratios, further declines in real interest rates, etc. In the second or third years of this process, we could witness a steep increase in direct foreign investment, adding another powerful factor to the positive growth and debt dynamics.

During this period, tight monetary and fiscal policies would have to remain in place to further reduce inflation close to ‘European’ levels and to stabilise expectations. With the investment rate rising to neighbourhood of 25% of GDP, the transfer of labour from low productivity to high productivity activities could accelerate and help consolidate the rhythm of GDP growth.

Such a scenario is feasible and likely if domestic structural reforms continue and become anchored in the negotiations process towards full membership. This could then be the beginning of the stabilization of stability. The debt ratio would fall quite rapidly as GDP (the denominator) expands and debt itself (the nominator) does not increase any more. The threat of volatility in financial markets would then also recede quickly. This in turn would then allow for a lengthening of the maturity structure of public debt at acceptable rates until Turkey is conceived no longer an ‘emerging’ market, but a market basically without political risk as the new member countries also experienced some time even before their accession to the EU.

¹⁴ See Acemoğlu et al. (2004) for an excellent overview of institutional change as the most fundamental engine of growth.

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Annex

On Dollarisation and Monetary Policy in Turkey

The most recent official statistics indicate that by the end of 2004, Turkey will do even better than the official 12% inflation target set only a couple of years ago when inflation was close to 70%. This unprecedented performance results from a well-coordinated policy mix between the Central Bank of Turkey and the Treasury.

Since 2002, price stability has in fact become the explicit primary objective of the monetary authority, allowing for growth-related actions as long as they do not interfere with such a policy goal. This has been pursued through an ‘implicit inflation targeting’ strategy where the short-term interest rate has been used actively to reflect changes in inflationary expectations, with constant monitoring of the dynamics of the relevant monetary aggregates. Indeed, the systematic downward trend in CPI inflation would not have been possible without putting some order in domestic and external public finances by creating primary surpluses over the last couple of years. Fiscal responsibility remains a necessary condition for price stability since it signals the commitment and political will of the government not to resort to inflationary finance when facing adverse shocks to the tax base or to interest payments.

However, despite these recent improvements, Turkey seems not to have gained full anti-inflationary credibility. High real interest rates on government-issued liabilities add to the fiscal burden and threaten both domestic and external sustainability of public finances. The market evaluates Turkey’s low reputation for anti-inflationary policies by attaching implicit inflation-risk and sovereign-risk premia on nominal interest rates. This is a common problem in post-crisis countries and therefore not unique to Turkey.

The market’s uncertainty on the anti-inflationary stance finds further confirmation in the still significant levels of currency substitution and liability dollarisation. Formally defined, currency substitution is the willingness of domestic residents to hold foreign currencies in their liquid portfolios to hedge their purchasing power uncertainty coming from volatile domestic inflation. Although a definite measure of the actual foreign currency holdings is not available -due to unregistered transactions and ‘money under the mattress’ behaviour-, foreign-currency denominated deposits by Turkish residents (indeed an underestimate of the overall level of ‘unofficial dollarisation’ in liquid assets) are still floating around 40% of extended M2, with only a slight sign of decline. Both foreign currency deposits and ‘under the mattress’ foreign cash guarantee purchasing power stability while still providing transaction services since they can be easily liquidated and exchanged for Turkish liras to finance private consumption.

The limited diversifiability of the exchange rate risk is reflected in a substantial amount of government-issued bonds denominated in a foreign currency (most often the US dollar), whether held by domestic or foreign investors. The resulting currency mismatch between the government’s assets/sources of revenues – denominated in domestic currency – and FX-denominated liabilities, coupled with limited efficiency in tax collection and expenditure control, increases the probability of a heavier use of the inflation tax if the economy has to hedge either nominal or real external shocks.

While liability dollarisation has implications for the sustainability of a low inflation regime if the economy is hit by real shocks (fundamentals uncertainty), the presence of dollarisation in liquid assets is a potential source of expectations-driven volatility under standard monetary policy rules.

By opting for currency substitution facing future inflation uncertainty, domestic residents generate an endogenous dollarisation of liquid/transaction-related assets. The cons of such economic behaviour have been extensively stressed in the literature. First, currency substitution generates high instability in domestic money demand since agents will be ready to optimally switch from domestic to foreign money whenever expected/forecasted inflation increases. Price stability is unlikely to be achieved through standard money-supply-driven policies. Second, the government would experience a substantial loss in rebates from the Central Bank coming from diminished seigniorage revenues.

We point to an additional negative effect. As we have mentioned above, the current monetary-fiscal policy mix in Turkey has been characterised by some kind of interest rate rule-based monetary policy together with positive primary surpluses. This practice is becoming quite usual among emerging economies that have recently abandoned fixed exchange rate regimes to move to free (or managed) floats because of its apparently good performance in developed economies and for its transparency.¹ More specifically, interest rate rules following the so-called Taylor principle (or active rules), i.e. rules where the nominal short-term interest rate is set as a function of current/expected inflation and raised more than proportionally to changes in its argument, seem to have been able to guarantee relatively stable inflation around some implicit target by eliminating non-fundamentals expectations-driven volatility.²

How likely is this strategy to achieve similar performances in emerging market economies featuring endemic dollarisation? Airaudo (2004) shows that the simple Taylor principle is not enough once domestic economic agents value foreign currencies for transaction purposes. For reasonable calibrations, we need a ‘reinforced’ Taylor principle, i.e. an interest rate rule that reacts even more strongly to inflationary expectations with such a degree of responsiveness depending on the degree of currency substitution/dollarisation. Though a formal description of the mechanics is rather involved and comes from dynamic general equilibrium modelling, the intuition is rather simple.

A key assumption would be that domestic residents attach a welfare value (besides consumption) to both domestic balances and foreign money balances. The latter two are valued for welfare because of their transaction services, a rather standard set-up in the literature. Further assume that m and f are not perfect substitutes in transactions, and that on top of that agents can also hold interest-bearing domestic and foreign currency-denominated assets that are not perfect substitutes, due to some market incompleteness.

Now suppose that agents revise upwards their inflationary expectations for reasons that are not related to the underlying economic fundamentals. This does not seem to be unlikely to occur in economies where the market is still uncertain about the future degree of commitment of the central bank and where central bank independence is very recent. The prospective purchasing power loss of domestic liquid assets creates an incentive to switch to more foreign currency holdings, while the impact on the demand for domestic bonds depends on the interest rate responsiveness to inflationary expectations. If the interest rate rule is active, higher expected inflation translates into higher real returns from domestic currency denominated assets and could therefore boost their demand. In general then, private portfolios get rebalanced with flows from the domestic currency to the foreign currency and/or domestic bonds. If the decrease in domestic money holdings is more than compensated for by increased foreign currency holdings in terms of overall transaction services/store of value, the economy might experience an increase in goods demand and therefore result in higher realised inflation. In this sense, higher inflationary expectations will be totally fulfilled, thus creating the potential for non-fundamentals driven volatility in inflation. Moreover, any inflationary expectation revision could be fulfilled thus producing a multiple-equilibria-related aggregate volatility in the economy.

¹ No central bank has ever explicitly stated that it follows any type of specific rule. However, the existence of some kind of systematic relationship between the short-term interest rate and the relevant inflation measure has been empirically documented for quite a number of countries.

² The intuition is rather simple. Take an “almost closed” no-growth economy and assume that the short term interest rate is set as an increasing function of expected inflation. Suppose that domestic agents raise their inflationary expectations, for reasons unrelated to economic fundamentals. The ex-ante real interest rate will go up (down) if the interest rate rule follows (doesn’t follow) the Taylor principle. If it does not, a lower ex-ante real interest rate pushes up current consumption (assume no income effect), and for constant output, this creates pressure on current prices. Inflationary expectations are fulfilled. Clearly, if the Taylor principle holds, we would have a higher real rate, therefore lower consumption, resulting in lower inflation and higher expected inflation would not be rational.

However, there is a way out of this expectation trap for the Central Bank as long as some monitoring on the endogenous level of dollarisation exists. The nominal interest rate's degree of responsiveness to expected inflation should take into account the overall value of foreign currency holdings to households, and more specifically, the higher their transaction/store of value services, the more reactive the rule should be to expected inflation. If the marginal benefit from holding domestic bonds (coming from their real return and the future consumption possibilities) more than compensates the marginal cost (the loss in transaction services from not holding additional units of the foreign currency), then higher expected inflation would only increase (non-liquid) domestic money holdings and therefore have no impact on consumption. Expectations will not be fulfilled and aggregate volatility could only come from fundamentals.

Our general equilibrium modelling seems also to suggest that in small open economies with dollarised liquid assets expectations-driven volatility can be ruled out if the central bank commits to a dollarisation-sensitive interest rate rule or to rules that have no feedback from endogenous variables, such as a pure interest rate peg (with possible realignment) or a fixed money growth rule. Given the difficulty in monitoring the actual degree of dollarisation in the economy, the former way seems quite challenging. Even a pure exchange rate peg would be desirable in this respect, as often argued in the currency substitution literature, although its long run sustainability has to strongly rely on systematic fiscal adjustment vis-à-vis aggregate shocks. We do not consider the latter a viable solution for Turkey given its recent history.

The liability of dollarisation

In countries with a history of high inflation/depreciations, the issue of dollarisation also appears in the denomination of government liabilities. Foreign and domestic investors concerned about real returns from their bond portfolios require inflation/exchange rate indexation of nominal returns and/or directly lend to the government in dollar (or another stable currency) terms.

It is well known from economic theory that the higher the share of non-indexed domestic currency denominated liabilities, the bigger the incentive for the government to use the inflation tax to hedge adverse fiscal conditions. By guaranteeing full central bank independence and making price stability its primary objective, this channel is ruled out and fiscal discipline becomes essential. Alternatively, the government can signal its anti-inflationary stance by issuing (real) inflation-indexed bonds.

Turkey seems to be somewhere in between these two extreme situations. The central bank of Turkey is still not completely independent in its 'inflation-targeting' policy and a significant portion (but not all) of government liabilities are either FX-indexed or FX-denominated. (This proportion has been steadily declining.)

Without going into formal general equilibrium modelling details, it is helpful to assess when and how low-inflation regimes are sustainable in an emerging economy with liability dollarisation.

Let the flow government budget constraint be:

$$M_t + B_t + F_t S_t + P_t T_t = (1 + i_{t-1})B_{t-1} + (1 + r)F_{t-1}S_t + M_{t-1} + P_t G_t \quad (1)$$

where M , B and F stand, respectively, for domestic currency, domestic currency denominated bonds, and foreign currency (say US\$) denominated bonds; S and P are, respectively, the spot exchange rate (TL/US\$) and the domestic price level; T tax revenues and G public expenditure; domestic bonds pay a nominal interest rate i ; foreign currency bonds a real rate r .

The intertemporal solvency condition for the government budget, from repeated forward iteration of the flow equation, is:

$$\frac{(1 + i_{t-1})B_{t-1}}{P_{T,t}} + (1 + r) \frac{F_{t-1}S_t}{P_{T,t}} + \frac{M_{t-1}}{P_{T,t}} = E_t \sum_{s=t}^{\infty} \left(\frac{1}{1 + r} \right)^{s-t} \left[T_s - G_s + \frac{M_s}{P_{T,t}} \left(\frac{i_s}{1 + i_s} \right) \right] \quad (2)$$

where we have used, as is standard in the literature, the domestic price of traded goods as the numeraire. In simple words, the intertemporal budget states that the current overall debt-money burden, in real terms, is sustainable, if it is equal to the expected present discounted value of future surpluses and savings from seigniorage.

The point we are concerned about is whether price stability is consistent with any fiscal policy plan, i.e. any future primary budget ($T_s - G_s$) surplus or deficit profile. The recent approach to the study of monetary-fiscal interactions, brought forward by the ‘fiscal theory of the price level’, shows that this is not generally the case, even in economies where seigniorage is not a relevant source of budget financing. If we ignore the latter and substitute for PPP in traded goods ($P_{T,t} = P_{T,t}^* S_t$, $P_{T,t}^*$ being the foreign price of tradables), the government intertemporal budget can be written as:

$$\frac{(1+i_{t-1})B_{t-1}}{P_{T,t}^* S_t} + (1+r) \frac{F_{t-1}}{P_{T,t}^*} = E_t \sum_{s=t}^{\infty} \left(\frac{1}{1+r} \right)^{s-t} [T_s - G_s] \quad (3)$$

Equation (3) implies that, for instance, the degree of endogenous price adjustment (through nominal exchange rate depreciation/appreciation) needed to keep intertemporal budget balance when hit by changes in foreign inflation (changes in $P_{T,t}^*$) is larger the lower the government control on the budget $T_s - G_s$. Moreover, given the feasible fiscal adjustment, the impact of a given foreign inflation shock is higher the higher the liability dollarisation, since the inflation tax base is reduced under FX-denomination. If the government was setting the primary budget with feedback from the current outstanding debt, it could be showed that it would be intertemporally solvent under any price level. What this means is that monetary policy would be in charge of price stability while the fiscal authority would be left to adjust the budget under any inflation target chosen.

The recent inflation stabilisation in Turkey seems to point out in this direction: the central bank has been pursuing some implicit inflation-targeting policy while the government has put fiscal discipline (and debt reduction) back onto the agenda. The question is how long this ‘monetary-fiscal regime’ can last.

What then, if we were in either one of the two extreme cases, i.e. no dollarisation at all or full dollarisation? Under full dollarisation of liabilities ($B = 0$), the government cannot resort to the inflation tax. Adverse shocks to the budget can be absorbed either by tightening up the control on fiscal policy or by explicit debt repudiation. This is the classical currency mismatch problem at the roots of debt crises. Under no dollarisation, the government is more flexible in its price stability – tax smoothing trade off, although with limited fiscal control full price stability is never achievable. But the bottom line is clear: under imperfect fiscal discipline, liability of dollarisation makes price stability even harder to achieve.

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