

**DYNAMICS OF MACROECONOMIC DISEQUILIBRIUM
AND INFLATION IN TURKEY:**

The State, Politics, And The Markets Under A Globalized Developing Economy

Ümit Cizre-Sakallıođlu
Department of Political Science
Bilkent University, Ankara

and

A. Erinç Yeldan
Department of Economics
Bilkent University, Ankara

September 1999

he is quoted as saying that 'compared to developed countries, Turkey stands at a disadvantaged position: it does not, for instance, have an unemployment insurance and therefore job-security scheme. Under such conditions, measures to fight against inflation will produce extremely serious social implications, will pose a threat to

employment prospects and cause stagnation in the economy'.¹

These arguments can fit the facts of the Turkish case with its memory of frustrations at neo-liberal reform; broken promises in the past, and now with the new awareness that sustainable growth may actually be induced by giving priority to improving distribution of income rather than the reverse. However, the more fundamental question from a political economy perspective is the political and ideological underpinning of Turkey's record of market-supporting approach in the 1990s. The core focus of this study, in other words, is to trace not just the adjustments of an indigenous developing economy facing an open macroeconomic environment in the globalized world markets, but also to disclose the underlying pressures emanating from the various interest groups and their 'political' calculation that is embedded in the neo-liberal model.

In what follows, we will specifically address the dynamics of ongoing price inflation as a direct attribute of the macroeconomic mis-management and disequilibria in the commodity and financial markets. Turkish price inflation, as revealed in the annual rate of change in consumer prices, is observed to follow a continued upward trend since the embarkment of the structural adjustment reforms in 1980. Price inflation, which ranged between 30-35% in the first half of the 1980s, jumped to 75% in 1988, and continued at the plateau of 65% during 1989-1993. Following the steep increase to 106% during the financial crisis of 1994, the consumer price index displayed variations of 80%, on the average, during the second half of the 1990s. The very recent deceleration of price inflation which had actually started in the first quarter of 1999 is far from providing relief, and seems to be more combined with the current deflationary trend in the domestic economy as a consequence of the crisis conditions in the world markets –especially in Russia and Germany. It is quite dubious that its prospects towards a downward trend will continue in a sustained fashion, as, at the time of writing, it is very hard to associate it with the realization of a significant change in the recent macroeconomic polity.

Our analysis will be organized in five parts. In the next section, we provide an overview of the political-economic foundations of the 1990s, and highlight the main mechanisms of macroeconomic adjustments of the Turkish economy. Next, we study the aspects of price inflation and the relative price movements, and provide a

¹ 'Yılmaz'dan Rejim Uyarısı'. (Warning by Yılmaz on the Regime) *Milliyet*, December 5, 1997.

quantitative analysis of the inflationary dynamics. Here, with the aid of the recent advances on the *Hodrick-Prescott* filtering methods, our task will be to decompose the quarterly variations of consumer prices into a trend component and cyclical deviations around the trend. In section III, we will turn our attention to the analysis of the widening public sector deficits and the strategic role of the banking sector as financiers of the fiscal disequilibria. We investigate the political economy aspects of this structure in section IV, where we try to disclose the underlying political discourse and the associated disequilibria from an interest group perspective. Section V, in turn, summarizes and concludes.

I. Main Economic Adjustments: Post-1988 Turkey

The Turkish adjustment path under the structural adjustment and liberalization era can be partitioned into two broad phases: “1981-1988” and “1989-current”. The main characteristic of the first phase is structural adjustment with export promotion, albeit under a foreign exchange system of controlled foreign capital inflows. Over this period, integration to the global markets was achieved mainly through commodity trade liberalization. More importantly, both the exchange rate and direct export subsidies acted as main instruments for the promotion of exports and pursuit of macroeconomic stability. The period was also characterized by a severe depression of wage incomes via hostile measures against organized labor. This “classic” mode of surplus creation reached its economic and political limits by 1988. Coupled with a new wave of populist pressures under the approaching civilian elections, organized labor succeeded in attaining significant increases in wages. Furthermore, the rural economy witnessed a significant improvement in its terms of trade vis-à-vis the industry. This occurred despite an ongoing process of worsening agricultural terms of trade in the world markets, signaling an interference to the economic signals in favor of the rural economy. Finally, beginning 1989, there had been a major shift in the public expenditure accounts towards populist patterns with an overall increase in both the share and level of public salaries.

The post-1988 populism could evidently be financed by expanding the tax base and moving towards a more “fair” tax burden on the working classes. Yet, the strategic preference of the state was the maintenance of its present stance towards evasion of taxable capital incomes and enabling a mechanism of surplus transfer by

way of a lax attitude towards the so-called unrecorded private transactions.² Consequently, the state apparatus turned into a bastion of privilege as it assumed a regulatory role in the creation and absorption of the economic surplus, and the fiscal balances have taken the major brunt of adjustment. The main macroeconomic policy response to the increased wage costs and the culminating fiscal deficits was complete deregulation of the financial markets. With the advent of elimination of controls on foreign capital transactions and the declaration of convertibility of the Turkish Lira in 1989, Turkey opened up its domestic asset markets to global financial competition. In this setting, the Central Bank lost its overall control over the exchange rate and the interest rate as instruments of independent policy making, as these practically turned into exogenous parameters set by the chaotic conditions of financial arbitrage in the global markets. Thus, we regard 1989 as a crucial year in our analysis, segmenting the post-1980 neo-liberal mode of economic development in Turkey.

In retrospect, it can be stated that the mode and the pace of financial reforms have progressed in leaps and bounds, mostly following pragmatic, on-site solutions to the emerging problems.³ Conceptually, what was expected from the financial liberalization reform agenda was the achievement of a more efficient and flexible financial system, capable of converting national savings into productive investments at the lowest cost. Based on this expectation there was a strong emotional commitment with a clear stance of irreversibility of the reform course. Contrary to what was expected, however, the reforms did not accompany any significant change in the financing behavior of the corporations, and did not lead to cheapening of investment costs (Akyüz, 1990). The state maintained its dominance in both the commodity and the asset markets through its complex system of price and fiscal incentives. The real rate of interest, in fact, rose to unprecedented levels; domestic asset markets, impacted by sudden changes in speculative foreign capital flows became volatile and uncertain, culminating in the complete breakdown of the financial system in 1994, and ultimately resulting in a severe economic crisis. We document the main economic indicators of the post-financial reform Turkish economy

² Yeldan (1995) and (1998) discuss the characteristics of the post-1989 Turkish macro adjustments in terms of creation and absorption of the economic surplus, and provide a quantitative analysis on the strategic role played by the state apparatus. Cizre-Sakallioglu and Yeldan (1999), Boratav, Türel and Yeldan (1996), Ekinci (1998), and Yeldan (1999) provide a similar analysis based on the effects of international speculative financial capital flows on the Turkish economy.

³ For a thorough account of the financial reform, see Boratav, Türel and Yeldan (1996); Yentürk (1996); Balkan and Yeldan (1998), Yeldan (1997) and Atiyas (1995).

in Table 1.

<Insert Table 1 approximately here>

The volatile character of Turkish economic growth, with mini boom-and-bust cycles, is evident from Table 1. The rate of growth of GDP was meager in 1988 and 1989, increased to 7.9 percent in 1990, but then fell to 1.1 percent in 1991, continuing to fluctuate then-after. Concomitant with this trend was the cyclical behavior of consumption and investment. Public investment expenditures were ideologically held on a downward trend, and the 20 percent decline of 1988 could not be recovered until 1997. Private investments, on the other hand, were not on a sustained basis. The peak of private capital accumulation in 1993 of 35 percent was immediately followed by the contraction of 1994 of -9.1 percent. The overall expansion of private capital accumulation followed quite a modest trend and could not provide a sustained invigoration to the overall economy.

Another observation from Table 1 pertains to the growing imbalances in foreign trade. By the end of the 1980s, exports are observed to finance, on the average, 70 percent of the volume of imports. After 1990 this ratio declined rapidly to 58 percent, and stayed at about that level until 1993. In 1993, just before the outbreak of the financial crisis, the export/import ratio dropped to 53 percent. Consequently, the current account deficit widened and reached 6.4 billion US \$. The current account balance turned to a surplus in 1994 due to the severe decline in import demand. After the crisis was overcome, however, import demand recovered again, and the current account deficit continued to widen, to reach US\$ 4.4 billions.

One of the direct facets of the vulnerability of the Turkish macroeconomic balances in this period was the continued inflation. Price inflation, as measured in the annual change in the consumer price index, is observed to lie around 60-65 percent in the second part of the 1980s. After 1991, inflation rate accelerated and reached a plateau of 70 percent. The post-crisis (after 1994) period witnessed a further acceleration, to 80-90 percent range between 1995 and 1998.

I-1. The Dominant Processes of the Post-Financial Reform

Throughout the course of these events, Turkey's banking sector and financial institutions became disengaged from production to become the dominant faction of the capital manipulating the overall economy. The driving force behind this development was two-fold, one domestic, the other global. On the *domestic* level, it

was the collapse of the public disposable income which led to the fever of public sector borrowing. The consequent high interest rates of government bonds and treasury bills set the course for the dominance of finance over the real economy. As a result, the economy is observed to be trapped in a vicious circle: commitment to high interest rates and cheap foreign currency (overvalued TL) against the threat of capital flight leads to further increase in the real interest rates. When adverse impacts on the current account balance become excessively destabilizing, real depreciation seems imminent, which, however, needs to be matched by further upward adjustment in the rate of interest if currency substitution or capital flight is to be restrained. This process, as in the case of Mexico in 1994, and the recent crises of East Asia, leads to overvaluation of the domestic currency, cheapening of imports, and thus an acceleration of domestic consumption demand at the expense of exports, and the real productive industries in general.

The *global* dimension of the rising prominence of finance is no less important. As internationalization of the Turkish state intensifies, it also becomes directly accountable to external bond markets as well. The judgments of global capital market as the ultimate arbiter about the government's creditworthiness gain primacy. Complete deregulation of the finance sector Turkish style brings through the backdoor, the veto on politics by the hot money holders who aim at immediate financial gain, rather than the long-term development of production. The crisis of 1994, in hindsight, shows the vulnerability of the Turkish economy to the speculative gains of hot money and 'casino capitalism' (Strange, 1986). The post-1993 experience is indicative of this observation. The fourth quarter of 1993 was the culmination of the fragility conditions in Turkey, when currency appreciation and the consequent current account deficit reached unprecedented levels.⁴ With the sudden drainage in short-term funds at the beginning of January 1994, production capacity contracted, and industrial output fell continuously throughout that year.

It is clear, however, that the promotion of financial liberalization was a conscious choice by the Turkish state, structured around the logic of globalizing capitalism. This design exclusively sought the management of relative prices according to dictates of the unfettered market forces. The outcome to this date,

⁴ Observe from Table 1 that the *real* exchange rate appreciated by 20 percentage points between 1988 and 1993.

however, had been a failure in maintaining price stability and achieving sustainable gains in *dis*-inflation. It is to these processes we turn to in the next section.

II. Dynamics of Price Inflation and the Relative Price System

We provide background information on the dynamics of price movements in the post-1988 Turkish economy in Table 2. We follow the rate of inflation through the behavior of three price indexes: (i) consumer prices, (ii) wholesale prices, and (iii) private manufacturing producer prices. The dynamics of private manufacturing producer prices is often regarded as the “core” inflation by many students of the Turkish economy. For this reason, we will investigate this index separately from the others in calculations of the “real” exchange rate and other relative prices of importance.

<insert table 2 here>

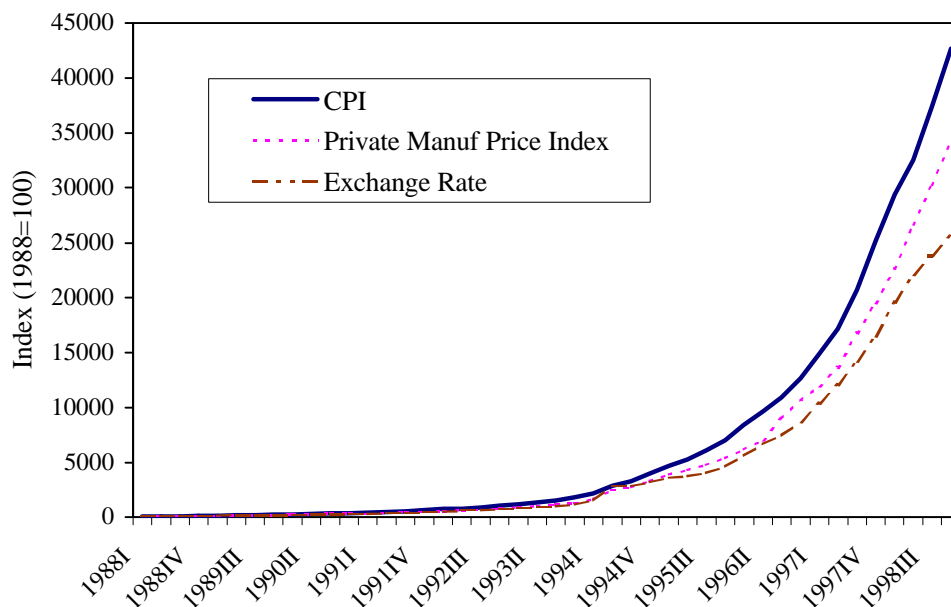
The indexes of both the consumer and the wholesale prices follow almost the same pattern over the analyzed period. Up until the 1994 jump, inflation on the consumer prices hovered around 70%, and that of the wholesale prices recorded an average of 55%. After 1994, however, both price indexes reached to the higher plateau of 80-85% annual inflation.

The behavior of the exchange rate discloses an overall tendency towards real appreciation when account is taken for the 1988-1994 period. After the 1994 crisis, the exchange rate is observed to display real *depreciation* with respect to private manufacturing producer prices, and real *appreciation* against consumer prices; while being almost at par with the wholesale prices. The overall path of the price indexes and the exchange rate are further portrayed in Figure 1, where the consequent cumulative appreciation of the Turkish Lira is clearly visible when the whole post-1988 period is concerned.

On the cost side, we observe that the two most important indicators –the private and public manufacturing wage costs– display two different adjustment paths: in the 1988-1994 period both sectors experience very rapid increases in real wage costs. This is especially pronounced in the public manufacturing sector where *real* wage costs increased by 50.5% in 1989, 22.9% in 1990, and 39.9% in 1991. This rapid acceleration in wage costs was suddenly hit by a steep contraction in 1994 and 1995, and experienced a general deceleration then after. This abrupt path of wage costs should be seen as manifestation of a sporadic disequilibrium in the labor market

with consequent informalization and marginalization, an issue which had been studied extensively in Yeldan and Köse (1999), and Onaran (1998).

Figure 1. Price Inflation and the Exchange Rate



In the financial markets, the yields offered on the government debt instruments (GDIs) dominated with real rates of return reaching to almost 35% after the 1994 crisis. For comparison, in Table 2 we contrast the rates of return on 1-year time deposits *versus* that of the GDIs. The annual compounded rate of yield on the GDIs is observed to be at par initially until 1991. After then, the gap between the two instruments widens continuously, reaching a plateau of 30% especially in the aftermath of the 1994 crisis.

Turning to the money markets, we next study the behavior of monetary aggregates and relevant monetary instruments in affecting the price inflation during the period analyzed. In Table 3 we document the main indicators surrounding monetary aggregates, M1, M2, and M2Y. Information on the first column of Table 3 discloses that, as far as the narrow definition of money is concerned, the Central bank achieved an overall contractionary policy. This is especially true following the 1994 crisis, with 1996, however, providing the singlemost exception. As deflated by the

wholesale producer prices, the real rate of contraction is found to be 9.0% in 1995, 8.8% in 1997, and 3.6% in 1998. The real expansion in M1 reached to 19.3% in 1996. Given the overall trend towards real contraction, however, the velocity of M1 with respect to the gross national product followed a secular increasing path. The velocity of M1 is observed to double between 1988 and 1998. This suggests that demand for M1-type money has been significantly reduced, accommodating inflationary pressures in the real sphere of the economy.

<Insert Table 3 here>

Money stocks of M2 and M2Y, on the other hand, were expansionary in stance in real terms. Consequently, income velocity of M2 was almost constant over the 10-year episode, accommodating expansion of real GNP. Yet that of M2Y was on a continued downward trend indicating that the demand for M2Y has increased at a faster rate than the rate of increase of real national product. Against the rising path of M1, this tendency discloses the culminating pressures of *currency substitution* (dollarization) of the domestic markets with increased demand towards foreign denominated assets, foreign currency in particular.

A striking aspect of the monetary aggregates observed from Table 3 concerns the behavior of money multipliers over the post-1988 period. Measured against the reserve money and the central bank money, we read only a slight rise of the money multiplier of M1. The behavior of M2Y is quite different, however, and reveals a tendency towards steep acceleration especially after 1993. This pattern discloses how erratic has the movement of broad money aggregate, M2Y, been and reveals the constraints on the ability and independence of the monetary authority in conducting anti-inflationary policy in Turkey.

II-1. Dynamics of Price Inflation: A Quantitative Analysis

We now turn to a quantitative investigation of the dynamics of price inflation using statistical methods. Our aim here is to study the behavior of price inflation in the post-1988 period by decomposing the historical realized rates into, a trend component and to, what we will term as, cyclical deviations. Such a decomposition will enable us to study the underlying characteristics of the trend, and investigate properties of the deviations in response to policy shifts and other macroeconomic aggregates.

One of the most widely used decomposition filters in the literature is that of

Hodrcik and Prescott.⁵ The Hodrick-Prescott filter decomposes a given variable into the *trend* $\{\tau_t\}_{t=1}^T$ and *cyclical components* $\{y_t - \tau_t\}_{t=1}^T$. It is expected that this method would satisfy the following two criteria: (i) the deviations of the analyzed variable from the attributed trend should be “minimal”; and (ii) the trend components should follow a uniform path as much as possible, in other words it should not display large variations along its historical path over time.

Under these criteria, one can find a path for the trend by solving this minimization program for each variable concerned:

$$\min_{\{\mathbf{t}\}_{t=1}^T} \sum_{t=1}^T \left[y_t - \mathbf{t}_t \right]^2 + \lambda \sum_{t=2}^{T-1} \left[(\mathbf{t}_{t+1} - \mathbf{t}_t) - (\mathbf{t}_t - \mathbf{t}_{t-1}) \right]^2$$

In this function, the first term gives the sum of the squared deviations ($\sum_{t=1}^T (y_t - \tau_t)^2$) and thus reflects the adjustment of the deviations to the trend path over time. The second term, on the other hand, is the multiple λ of the sum of the squares of the trend component's second differences. This second term penalizes variations in the growth rate of the trend component with the penalty being correspondingly larger if λ is larger. The first order conditions of this minimization program can then be solved for the trend path, τ_t .

In what follows, we will assume that a deviation of 5% of the quarterly value of the cyclical component from its trend, and a 0.125% deviation within the trend are to be regarded as “large” deviations from the point of view of the above program.

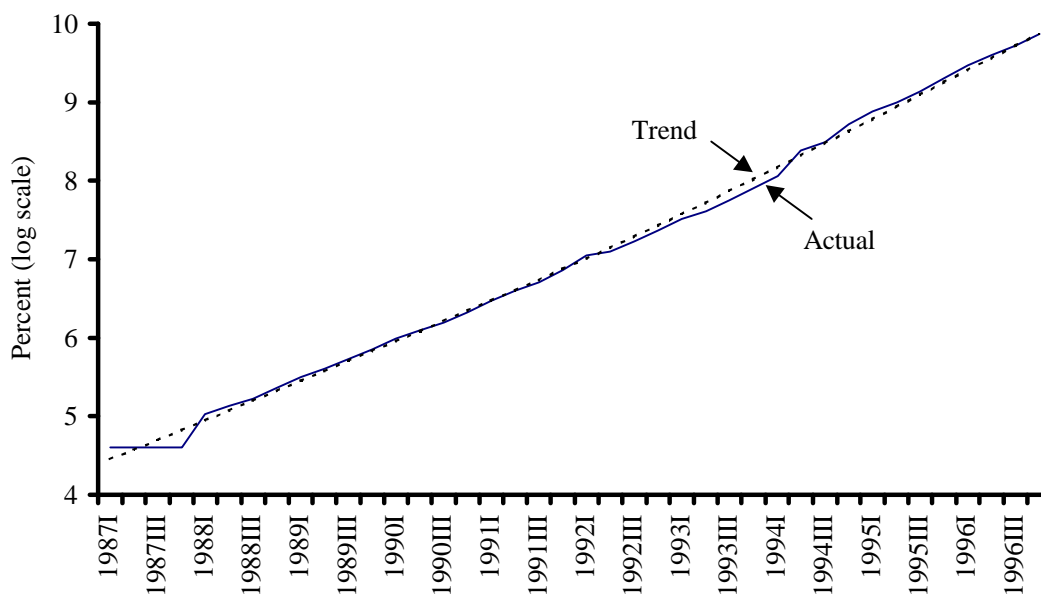
Consequently, the value of the λ in the above equation is taken as $\left(\frac{5}{1/8} \right)^2$, or in other words, 1600.

For the price inflation variable we made use of the quarterly variations in consumer price index covering from the first quarter of 1987 onwards. We portray the path of the trend component in Figure 2a. The figure clearly indicates an almost perfectly linear path admitting very small deviations for the actually realized values.

⁵ See, e.g. Hodrick and Prescott (1980, 1997) and Kydland and Prescott (1990).

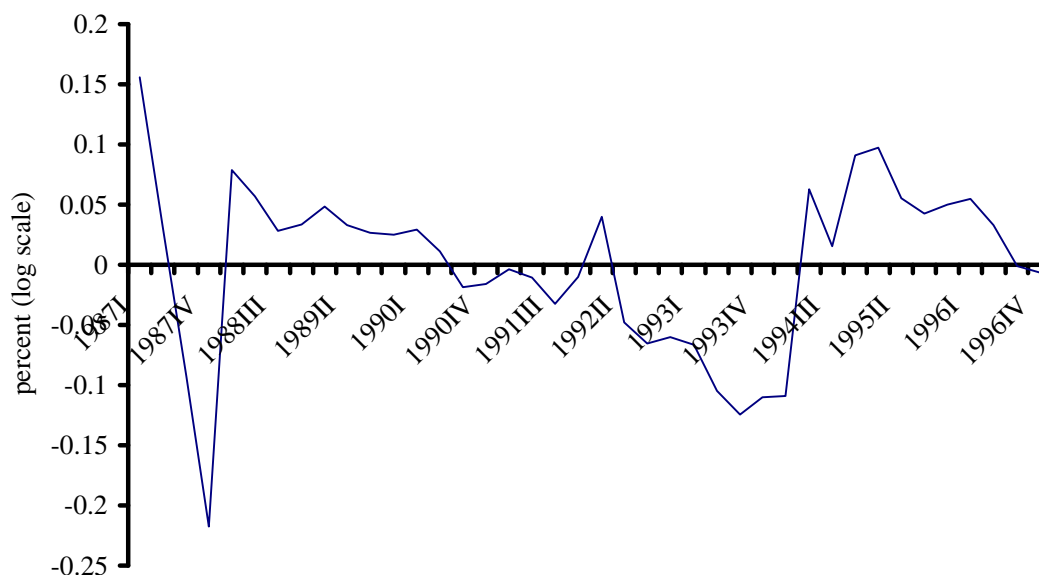
This indicates how rigid the inertial expectations had been in the Turkish economy in generating forward dynamics for price increases. The actual values do almost stuck their trend revealing the non-responsiveness of price inflation to cyclical changes in macroeconomic policy. This becomes clearer if we plot the normalized values of such deviations from the trend and inspect their amplitude. This is achieved Figure 2b where deviations from the trend are portrayed as normalized oscillations around the vertical axis. We note that the widest discrepancy in the deviation component occur in the first half of 1988 and then again in the first half of 1994. In the former case the deviations reveal a jump of 2.3-folds between the peak and the trough, and in the latter case the relevant change is 1.25-folds. In the remaining periods the shift of the inflation from one peak to the trough is observed to be quite marginal.

Figure 2a. Dynamics of Turkish Inflation: Historical Values and the Trend



It seems that the inertial element provides the whole of the price inflation generated in the analyzed period, leaving little room to macro phenomena. This characteristic alone is suggestive of the fact that the disinflationary policy had to be much concerned with inertial expectations first and foremost, rather than solely contractionary mechanisms of monetary management and demand deflation.

Figure 2b. Dynamics of Turkish Inflation: Cyclical Deviations from the Trend



Carrying our analysis a step further, we look into the statistical properties of the policy induced shifts in price inflation with other macro variables. In Table 4, we tabulate the results of our statistical analysis on the correlation coefficients of relevant macro aggregates with the CPI at various time lengths. The statistics in each column are the correlation coefficients of the cyclical deviations of each variable with the cyclical deviations of CPI. A number close to one indicates that the variable is highly *procyclical*; a number close to one but of the opposite sign indicates that it is *countercyclical*. A number close to zero means that the series does not vary contemporaneously with the inflation cycle in any systematic way. In the Table the series have been shifted backward and forward, relative to the CPI, from t-2 to t+2 quarters. We say a variable *leads* the cycle by j-quarters if it discloses a high correlation coefficient for the time period (t-j), where $j > 0$; and we say that it *lags* the cycle by j-quarters if its admits a high coefficient for the period t+j.

<Insert Table 4 here>

Our results are tabulated in Table 4 where we find that the CPI has relatively strong pro-cyclical contemporaneous relationship with the broad money supply, M2Y. The finding that both of the narrow supplies of money, M1 and M2, display quite

weak – and mixed– correlations is suggestive of the fact that any link between the money stocks and price movements –if at all–originate from the foreign currency flows and the banks’ ability to create money via the forex deposits. The CPI reveals a very weak association with either of the two interest rates –the rate of return on government debt instruments and the one-year time deposits– or the nominal exchange rate. In formal terms, the deviations of the consumer price index have very weak, non-robust and often contradictory correlations with the cyclical deviations of either the macro aggregates or the monetary magnitudes. All of these are indicative of the fact that the behavior of the CPI is very much explainable by its inertial component, rather than by the cyclical variations.

III. Disequilibria in the Public Sector Balances and Fiscal Policy

It is during the post-1988 years that a drastic deterioration of the fiscal balances took place in Turkey. The ratio of PSBR to gross domestic product averaged 4.5 percent during 1981-1988, but rose to 8.6 percent for the 1989-1997 period. We document this deterioration in Table 5 which is based on real values of the fiscal accounts, using 1987 prices.

< Insert Table 5 >

It can be directly noted that during 1988-1993, the major erosion has occurred in the *factor revenues* item, i.e. net factor income generated by the state economic enterprise system. Factor revenues of the state declined by 86 percent. in five years in real terms. The real erosion up till 1992 corresponds approximately to 5% of the GNP of the period. The swift upward movement in transfer expenditures started in 1992. Between 1991 and 1996 the increase is more than 125 percent in real terms. The major item in this account was interest payments. The rise in the domestic debt gave way to a rapid build up of interest costs.

On the revenue side, tax collections had registered modest improvements in real terms by 50 percent up till 1993, but they started to decline thereafter essentially due to the erosion of direct taxes. The share of indirect taxes in the total rose to 64% in 1997 from 59% in 1990.

These developments led to a sharp collapse in the disposable income of the public sector, declining by 45 percent *in real terms*. The PSBR as a ratio of GNP stood around 10% on the average over 1990-1996. The peak of this ratio was witnessed in 1993, just before the financial crisis of 1994 (12.4%). Even though there

were some improvements in the borrowing requirements of the state under the 1994/1995 crisis management, the PSBR rose again to an alarming rate of 9.6% in 1996.

In this context, it is important to note a fundamental change in financing of the PSBR, breaking away with the pre-liberalization period of the 1970's and 80's. Data on the financing patterns of the PSBR suggest that, under the financially repressed conditions of the 1970's and early 1980's, deficit financing through central bank advances (monetization) was the most direct method. However, after the embankment of the structural adjustment reforms and especially with the removal of the interest ceilings in a series of reforms throughout the 1980s, the government found it much easier to finance its borrowing requirements from domestic borrowing through issues of the government debt instruments (GDIs). This also enabled successive governments to by-pass many of the formal constraints on their fiscal operations. Consequently, with the advent of full-fledged financial liberalization after 1988, the PSBR financing relied almost exclusively on issues of GDIs to the internal market – especially to the banking sector. The elements of this process are clearly visible in Figure 3.

<insert Figure 3>

Figure 3 documents two sharp peaks on the size of the PSBR over the two decades following 1975. The first is the period, 1975-80, where the ratio of PSBR to GNP stands around 8%: and the second is the post-1990 period, where the same ratio climbed to the plateau of 10%. The first period was characterized by the foreign exchange crisis whereas the second incorporates the culmination of financial reform with capital account liberalization. The major difference between the two periods is on the mode of financing of the PSBR: In the former the fiscal deficit is monetized, whereas it is financed by the GDI operations under the latter. The stock of domestic debt was only about 6% of the GNP in 1989, just when the liberalization of the capital account was completed. It grew rapidly, and reached 20% by 1997. Thus, the public sector has been trapped in a short term rolling of debt, a phenomenon characterized as *Ponzi-financing* in the fiscal economics literature. This clearly unsustainable process contributed to the so-called confidence crisis of the 1990's. For this scheme to work, however, domestic financial markets required the continued inflow of short term capital inflows.

Given these facts it is clear that the episode of hot money inflows should be interpreted, in the Turkish context, as the long arm of fiscal policy, overcoming credit restraints and monetary constraints of the monetary authority. The availability of such funds enabled the fiscal authority to postpone any adjustment in its revenue enhancing capabilities such as implementation of added taxes on capital earnings and reducing evasions on taxable corporate earnings. Yeldan (1995) discusses this stance in terms of a discretionary surplus redistribution strategy on the part of the state via its fiscal policy. Thereby, through the availability of short term borrowable funds, the fiscal operations of the state became a viable apparatus to generate an economic surplus for the corporate incomes by way of a lax attitude towards tax evasion and the consequent deficits. In so doing, as the Treasury offered market-yields on its instruments, it became the dominant agent in the financial economy, enabling the banking system significant returns based on the arbitrage of *open-positions*.

The distribution of the issues of GDI's are portrayed in Figure 4. Currently more than 90% of the newly securitized deficit is observed to be purchased by the banking sector. Thus, the so-called deepening of the financial system in the Turkish economy has turned into a process of self-feeding cycles, ready to burst. High real rates of interest on the GDI's attract speculative short-term funds, and through the operations of the banking system, these are channelled to the vaults of the treasury, which in turn finds a way out of the regulations of the monetary authority, as well as the restricted long-term foreign borrowing opportunities directly from world markets. Capital account liberalization, thus, served the government by enabling banks to engage in extremely profitable short-term borrowing abroad so as to finance Treasury's bond auctions. The major brunt of the costs of this fragile environment, however, falls on the productive sphere of the economy, especially the . traded sectors. High interest rates attract short term foreign capital, and the availability of abundant foreign exchange results in overvaluation of the domestic currency, generates disincentives to exporters and contributes to a widening trade deficit.

In Boratav, Turel and Yeldan's (1995) words, "all of these reveal an extremely unpredictable environment. The post-1990 Turkish experience shows the serious problems confronting a developing economy which decides to move into full external and internal deregulation in the financial system under conditions of high inflation. "The specter of capital flight" becomes the dominant motive in policy-making and creates commitment to high interest rates and expectations for cheap

foreign exchange. The links of these two policy variables with the real sphere of the economy, i.e. investment on physical capital and the current account balance of payments, are deeply severed. When adverse impacts on the current account balance becomes excessively destabilizing, real depreciation seems imminent, which, however, needs to be matched by further upward adjustment in the rate of interest if currency substitution or capital flight is to be restrained. Even with all the necessary adjustments the country may experience capital flight for other reasons which are beyond its control. Instability in the rates of foreign exchange and interest rates creates feedbacks which lead the economy into further instability.” It will be the topic of the next section to analyze the political calculus behind these dynamics.

IV. The Political Factors Endearing Or Impeding Disinflation

Given the historical context of Turkish democracy with state-ridden populism, the economic realm of politics is necessarily inflation-prone. Contrary to conventional wisdom that inflationary policies deviate from market rationality, maintaining an anti-inflationist mandate is regarded as instrumental to endearing neoliberal policies to low income groups who bear the brunt of high inflation. However, the irony of the situation is that it is the failure to control inflation by a series of governments that has led the newspaper columnists and political leaders to project inflation as a matter of "national interest", a matter of life and death. The issue took on new significance at the beginning of 1998, when the inflation rate hit three-digit figures (101 percent in January 1998). But, the high social costs of orthodox anti-inflationary policies proved to be a political liability by the Mesut Yılmaz-led coalition government, which had declared war on inflation upon taking office in June 1999. Although it was the same leader who had shown unprecedented alarm and sensitivity to the issue prior to taking office, he was reported as rejecting the International Monetary Fund's suggestion that he should implement a one-year shock therapy to bring down the rate of inflation by structural reform and fiscal discipline. His grounds were that he had no intentions of following in the footsteps of former Israeli Prime Minister Simon Peres who is believed to have lost office under the impact of his policies in that direction. Before he fell from office, Mr.Yılmaz defended his stand by making references to the waning of popular support for anti-inflationary measures.

The new government's seeming willingness to embrace bolder policy changes with regard to its "economic reform" program needs to be connected with the four hypothesis that are laid out in terms of reference of this paper. First of all, whether the parameters of political action have changed in such a way as to render Turkey's political class ready to adopt a "rational choice" and shift course toward a painful reform which no government dared to embrace in the past. This must be placed within the larger historical evolution of the political preconditions for deflationary policies in Turkey in the 1990s. Indeed, why is that majority citizens endorsed a socially risky adjustment plan of Mr.Özal who won 2 elections (1983, 1987) on his promise of transforming the country's development model, whereas his successors failed to do the same?

Relatedly, the second hypothesis which should be tested is "who is hurt" and "when" under the impact of persisting moderate inflation, of the kind experienced in Turkey in the last 19 years, while the third is the political role the public dept plays in Turkey's regulatory policies with regard to inflation. Furthermore, another important question to be addressed is the regulation of the finance sector as part of the attempt to control inflation.

IV-1. Turkey's Political Class and Inflation

The most significant evidence on Turkey's political class not being likely to shift course toward establishing the political preconditions for deflationary policies comes from 1999 election campaign. Although reducing inflation continued to be the pet item of most of the parties, ironically "there was much economy in 1999 election campaigns in the sense that economic policies were barely touched upon. In contrast to previous campaigns, we did not see any detailed economic programs. Nor did we witness any debates concerning economic policies"⁶. What distinguishes 1999 elections from the previous ones was the convergence of Turkey's political parties on the "definition of the problem areas and also on the solution mechanisms"⁷ which shows that there will not be a significant divergence in the coming days from the dominant inherent tendencies of the Turkish economy and the economic strategies followed by Turkey's political class so far.

⁶ Ümit

⁷ ibid

It would be safe to suggest, therefore, that only a few selected areas of the challenging reforms on the tax, agriculture, banking and the social security systems can be undertaken to appease the IMF and to collect just enough popular support from the sectors that will benefit from the ensuing pressure to keep the inflation (and growth) rate down. Legal changes favoring foreign investment will also be made to attract foreign capital which is expected to ease the financing of the budget. But deeper reforms of the institutions shaping the economy within the logic of structural adjustment, curbing government budget deficit, allowing interest rates to rise to levels comparable to other countries' are not likely to materialize. The reasons for this are to be sought in two realms: the first has to do with the conception of the economy and society by typical neo-liberal policies, the second with the powerlessness of Turkey's political class to implement full marketization even if they were committed to its realization.

In fact, these two realms are linked. The typical stabilization and structural adjustment programs, by nature, are not concerned about the incomes of the poor, the workers, the peasants which are supposed to benefit by the establishment of market-based prices in the long run, together with the other social sectors. But on the question of what to do about the fixed-income receivers who bear a disproportionate share of the pain of above reforms and therefore, weaken the political support for governments in condition of widening social inequities, free-market orthodoxy has no convincing answers. The weakness of the foundation upon which the market reforms rest is therefore linked with weakening support for the government at a time when there is social pressure protect people against the ill effects of socio-economic dislocations, which in itself contributes to the growing distance between politicians and the popular demands. This vicious circle diminishes any prospects for ambitious reforms either because the political class is immune to public pressure or resistant to reforms or unable to put together sufficient support to enact them, though maintaining a reform discourse.

IV-2. Who is Hurt and When?

When one looks at the expectations and demands of various sectors in the economy as voiced by the key business figures in the media, one is struck by a big paradox: while exporters and the tourism sector demand more infusion of state credits, state employees are in pursuit of more pay rises, contractors more state

Radikal (daily),

June 3, 1999

⁹ ibid

¹⁰ Kurt Weyland, "The political Fate of Market Reform in Latin America, Africa and Eastern Europe", *International Studies Quarterly*, 42 (December 1998), p.657

effects of the crisis in the Far East that Turkish economy is resistant to crises¹². If the crisis theory holds, then, part of the focus of analysis should be shifted from the failure of Turkish politics and economy to embark on a deflationary course to an analysis of the forces shaping the inflation expectations of the popular masses themselves, including the perception of the character of the economic crises if any. One such force that helps popular acceptance of stable inflation in the face of its unequal distributional effects is the popular enthusiasm for the market. Despite the social pains Turkey's various social groups are exposed to, the costs do not seem to shake the popular confidence in the prospects for new opportunities the ongoing economic model is expected to bring in future. Advances made in certain areas of life for some social groups seem to create the hope of gain for the others. It will not be wrong to argue that Turkey's urban middle classes agree to believe in the "process" rather than the "outcome" of the existing economic model which can be characterized as operating under the mixed dynamism of the market and the state forces.

It follows that the popular masses do not necessarily perceive the inflation as the result of the "financial" mismanagement on the part of governments of the last 16 years. Nor is there any evidence that the blame is put squarely on the irresponsibility and speculative tendencies of the banking sector and private investors. The rising nationalism in the country also prevents the public from pointing its finger to the expenditure of the war fought in the southeast against the PKK which puts a heavy pressure on the budget. By and large, the public sees the source of widening social disparities in the existing "political" arrangements which is weak, unresponsive and unrepresentative of gross roots.

IV-3. The Challenge of the Public Deficit and the Distributional Deterioration

The perception of "crisis" by popular sectors should also be connected with the political implications of distributional deterioration. A ballooning public debt and high inflation contributes to both the delegitimation and legitimation of the political system because it produces the above sense of loss of control, instability and hopelessness. But it can also act -through populist policies, a persistent failure of Turkish politics- as an integrative mechanism. Turkey's public sector deficit should

¹¹ *ibid*, p.653

¹² This misperception is criticised by Erkut Yücaođlu, the president of TÜSÝAD. See "TÜSÝAD: Nereden Buldun Kalsýn"(*TUSIAD: Drop Questioning of Private Wealth*)

therefore be analyzed more as a source of political and social instability which produces an unsuitable context for understanding decisive economic reform.

By July 1999, there was a widespread consensus that just as the agent responsible for lowering the inflation in 1998 was the public sector, it is the same sector which has caused an increase in the inflation rate by making price adjustments in the first four months of 1999 on a monthly average of 4.7 percent, which is above the same percentage increase (3.9 percent) in the private sector.¹³ Consequently, public sector wages are considered instrumental in pushing the increase in real wages in the private sector. Together with an expansionist monetary policy and the real depreciation of TL, the rate of inflation was presumed to rise in the second half of 1999, despite the fact that the same rate fell in the first half.

Indeed, macro-economic balances in the first three months of 1999 showed a recessionary trend: the industrial production fell, investment was zero, capital was fleeing, growth was low, money supply contracted. Yılmaz-led government which lasted 17 months fell on November 25, 1998, after in a corruption scandal. The interim coalition government led by center-left leader Bülent Ecevit was politically fragile to implement any anti-inflationary agenda. The April 18, 1999 elections brought to power a new coalition government between the far-right Nationalist Action Party (NAP) (which won a second place showing), the Democratic Left Party (DLP) (which finished the elections first) and Mr.Yılmaz's Motherland Party which fell to the fourth place, under Mr.Ecevit as the new Prime Minister. By then, the macroeconomic balances had regressed and the budget deficit had reached, in Mr.Yılmaz's words, to a "pertifying" level. The domestic and international opinion converged in demanding a radical structural reform in response to the dramatic economic deterioration. As such, the new government proposes to launch a drastic structural reform in ten key areas of the economy.

However, the package that was opened confirmed the suspicions of those who think " it will be more realistic to assume that a few of these reforms will be actualized for the sake of the IMF agreement. That agreement will keep the inflation rate and the growth rate down and will help ease the financing problem of the budget via more favourable terms on foreign borrowing"¹⁴. Prudent fiscal policies to

¹³ Ercan Kumcu, "Enflasyon Neden

¹⁴ Yılmaz, op.cit., p.26

Rise), Radikal, 25 May 1999.

discipline inflation also entails disciplining the narrow class of financiers and entrepreneurs whose actions no government has been able to control effectively. The most significant characteristics of the structural adjustment programme of the last 19 years has been a disproportional growth in financial markets relative to real investment and production. That the banking sector is a specific target area for structural reforms in the economy testifies to the importance of the negative social and political impact of Turkey's finance sector.

V. Conclusions

In this paper we have studied the dynamics of Turkish inflation as a direct manifestation of macroeconomic mis-management and disequilibria in the commodity and financial markets. Our analytical results indicate that much of the behavior of price dynamics is governed by inertial expectations rather than shifts in the monetary variables such as money supplies, and or the fiscal deficit. This finding is suggestive of the fact that the disinflationary policy had to be much concerned with inertial expectations first and foremost, rather than solely contractionary mechanisms of monetary management and demand deflation.

From a broader political-economy perspective, in the Turkish historical context with a state-dominated economy, where politics has traditionally been understood and defined as an activity centering on distribution of state largesse to voters/clienteles, needless to say, politics is inflation-prone. During the era of import substitution development, which characterized the post-1963 planning phase until the last military coup in 1980, the traditional political discourse focused on the public sector manipulating an “electoral” rather than “democratic” form of capitalism. With transition into market-economy, for reasons to do with politics being too restrictive to allow free competition of ideas, by and large, it has been the instrumental role of public spending which continued to produce moral and political sustainability of the political system. Under such conditions of seeking to buy political support through massive patronage, politicians have been reluctant to impose radical market reforms with heavy short-term costs, which would invoke opposition and lead to their ouster from office.

Federal Reserve Bank of Minneapolis Quarterly Review, Spring, 3-18.

Onaran, Ö. (1998) "The Wage Setting Mechanism in Turkish Private Manufacturing Industry" Istanbul Technical University, mimeograph.

- Yeldan, E. (1999) “Küreselle°me Sürecinde Türkiye Ekonomisinde Üretim, Birikim Ve Bölünüm Yıpkilerine Toplu Bir Bakıþ”, *Petrol Ýþ Sendikası, 1997/98 Yıllıđı*, in press.
- Yeldan (1998) “On Structural Sources of the 1994 Turkish Crisis: A CGE Modeling Analysis” *The International Review of Applied Economics*, 12(3): 397-414.
- Yeldan, E. (1995) “Surplus Creation and Extraction under Structural Adjustment: *Review of Radical Political Economics*, 27(2): 38-72, June.
- Yeldan, E. and A. Köse (1999) “An Assessment of The Turkish Labor Market Against its Macroeconomics Policies”, *The Burdens Related with Turkish Labor Markets and Policies*, ed. T. Bulutay, State Institute of Statistics, Ankara

Table 1. Main Economic Indicators, Turkey, 1988-1998

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<i>Annual % Change</i>											
GDP	2.7	1.2	7.9	1.1	5.9	8.0	-5.5	7.2	7.0	7.5	2.8
<i>Consumption</i>											
Private	1.2	-1.0	13.1	1.9	3.3	8.4	-5.3	4.8	8.5	8.4	0.1
Public	-1.1	0.8	7.9	4.5	3.8	2.3	-3.5	6.8	8.6	4.1	5.0
<i>Fixed Investments</i>											
Private	12.6	1.7	19.4	0.9	4.3	35.0	-9.1	16.9	12.1	11.9	-6.7
Public	-20.2	3.2	8.9	1.8	4.3	3.4	-34.8	-18.8	24.4	28.4	15.1
Exports (Millions US\$) ^a	11929	11780	13026	13667	14891	15611	18390	21637	23225	26261	26974
Imports (Millions US\$) ^a	14335	15792	22302	21047	22871	29428	23270	35709	43626	48559	45935
Current Account (M. US\$) ^a	1596	961	-2625	250	-974	-6433	2631	-2339	-2437	-2638	2692
Inflation rate (CPI, %)	75.4	64.3	60.4	71.1	66.1	71.1	106.3	88.0	80.4	85.7	84.6
Real Exchange Rate ^b	101.5	96.2	82.6	84.7	88.5	88.5	114.9	102.9	104.2	104.0	101.4
<i>Ratios to the GNP (%):</i>											
Savings	27.2	22.1	22.0	21.3	21.6	22.7	23.0	21.5	20.0	21.3	21.2
Investment	26.1	22.5	22.6	23.7	23.4	26.3	24.4	23.4	25.0	25.3	25.6
Budget Balance	-3.0	-3.3	-3.1	-5.3	-4.3	-6.7	-3.9	-4.0	-8.3	-7.6	-7.0
PSBR	4.8	5.2	7.4	10.3	10.6	12.1	7.9	5.4	9.6	8.2	8.6
Stock of Domestic Debt	5.7	6.3	7.0	8.1	11.7	12.8	14.0	14.6	18.8	21.4	22.5
Interest Payments on Domestic Debt	2.4	2.2	2.4	2.7	2.8	4.6	6.0	6.2	9.0	7.7	10.9

Source: SPO Main Economic Indicators; SPO, *Ekonomik ve Sosyal Gostergeler (1950-1997)*.

(a) Beginning 1996, luggage trade inclusive.

(b) Index, 1987=100. Derived from the basket with weights, 0.75\$+0.25DM; deflated by the wholesale price index. An increase means depreciation of the Lira.

Table 2. Determinants of Inflation and Relative Prices

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<i>Annual % Change</i>											
Consumer Prices	75.4	64.3	60.4	71.1	66.1	71.1	106.3	88.0	80.4	85.7	84.6
Wholesale Prices	67.9	64.0	52.3	55.3	62.1	58.4	120.7	88.5	75.9	81.8	71.8
Private Manufacturing											
Producer Prices	82.1	60.9	42.6	53.8	59.8	59.3	130.5	83.4	68.2	77.6	57.2
Depreciation of TL ^a	66.0	49.0	23.0	60.0	65.0	59.0	170.0	54.0	77.0	78.0	71.8
Real Wage Costs in :											
Private Manufacturing	-3.2	24.4	17.0	24.0	-1.1	15.5	-24.1	-16.7	11.7	-8.1	3.4
Public Manufacturing	-7.3	50.5	22.9	39.9	25.2	-2.7	-22.2	-19.8	10.0		
<i>Interest Rate on:</i>											
Gov. Debt Instruments	69.6	59.8	54.0	80.5	87.7	87.6	164.4	121.9	134.3	108.4	115.5
1-Year Time Deposits	83.9	58.8	59.4	72.7	74.2	74.8	95.6	92.3	92.4	96.6	88.3

a. According to the basket of 1.5 US\$ + 1 DM.

Table 3. Monetary Aggregates and Money Multipliers

	<u>% Rate of Real Increase ^a</u>			<u>Income Velocity</u>			<u>Money Multipliers</u>			
	<u>M1</u>	<u>M2</u>	<u>M2Y</u>	<u>M1</u>	<u>M2</u>	<u>M2Y</u>	<u>M1/RM [*]</u>	<u>M1/CBM ^{**}</u>	<u>M2Y/RM [*]</u>	<u>M2Y/CBM ^{**}</u>
1988	-26.3	-13.3	-10.3	11.42	4.75	3.52	1.12	0.95	3.62	3.10
1989	5.4	5.7	1.8	11.78	4.89	3.76	1.15	1.06	3.60	3.31
1990	5.4	-0.3	0.0	12.65	5.55	4.25	1.32	1.32	3.91	3.92
1991	-4.0	5.4	15.9	13.56	5.42	3.77	1.26	1.06	4.51	3.82
1992	3.3	0.5	7.9	14.09	5.79	3.75	1.28	0.89	4.80	3.35
1993	4.0	-6.5	1.6	15.47	7.07	4.22	1.27	1.01	4.65	3.69
1994	-19.0	1.1	14.5	16.84	6.17	3.25	1.24	1.20	6.44	6.19
1995	-9.0	5.8	7.2	19.83	6.25	3.25	1.15	1.06	7.03	6.48
1996	19.3	26.7	29.6	18.02	5.35	2.72	1.34	1.30	8.90	8.57
1997	-8.8	3.4	1.2	21.32	5.58	2.90	1.21	1.99	8.87	14.62
1998	-3.6	20.0	11.6	23.21	4.88	2.73	1.12	4.33	9.52	36.85

a. Deflated by the wholesale price index.

* RM: Reserve Money, ** CBM: Central Bank Money.

TABLE 4. Monetary Aggregates and Price Inflation, Correlation Coefficients

(Quarterly Data: 1987.I-1996.IV)

	Cross-corr. Between CPI at t and C at (%)				
Variable C	<i>t</i> -2	<i>t</i> -1	<i>t</i>	<i>t</i> +1	<i>t</i> +2
M1, <i>Nominal</i>	16.83	-8.55	-28.90	-2.45	-6.43
M1, <i>Real</i>	18.78	-0.21	-31.58	-6.47	-1.68
M2, <i>Nominal</i>	-11.32	29.80	-3.38	-4.39	7.31
M2, <i>Real</i>	6.02	-1.73	-3.70	3.96	12.01
M2Y, <i>Nominal</i>	3.50	22.01	71.03	16.65	-9.68
M2Y, <i>Real</i>	-7.16	11.87	21.98	12.64	10.10
Rate of Return on GDIs	11.10	-6.70	-11.94	0.98	1.17
Interest Rate on 1-Year Time Deposits	14.14	11.15	-9.90	-10.68	-19.82
Exchange Rate	-5.61	-7.22	-3.21	-0.12	12.48

Table 5. Public Sector Balances (Real 1987 Prices, Billions TL) (1)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997 ²
<i>Tax Revenues</i>	10313.8	11818.9	13855.2	13965.6	15145.1	17452.2	15597.0	15830.0	17095.1	20349.8
<i>Direct</i>	3983.1	5120.1	5879.7	6013.8	6359.6	7115.8	6820.7	6061.9	6195.1	7276.9
<i>Indirect</i>	6330.7	6698.8	7975.5	7951.8	8785.5	10336.4	8776.4	9768.1	10900.0	13072.9
<i>Factor Revenues</i>	4612.5	3987.4	2805.2	531.3	-70.4	729.2	1732.1	3122.4	4372.9	4375.8
<i>Current Transfers</i>	-6077.6	-6230.8	-5892.8	-5272.4	-5947.8	-9201.7	-9504.5	-10167.4	-12946.5	12424.6
<i>Public Disposable Income</i>	9866.1	10587.0	12095.6	10196.4	9966.8	9498.1	8083.3	8779.7	7600.3	10275.1
<i>Public Savings</i>	4970.8	3801.4	3084.7	613.1	-718.0	-2660.6	-925.0	-69.0	-1815.9	-1816.4
<i>Public Investment</i>	-6147.9	-5938.0	-7762.3	-6516.7	-5926.4	-7224.9	-3071.7	-3553.3	-5086.8	-6472.1
<i>Public Sav-Inv Balance</i>	-1177.2	-2136.6	-4677.6	-5903.6	-6644.4	-9885.5	-3996.7	-3622.3	-6902.7	-8288.5
Ratios to GNP (%)										
<i>PSBR</i>	4.8	5.3	7.4	10.2	10.6	12.1	7.9	5.2	8.8	7.6
<i>Budget Balance</i>	-3.1	-3.3	-3.1	-5.3	-4.3	-6.7	-3.9	-4.0	-8.3	-9.0
<i>Budget</i>	0.8	0.3	0.5	-1.5	-0.6	-0.9	3.8	3.4	1.7	-1.1
<i>Borrowing</i>	2.1	0.8	0.9	0.4	1.6	1.4	-1.7	-1.1	-1.2	0.3
<i>Stock of GDI's (3)</i>	5.7	6.3	7.0	8.1	11.7	12.8	14.0	14.6	18.8	21.8
<i>Interest Payments on:</i>	3.8	3.6	3.5	3.8	3.7	5.8	7.7	7.5	10.2	8.8
<i>Domestic Debt</i>	2.4	2.2	2.4	2.7	2.8	4.6	6.0	6.2	9.0	7.7
<i>Foreign Debt</i>	1.4	1.4	1.1	1.1	0.9	1.2	1.7	1.3	1.2	1.1
<i>New Domestic Borrowing / Domestic Debt Stock (%)</i>	60.2	57.5	52.3	67.0	94.4	105.3	128.9	129.4	163.5	99.1

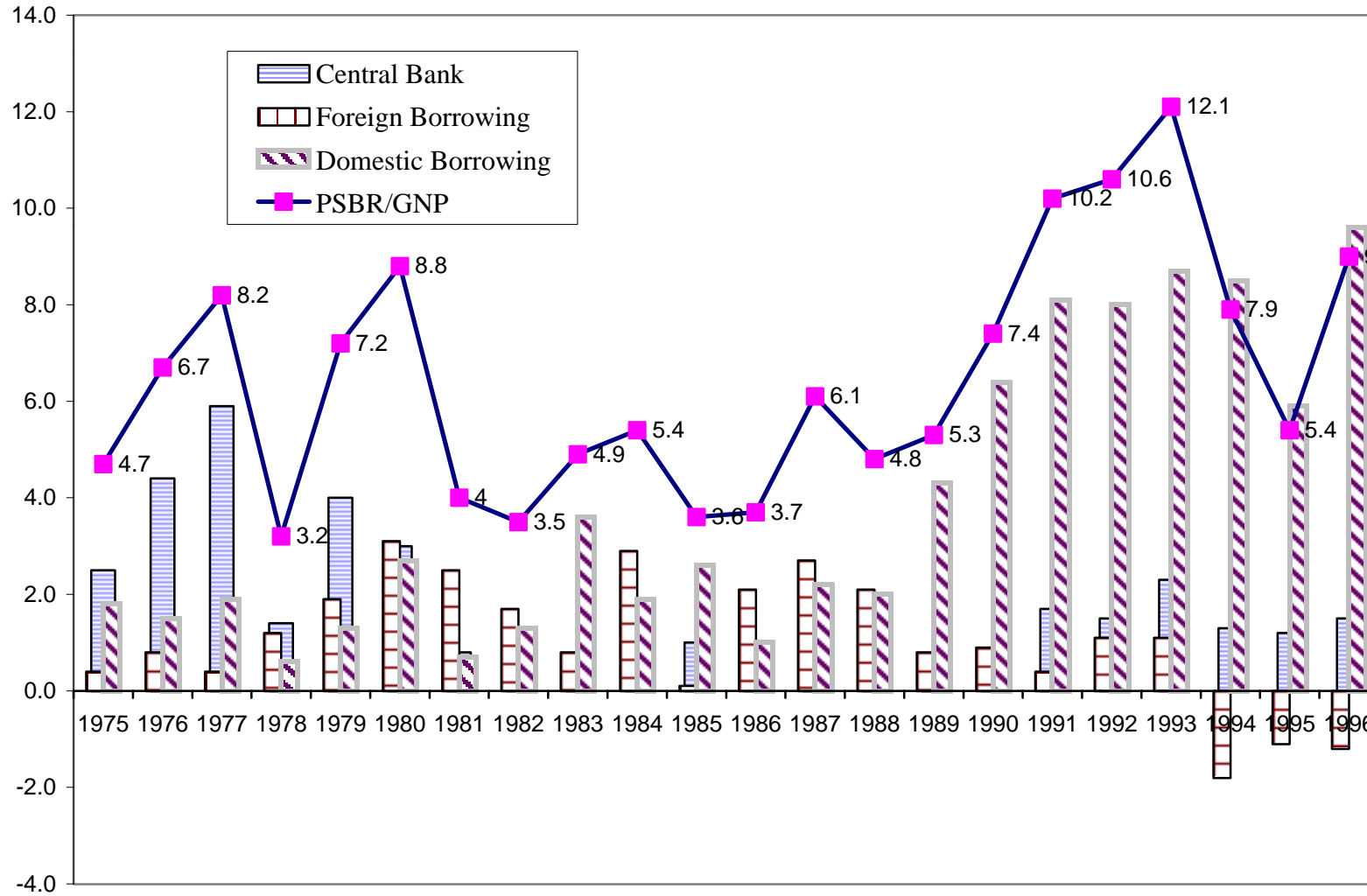
Sources: SPO Main Economic Indicators; Treasury Monthly Statistics

(1) Deflated by the Wholesale Price Index.

(2) Provisional

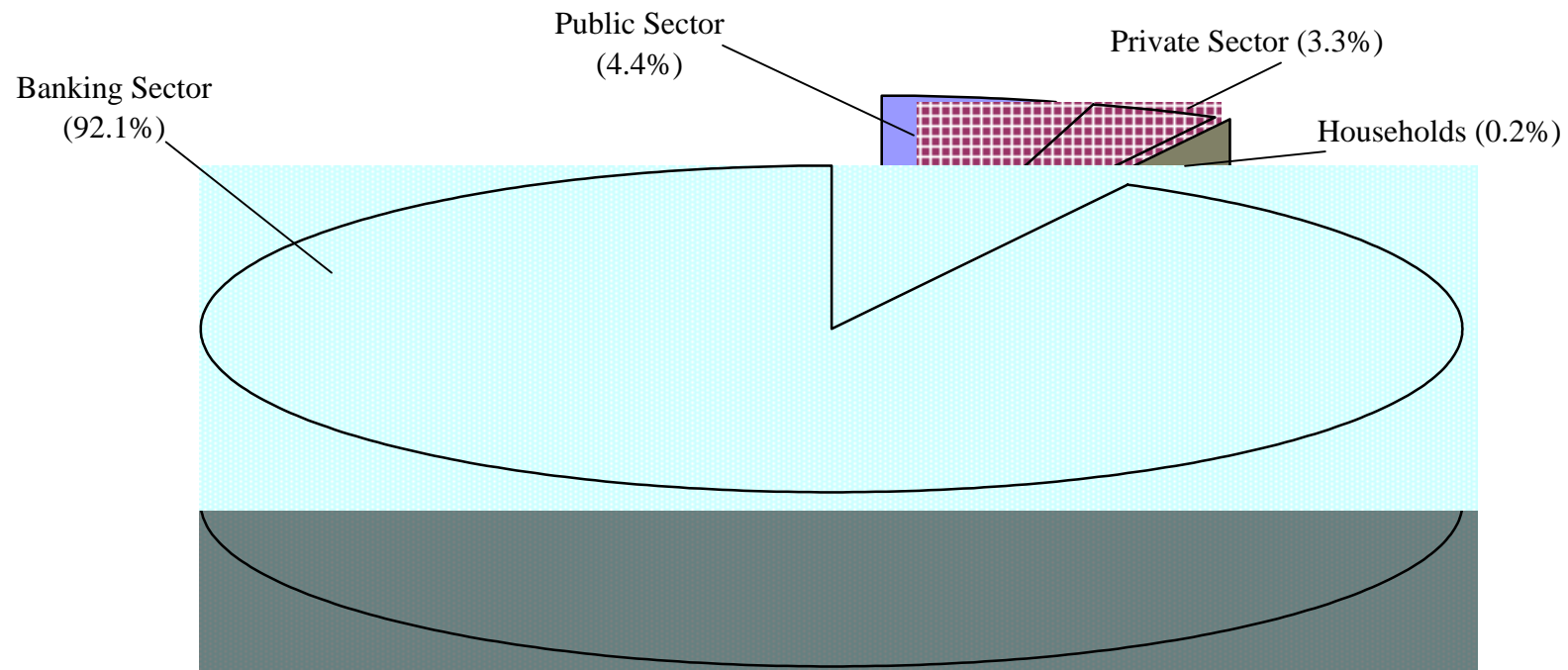
(3) Government Debt Instruments. Exclusive of Central Bank Advances and Consolidated Debts.

Figure 3. Sources of Financing of the PSBR (As % of GNP)



Source: SPO Main Economic Indicators

Figure 4. Distribution of Domestic Debt by Sectors (January-August 1997)



Source: Undersecretariat Of Foreign Trade and Treasury, Main Economic Indicators