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Turkey: Financial Crises in Context

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Summary

In December 1999, with International Monetary Fund support, Turkey launched a major economic reform program intended to cure chronic inflation. Its main elements were a crawling exchange rate peg, structural reforms, and privatization. Some progress was made in 2000, but implementation was uneven. A severe liquidity crisis in late November 2000 required a new IMF loan. On February 22, 2001, after a second crisis, Turkey abandoned the currency peg and, with it, the program. Analysts concur that stabilization, privatization, and banking reform are still needed, but Turkey's statist ideology and divided coalition government may continue to undermine the prospects for radical change in economic policy. Neither the government nor individual ministers have taken responsibility for the crises, yet there may be no alternative to the current government under present circumstances. The crises set back Turkey's hope to comply with economic criteria for EU membership. U.S. officials believe that the United States needs a stable Turkey for geopolitical reasons and, as a result, the U.S. supports continuing economic reforms. See also CRS Report RS20253, *Turkey: Continuity and Change after Elections*.

The Crises

Turkey's April 1999 national elections brought to power a three-party coalition government that launched an ambitious economic program with International Monetary Fund's (IMF) approval of a three-year \$4 billion standby-credit in December 1999. The program's main goal was to cut the country's chronically high inflation rate from about 65% at the end of 1999 to single digits by the end of 2002 and, thereby, enhance the prospects for economic growth and an improved standard of living (Turkey: Letter of Intent, [<http://www.imf.org/external/np/loi/1999/120999.htm>]). The main policy tool was a "crawling" exchange rate peg which allowed for nominal depreciation of the lira against the dollar and euro monthly according to a pre-announced schedule. The peg was intended to keep the lira from becoming overvalued, thus preventing pressure for a potentially destabilizing large devaluation, and to decrease inflationary expectations. To succeed, the program required the support of major structural reforms and accelerated privatization of state enterprises.

However, the government's implementation of the program was uneven, and reforms were undermined by other factors as well. The stability of the government, and by extension confidence in its economic program, was repeatedly questioned because of the philosophical incompatibility of the ruling coalition partners as well as an ongoing court case to ban the opposition Islamist Fazilet Party, the third largest party in parliament. If the party is banned and more than 100 deputies are expelled from parliament, early elections are likely. In addition, Turkey's arrangement with the IMF had a built-in exit strategy to shift to a more flexible exchange rate in July 2001, creating expectations that the crawling peg system would change. It was widely believed that there would be a devaluation before July because the lira was perceived as overvalued.

Problems multiplied. The government postponed privatizing Turk Telekom, the state telecommunications agency, after its initial offering of 20% ownership with no management rights drew no bids. The sale had been expected to generate at least \$2 billion in revenues to help offset an anticipated fiscal deficit of 11.3% of gross national product for 2000. At the same time, investigations into corruption revealed scandals in the banking and energy sectors. Investor and public confidence deteriorated. At the end of November 2000, the failure of a small bank sparked a major outflow of capital and a severe liquidity crisis. The IMF provided \$7.5 billion in new loans to replenish reserves on December 21, 2000.

The government admitted that it would not meet its inflation rate target of 25%, and projected inflation at 39% for 2000. Energy prices had risen, while lower nominal interest rates fueled consumer spending. By year's end, exports had grown by 6.4%, while imports soared by 34.7%, producing a very large current account deficit.¹ The current account deficit had grown from \$1.36 billion in 1999 to \$9.76 billion in 2000, or 5% of the gross national product compared to a program target of 1.8% of GNP. Meanwhile, as the government took over weak banks, it exacerbated the projected fiscal deficit. By the end of December, the fiscal deficit would increase to an estimated 12.6% of GNP.

On February 19, at a meeting of Turkey's National Security Council, President Ahmed Necdet Sezer proposed that the State Inspections Board look into the banking sector. Prime Minister Bulent Ecevit considered this an insult to his government's anti-corruption efforts, although investigations have not snared allegedly corrupt ministers who many believe have been protected partly by the need to hold the coalition together.² After an unseemly confrontation, Ecevit left the meeting and declared to a waiting press that there was a "serious crisis." He was assumed to be questioning his government's stability. Investors panicked and capital took flight from lira to dollars. Interest rates soared briefly, making it difficult for banks to secure funds and remain solvent, and the stock market plunged. On February 22, 2001, the government abandoned the crawling peg and let the lira float, causing a 24% devaluation as of March 2. By February 23, hard currency reserves had fallen by \$5.4 billion, or from \$27.9 billion to \$22.5 billion. The economic reform program was apparently dead.

¹ The current account measures the balance of trade in goods, services, and other transfers funded by external dollar borrowing.

² Bulent Aliriza, Turkey's Crisis: Corruption at the Core, *CSIS Turkey Update*, March 5, 2001.

Ideological and Political Context

The Turkish Republic founded in 1923, adopted statism as a fundamental principle, giving the state the central role in directing the economy. Liberalization of the economy began only in the late 1980s and, by 1999, still had not reached critical sectors of the economy or changed the people's expectations of their government. State ownership of enterprises persisted despite inefficient performance because they employed thousands. They also drained the treasury. A social security system with inordinately low retirement ages further contributed to the fiscal deficit. For many years, growth in the money supply and high interest rate bonds financed the deficits, producing chronically high inflation.

The government formed in 1999 included two parties, the Democratic Socialist Party (DSP) and the Nationalist Action Party (MHP), which are ideologically committed to the central role of the state in the economy. The leftist DSP believes in a strong state to serve the people, while the xenophobic, rightist MHP advocates state, not foreign, ownership of resources. The Motherland Party (ANAP), the third partner, generally favors a market economy. Although some DSP and MHP ministers publicly supported the economic reform program, they delayed or obstructed implementation. They were abetted by ideological purists, public sector labor unions, opposition parties, or others outside of the government who filed lawsuits or demonstrated against reform initiatives. Court action succeeded in part because the 1982 Constitution and many laws mandate or protect statism.

Turkish opponents, and even advocates, of economic reform commonly referred to it as the "IMF Program" or denigrated the IMF desk officer for Turkey, an Italian national, as if this somehow influenced the terms of the program. This line of attack made the program appear as a foreign imposition, prompting concerns about national sovereignty and making the program an easy target for nationalist media and politicians. Prime Minister Ecevit and others have blamed the IMF for the program's failure. Others point out, however, that the most controversial, and arguably the weakest, element of the program, the crawling peg, had been a Turkish idea used despite IMF skepticism about its efficacy.³

Key Issues

Privatization. After the failure of its 20% offering, the government announced in January 2001 that it would sell 33.5% of Turk Telekom with management rights and requested bids by May 14. Critics contended that the government would not grant substantive management rights to minority shareholders. They also observed that the government had waited too long to enhance the offering, and did so during a glut in the international telecommunications market. In February, the government admitted that it had no bidders and that the May 14 deadline would slide. The terms of the offer may have to be improved for a sale to go forward. This will require new authorization legislation, which requires time to pass. Parliament has passed a law to allow privatization of electric power production and distribution, although investors may want to see detailed regulations before bidding. Officers of the state power company were arrested for taking kickbacks

³ Paul Blustein, Turkish Crisis Weakens Case for Intervention, *The Washington Post*, March 2, 2001.

for contracts in a major recent scandal. Privatization of 51% of Turkish Airlines (THY) also is in the offing. THY owns prime routes and other lucrative assets that would be attractive to investors, but foreigners will only be allowed to purchase 24%, which may lessen their interest.

Banking. Some Turkish banks reputedly profited by borrowing foreign currency at low interest rates, changing it into lira, and lending to the government at higher rates. Bad or corrupt bank management appeared common, according to many reports. As the government's anti-inflation program began to work, interest rates on lira dropped and the weaknesses of some banks' operations were exposed. State banks in particular are the major vulnerability of the banking sector. Four state banks control a third to a half of all bank assets, employ 65,000 people, and have thousands of branches.⁴ They lost an estimated \$20 billion in 2000, partly due to their state-imposed obligations to support assigned sectors of the economy, such as agriculture, real estate, and small businesses. Two state banks defaulted on obligations to domestic banks on February 20.

Most analysts agree that restructuring banks to get rid of insolvent ones must be the highest priority in a new economic reform program. Some members of the government, however, reportedly oppose privatization of state banks. This may be because privatization would require truthful audits and disclose misdeeds, but it also reflects traditional statist ideology as well as loyalty to key constituencies that the banks serve. The government supports the banking sector by providing unlimited guarantees on deposits, creating large liabilities. A semi-independent Banking Regulation and Inspection Board created in 2000 has taken over 12 banks. In mid-November, it had been allowed to draw \$6.1 billion from the treasury to assume the insurance burdens of banks taken over. Complete restructuring of the banking sector will be far more costly.

Outlook

Economy. On March 2, 2001, Prime Minister Ecevit appointed World Bank Vice President Kemal Dervis, a Turkish national who has since resigned from the Bank, to be State Minister in charge of the Treasury, with responsibility as well for the Banking Board, the Central Bank, the Capital Market Council, two state banks, and the Turkish Development Bank. All of these agencies are DSP portfolios. MHP and ANAP, which are responsible for the privatization program, the State Planning Organization, other state banks, and foreign trade, reportedly refused to surrender these responsibilities to Dervis. Dervis' lack of complete control over the economy may detrimentally affect his ability to coordinate policy changes and make reforms rapidly. Nonetheless, he is a respected international banker and his appointment is generating confidence in domestic and international markets.

The financial crises have produced higher unemployment (20%), thousands of small business failures, and price hikes on basic commodities. The devaluation greatly diminished the value of lira assets, impoverishing those who have few or no dollars. The coalition members had gambled their political futures on the benefits to the people that would follow what they assumed was the short-term pain of the now failed economic program. They are already looking for ways to deal with social pressures which may

⁴ Elif Kaban, Skeletons in state bank cupboards rattle Turkey, Reuters, February 28, 2001.

require new spending. Moreover, in the midst of the turmoil, the Constitutional Court voided some articles of a social security reform that had changed retirement eligibility from 25 years of work with no age limit to 58 years of age for women and 60 for men. The Court said that the law could apply only to individuals who began work after the law was passed in 1999. Therefore, a large drain on the budget may continue for some time.

With the abandonment of the crawling peg, the government may have to adopt a more orthodox macroeconomic stabilization program -- one focused on inflation targeting through tighter monetary policy, fiscal restraint, structural reform, and privatization of state enterprises. It will likely be even more painful than the failed program, and face the same political obstacles. The details of a new program will determine how much assistance international financial institutions will be willing to provide.

Government. The government has not accepted responsibility for the crisis. Since February 20, no ministers have resigned, although the head of the Central Bank and the Undersecretary of the Treasury, who were public advocates of the currency peg, and the head of the Banking Board have stepped down. The cabinet rode out the crisis intact apparently because the governing parties could not agree on which ministers to sacrifice. Prime Minister Ecevit, who is 75-years-old and physically frail, refuses to leave. His DSP holds a party congress in April. It might provide an opportunity for him to give way to a successor in a setting that is more palatable than the immediate aftermath of the failure of his government's economic reform program. Given the make-up of parliament, there is no real alternative to the current government. The two opposition parties have uneven records. The True Path Party is led by former Prime Minister Tansu Ciller, who had been criticized for inept handling of a 1994 financial crisis, her reputation for alleged corruption, and her role in bringing Islamists to power in 1996. The Islamist Fazilet Party (FP) faces a possible ban and is splintering. If a ban leads to the expulsion of over 100 FP deputies from parliament, it may trigger new elections. A party not now represented in parliament, the Republican People's Party (CHP), might enter parliament or government after an election. Led by Deniz Baykal, it has its own factional problems. After an election, most, if not all, parties will have the same leaders.

Many Turks have recognized that economic progress may only be possible with radical political changes that would produce a different governing establishment endowed with the political will to carry out needed economic reforms. On March 4, President Sezer voiced this thought, declaring that greater democratization through Constitutional amendment, and new political parties' and election laws are essential. He emphasized the need to intensify the fight against corruption. The President noted that these and other measures could produce a state governed by the rule of law and worthy of the confidence of the people.⁵ Polls indicate that Sezer has the overwhelming support of the people, but apparently not of the entrenched party leaders whose power would be diluted by such reform measures. Thus, fulfilling Sezer's goals is not on the government's legislative agenda.

European Union Membership. Turkey's candidacy for European Union membership was affirmed in December 1999. Turkey does not currently meet EU criteria for membership. However, successful completion of the economic program would at least

⁵ Details Sezer Holiday Message, Ankara Anatolia, March 4, 2001.

have assisted Turkey in meeting the economic criteria, including adoption of a functioning market economy with the capacity to cope with competitive pressures and market forces within the Union. The program's failure is a serious setback for Turkey's EU hopes.

Implications for the United States

U.S. government officials generally agree that the United States needs a stable Turkey. U.S. and British overflights to enforce a no-fly zone over northern Iraq (Operation Northern Watch) stage from Turkey's Incirlik Air Base. The Turkish parliament has extended the mandate for Operation Northern Watch repeatedly for over ten years. Turkey also has been key to the enforcement of international sanctions against neighboring Iraq despite some violations. During the Kosovo conflict, Turkish and U.S. planes flew side-by-side and Turkey temporarily hosted thousands of Kosovar Albanian refugees. Turkish troops participate in NATO peacekeeping in Bosnia and Kosovo. Turkey supports U.S. policy to stabilize southeast Europe. With U.S. encouragement, Turkey and Greece are developing a rapprochement that could abate historic tensions between these two NATO allies. Turkey is a linchpin of U.S. policy seeking to ensure the independence of Caucasian and Central Asian countries through energy pipelines and transport routes that bypass Russia and Iran. Turkey has developed strong ties with Israel, and has served as an intermediary between Israel and the Palestinian Authority.

Because of Turkey's geopolitical importance, therefore, political considerations may supersede the debate over the weaknesses of the IMF's approach to financial crises and the value of large bail-outs. Treasury Secretary Paul O'Neill, a critic of crisis intervention, has backed "the IMF's ongoing support for Turkey's economic reform program." On February 23, 2001, President Bush spoke to Prime Minister Ecevit, urging continued economic reforms. On February 27, President Bush sent a letter to President Sezer, reportedly pledging continued support for Turkey's program of political and economic modernization.⁶ At the same time, the U.S. Ambassador to Turkey and his staff have actively consulted Prime Minister Ecevit, Deputy Prime Minister Ozkan, and Turkey's Acting Treasury Undersecretary. It is uncertain, however, what the Administration's position will be when Turkey, as anticipated, requests substantial new assistance from the IMF.

The Turkish crisis has limited economic implications for the United States. No U.S. bank holds more than 1% of its assets in Turkey, and investment funds reportedly reduced their Turkish holdings after the November crisis. Bilateral trade totals \$7 billion and some U.S. companies may feel a profit pinch. So far, however, Proctor and Gamble is the only large corporation to show a decline in earnings projections for the second half of 2001 due to the Turkish situation. Turkey is P&G's twelfth largest market.

⁶ Bush says US backs Turkish reform - Turkish officials, Reuters, March 1, 2001.

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