

## SHORT-TERM CAPITAL INFLOWS AND THEIR IMPACT ON MACROECONOMIC STRUCTURE: TURKEY IN THE 1990s

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### INTRODUCTION

**D**URING the period of 1963–77, governments in Turkey adopted import-substitution industrialization strategies (ISI),<sup>1</sup> with high protection rates for consumer goods and an overvalued rate of exchange. Under ISI, public enterprises reduced their involvement in the production of consumer goods, allowing private capital to develop in that sector, and concentrated in the production of intermediate goods. In spite of the high investment and growth rate during this period, absolute protection encouraged the creation of an industry that operated without any consideration for quality and cost.

The overvaluation of domestic currency penalized exports while prices of imported capital goods remained low. The result was a high current account deficit coupled with a high dependence on imported technology. However, this situation proved to be unsustainable; from 1975, foreign currency reserves dropped drastically, leading the Turkish economy into a dead-end. The economic crisis of 1978–79 was the most severe that the country had experienced until then.

Adjustment policies that were put into effect in 1980 aimed at liberalizing this crisis-prone economy. As such, this was an attempt for a radical reorientation of the Turkish economic structure. The steps taken in 1980 were mainly concerned with the problem of the foreign exchange bottleneck and aimed to maintain an external balance. To promote exports, high real depreciation of the Turkish lira (TL), negative real wages and direct support to exports were implemented (Önis 1993). Until 1988, the increase in the exports/imports ratio (Table I, line 1) was hailed as the successful outcome of these policies. However, an important point was overlooked: the sizable increase in exports until 1988 was not caused by new investments, but rather by the increase in the capacity utilization rates (Yentürk 1992).

The year 1989 marked a transition to a liberal capital accounts regime in Turkey. The liberation of capital transaction in August 1989, going even beyond those in the developed countries, lifted restrictions on capital movements and on foreign borrowing by residents.

<sup>1</sup> See Appendix for a chronology of the economic policies and political parties in Turkey.

TABLE  
TURKEY: MAIN ECO-

	1980	1981	1982	1983	1984	1985	1986
1. Exports/Imports	38.73	54.90	69.15	66.39	71.52	73.51	71.11
2. Consumer goods imports/ Total imports	2.10	2.00	2.1	2.60	4.40	8.00	8.60
3. Interest payments/GNP	1.69	2.03	2.25	2.53	2.43	2.16	2.39
4. Primary deficit/GNP	-3.37	-0.69	0.78	-0.65	0.00	0.66	0.44
5. Current account deficit/GNP	-5.06	-2.72	-1.47	-3.18	-2.42	-1.51	-1.95
6. Capital account/GNP	1.00	1.26	0.43	1.46	0.12	1.58	2.83
7. Direct investment/GNP	0.03	0.13	0.09	0.08	0.19	0.15	0.17
8. Portfolio investment/GNP	0.00	0.00	0.00	0.00	0.00	0.00	0.19
9. Short-term capital inflow/GNP	0.00	0.17	0.15	1.32	-1.10	2.20	1.08
10. International reserves (U.S.\$ million net)	1,209	1,658	1,979	2,093	3,482	3,279	4,347
11. Foreign exchange deposits/M2Y <sup>a</sup>							13.36
12. M2Y <sup>b</sup> (U.S.\$ million)							18,149
13. Credit growth/Deposit growth		0.73	0.40	1.02	0.46	0.72	1.68
14. PSBR <sup>c</sup> /GNP	8.77	3.98	3.52	4.95	5.39	3.58	3.65
15. Budget deficit/GNP	-3.13	-1.55	-1.48	-2.25	-4.42	-2.26	-2.75
16. Interest payments/GNP	0.60	0.93	0.82	1.51	1.99	1.91	2.60
17. Wage payments/GNP	6.60	5.05	5.21	4.82	4.17	3.61	3.59
18. Primary deficit/GNP	-2.53	-0.61	-0.66	-0.73	-2.43	-0.35	-0.15
19. Domestic debt stock/GNP					3.90	4.30	4.60
20. Treasury bill stock/ Total domestic debt stock					7.34	7.03	7.83
21. Domestic borrowing/ Total borrowing					34.50	71.00	27.90
22. Foreign debt stock/GNP	24.09	23.96	27.29	30.40	34.80	37.87	42.77
23. Private tradable investment/IPR <sup>d</sup>	37.9	45.50	45.40	45.40	44.1	40.80	38.60
24. Relative prices of tradables	113.13	111.75	110.32	109.49	110.67	108.77	105.05
25. GNP growth rate	-2.8	4.81	3.09	4.21	7.11	4.30	6.76
26. Devaluation rate	150.81	43.27	45.72	40.18	62.05	40.74	29.75
27. Real exchange rate <sup>e</sup>			97.44	92.53	87.62	89.1	80.09
28. Inflation rate (CPI)	115.59	33.91	21.91	31.39	48.4	45	34.6
29. Interest rate <sup>f</sup>					45	55	48
30. Treasury bill rate					43.7	50.2	53.6
31. Return on hot money <sup>g</sup>					-5.9	12.8	20.7

Sources: Turkey, Prime Ministry, State Planning Organization, *Main Economic Indicators, Turkey, Statistical Bulletin*, various issues.

<sup>a</sup> M2Y = M2 plus domestic foreign exchange deposits.

<sup>b</sup> M2Y\$ = M2Y/Nominal exchange rate (Nominal exchange rate: Annual average of buying and selling)

<sup>c</sup> PSBR is public sector borrowing requirement.

<sup>d</sup> IPR is total private investment.

<sup>e</sup> Real exchange rate = for 1982-86, U.S.\$0.5 + DM 0.5; after 1987, U.S.\$0.75 + DM 0.25, an increase

<sup>f</sup> Interest rate = Interest rates on saving deposits, one year.

<sup>g</sup> Return on hot money =  $(1 + i)/(1 + e) - 1$ ;  $i$  = highest interest rate of the period,  $e$  = devaluation rate.

## I

## NOMIC INDICATORS

									(%)
1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
76.17	87.03	73.63	57.69	65.06	64.51	52.43	80.09	61.49	53.76
8.20	7.80	8.70	12.90	13.70	13.00	14.00	12.00	12.00	15.60
2.32	2.72	2.07	1.56	1.68	1.40	1.31	2.36	1.61	1.41
1.39	4.52	2.96	-0.18	1.85	0.80	-2.53	4.40	0.27	-0.95
-0.93	1.79	0.80	-1.74	0.17	-0.60	-3.84	2.05	-1.34	-2.36
2.19	-1.08	0.72	2.68	-1.61	2.32	5.03	-3.26	2.66	5.22
0.12	0.40	0.62	0.46	0.53	0.49	0.35	0.43	0.44	0.33
0.33	1.32	1.47	0.36	0.44	1.53	2.20	0.90	0.14	0.31
0.06	-2.56	-0.49	1.99	-2.03	0.89	1.71	-3.99	2.13	3.71
5,212	6,428	9,283	11,387	12,150	15,252	17,761	16,514	23,923	27,735
21.91	23.85	19.12	21.40	29.09	37.10	47.09	49.82	49.64	49.29
21,383	21,688	26,803	33,173	36,672	40,643	45,175	39,823	52,840	68,829
1.59	0.71	0.70	1.46	1.21	1.39	2.03	0.61	1.07	
6.08	4.82	5.33	7.38	10.34	10.56	11.71	8.08	5.33	9.40
-3.46	-2.99	-3.26	-3.01	-5.28	-4.30	-6.63	-3.91	-3.96	-8.05
3.02	3.85	3.59	3.52	3.79	3.65	5.83	7.67	7.21	9.90
3.06	3.91	5.44	6.66	7.77	8.52	8.49	7.02	6.30	6.44
-0.44	0.87	0.33	0.51	-1.49	-0.65	-0.80	3.76	3.25	1.70
5.80	5.70	6.30	6.10	6.80	10.50	12.80	13.90	14.60	18.40
11.17	8.93	8.43	9.88	18.70	21.75	18.05	38.06	46.38	48.52
35.40	40.90	81.00	87.00	79.80	71.00	77.90	78.10		
46.79	45.74	38.78	32.56	33.97	35.30	37.82	51.01	41.94	42.79
32.10	26.90	24.10	30.90	29.60	28.20	27.70	27.50	30.40	31.10
100.00	61.89	98.55	93.64	87.67	83.55	76.10	85.24	83.00	80.79
9.81	1.45	1.63	9.37	0.34	6.42	8.14	-6.09	7.95	7.94
27.33	67.12	47.49	23.23	61.87	64.17	60.03	169.56	51.19	77.52
78.76	77.32	84.34	100.17	98.44	94.58	93.64	75.94	87.28	86.78
38.8	73.7	63.3	60.3	66	70.1	66.1	106.26	93.63	80.4
	83.9	58.8	59.4	72.7	74.2	74.8	95.56	92.32	95
48.1	64.3	58.8	52.9	79.5	86.5	87.6	164.4	121.8	135.2
16.2	-7.9	25.0	28.9	10.9	15.7	17.2	-2.1	46.8	32.4

1995; The Central Bank of the Republic of Turkey, *Quarterly Bulletin*, various issues; idem, *Monthly*

rates).

means appreciation.

A year later, in 1990, international capital flows started to change course away from developed countries and toward developing countries.<sup>2</sup> In fact, the capital account surplus (including net errors and omissions) for all developing countries increased from U.S.\$48.7 billion in 1987 to a record level of U.S.\$162.9 billion in 1993 before easing down to U.S.\$142.2 billion in 1994 (Corbo and Hernandez 1996).

With the exception of 1991 (the year of the Gulf crisis) and 1994 (the year of the financial crisis), between 1990 and 1996, Turkey suffered from an excess of speculative capital inflows. As in most Latin American countries, the new inflows into Turkey of the 1990 took the forms of portfolio investment and short-term inflows. The capital account surplus which was U.S.\$1.9 billion in 1987 jumped to U.S.\$8.9 billion in 1993. In the year of the financial crisis (1994) the capital account deficit was U.S.\$4 billion. After the crisis, inflows continued to surge and the capital account surplus reached U.S.\$4.6 billion in 1995. In 1996 it jumped to U.S.\$9.7 billion signaling a new financial crisis. Yeldan (1996) calculated that between 1991 and 1995 average gross inflows of speculative hot money exceeded the real production of total agriculture and industry in Turkey.<sup>3</sup>

Section I provides a literature survey of the macroeconomic effects of capital inflows. Sections II and III show that, after the liberalization of capital transactions, the surge in speculative inflows increased the magnitude of current account and public deficit, and coupled with the mishandling and mismanagement of the capital inflows, a new crisis hit Turkey in 1994. Section IV highlights the fact that Turkey is an interesting case from the point of post-crisis management, since most of the pre-crisis imbalance continue to exist during the post-crisis period strongly indicating a financial crisis in the near future.

## I. MACROECONOMIC EFFECTS OF CAPITAL INFLOWS

### A. *Effects on Current and Capital Account*

A surge of capital inflows takes the form of a deficit in the current account of the balance of payments. It is known that a net increase in the capital account of the balance of payments is used to finance the current account if there is no reserve

<sup>2</sup> The main reasons for this change were the falling interest rates and continuing recession in developed countries, and higher interest rates in developing countries (Calvo, Leiderman, and Reinhart 1993). Another approach which explained capital inflows toward developing countries highlighted the autonomy of the capital flows (Akyüz 1993a, 1993b) which created a large arbitrage margin regardless of the initial level of interest and exchange rates by raising the former and appreciating the latter.

<sup>3</sup> In Yeldan (1996), hot money is calculated as the flows of Portfolio investments + Foreign exchange deposits of non-residents + Foreign exchange credit brought by the banking system + Net errors and omissions.

accumulation or capital flight. In other words, an increase in the capital inflows worsen the current account deficit since the availability of currency allows the financing of the deficit and encourages exchange rate appreciation (Ffrench-Davis, Titelman, and Uthoff 1994). Appreciation of the real exchange rate damages international competitiveness and the trade balance, and increases the dependency on imports (Calvo 1994).

### B. *Effects on Aggregate Demand*

A surge in capital inflows has a decreasing effect on domestic savings by increasing current consumption and current account deficit. A considerable part of domestic savings is used to finance transfers abroad due to the increased burden of external interest payments which grows together with the excessive external debt. On the other hand, foreign savings are mostly used to finance domestic consumption and imports of consumer goods (Frenkel, Fanelli, and Rozenwurcel 1993; Agosin and Tussie 1994; Yentürk 1996).

Another important factor which puts upward pressure on the aggregate demand is the higher growth rates of private bank credit stocks than that of deposits. High credit stocks arise primarily from the private capital inflows since resident banks<sup>4</sup> are often involved as intermediaries between international capital markets and domestic borrowers (Akyüz 1993b). Excessive capital inflows are the factor lying behind high growth rates of lending to the private sector, indicating a weakness in bank balance sheets. Moreover, empirical links between lending booms and financial crises are found to be very strong (Sachs, Tornell, and Velasco 1996).

### C. *Effects on Investment*

Capital flows toward developing countries are motivated primarily by speculative activities of rentiers rather than by real investments. Since speculative activities are oriented to short-term gains, there has been no narrowing difference in the rates of return on investment between countries and between high domestic interest rates and low foreign interest rates (Akyüz 1993a; UNCTAD 1992; Vos 1993). Moreover, in developing countries, higher interest rates affected by speculative capital inflows discourage real investment decisions and reduce the ability of governments to achieve national objectives by using the interest rate as an instrument for investment decisions. This is known as a loss of policy autonomy (Akyüz 1993b; Akyüz and Held 1993; Banuri and Schor 1992).

An appreciation of the real exchange rate also creates an enlargement of aggregate demand. This leads to a rise in the production of non-tradable goods since an increase in the demand for non-tradable goods can only be satisfied by domestic production. By contrast, an increase in demand for tradable goods can be satisfied

<sup>4</sup> Resident banks are domestic + foreign banks in Turkey.

by imports. Taking into consideration that an appreciation of the real exchange rate also creates a change in relative prices in favor of non-tradable sectors, it can be concluded that an upward trend in the investments of non-tradable sectors and an excessive growth of the service sectors can occur in countries receiving large capital inflows (Corbo and De Melo 1987; Jourmard and Reisen 1992; Uygur 1994). Making a welfare-enhancing transfer from non-tradable to tradable sectors turns out to be necessary in order to compensate for the situation which discourages exports (Calvo 1994).

#### *D. Effects on the Public Account*

An increase in the external debt by large financial bubbles of a speculative nature, given that much of the external debt is held by the public sector, raises the burden of interest payments, resulting in a sharp growth of public expenditure (Frenkel, Fanelli, and Rozenwurcel 1993; Williamson 1990). This, in turn, causes a big jump in interest rates and creates a vicious circle continuously pushing up the public deficit even in countries where a primary budget balance exists (Calvo, Leiderman, and Reinhart 1993; UNCTAD 1992). The outcome is a drop in public savings and a rise in external debt which regenerate a rise in interests rates (Vos 1993).

To avoid the destabilizing macroeconomic consequences induced by a higher deficit, a primary fiscal surplus becomes necessary. This is followed by a fall in public investment or a reduction in non-interest expenditures (Calvo 1994; Cho and Khatkhate 1989). Consequently, in capital receiving countries a domestic transfer problem emerges when difficulties of tax raising from fiscal revenues is taken into consideration (Frenkel, Fanelli, and Rozenwurcel 1993; Taylor 1990, 1991).

Besides the above mentioned detrimental macroeconomic effects, capital inflows into developing countries tend to raise interest rates and appreciate exchange rate (Kuczynski 1992). This trend leads to a vicious circle by displaying a continuous need for capital inflows in order to carry on interest payment and an appreciation of the real exchange rate.

#### *E. Effects on the Monetary Aggregates*

Liberalization of foreign currency transactions among residents coupled with high speculative capital inflows encourage residents to hold foreign exchange deposits with banks at home, increasing the importance of foreign currency in the economy (Akyüz 1994). Furthermore, the effect of high speculative capital inflows on inflation will be different in relation to monetary policies pursued by governments.

There are two monetary policy options vis-à-vis speculative capital inflows: intervention and non-intervention. If the Central Bank of Turkey pursues a non-intervention policy, there will be no increase in its foreign assets. Capital inflows

will be fully directed to finance a net growth of imports, and will apply upward pressure for an appreciation. Thus, one of the responses to speculative capital inflows is to intervene and accumulate reserves to prevent them from financing the deficit of the current account. In this case, the accumulation of reserves influences the economy's degree of liquidity through an increase in money supply and puts upward pressure on inflation.

If the decision is to intervene, there are two propositions to consider. The first proposition advocates that sterilized intervention is sufficient to prevent an increase in the money supply (Fischer and Reisen 1992, 1993; Reisen and Fischer 1993; Reisen 1993). The second view maintains that the sterilization alternative is not free from problems, hence, a direct tax on short-term capital inflows may be highly effective (Akyüz 1993b; Calvo, Leiderman, and Reinhart 1993; Ffrench-Davis, Titelman, and Uthoff 1994; Zahler 1992).

*Sterilized intervention.* When the government decides to intervene in order to slow down the appreciation of the real exchange rate, the central bank accumulates international reserves which in turn has repercussions on the monetary market. The monetary effect of the accumulation of reserves is the increase in money supply. Sterilized intervention is an active policy which aims at insulating the money supply. Usually the central bank issues paper or certificates in order to recall them and to prevent them from being reflected in higher inflation.

*Tax on capital flows.* This was initially proposed by Tobin in the 1970s in order to squeeze the profitability of short-term speculative activities which make up 80 per cent of global financial transactions (Felix 1995). This type of measure was undertaken by Chile along with the sterilized intervention (Zahler 1992). A tax vis-à-vis short-term capital inflows, which originate from deregulation of international markets, is necessary for developing countries that have suffered from international volatility more than developed countries. This will help them to reduce the arbitrage margin, and to discourage inflows of speculative capitals that does not contribute to long-term productive investments.

According to the approach advocating a tax on short-term capital inflows, sterilization is not free of problems (Ffrench-Davis, Titelman, and Uthoff 1994; Calvo 1994). The main problem with the sterilized intervention is that open market sterilization of capital inflows may contribute to a larger deficit due to the spread between domestic and international markets. In this case, sterilization may be a source of quasi-fiscal deficit since the central bank is placing paper in the domestic market at higher interest rates than it collects in the international markets. In other words, the cost of reserves becomes higher than its revenue and the higher the capital inflows the higher the difference between the revenue and the cost of reserves. The central bank should, therefore, issue paper to sterilize money supply on the one hand and to finance the deficit arising from the difference between cost and revenue of reserves on the other.

Furthermore, large inflows during speculative bubbles raise the interest rates of paper and create a larger spread between domestic and international interest rates since the increase in the monetary base and the deficit of the current account accentuate the expectation of devaluation and inflation, and therefore, put upward pressure on interest rates providing additional incentives for short-term capital inflows (Corvo and Hernandez 1996; Calvo 1994; Ffrench-Davis, Titelman, and Uthoff 1994). As explained in Sachs, Tornell, and Velasco (1996), broad money increases due to the accumulation of reserves represent the potential amount of liquid assets that agents can convert into foreign currency. When interest rates become too high and currency devaluation is expected, the central bank is forced to sell foreign exchange reserves, at least until these reserves run out and the domestic currency is devaluated.

Another problem resulting from sterilization is that in the case of large capital inflows, paper issued by the central bank may be insufficient and treasury paper may be utilized to absorb the liquidity. However, when absorbed funds are being used for public expenditures, they in turn increase the liquidity of the economy and push up inflation.

## II. STYLIZED FACTS OF THE TURKISH ECONOMY, 1980–96

Up to the foreign exchange crisis of 1978–79, the Turkish economy maintained import substitution industrialization policies. After two years of economic crisis, the government announced on January 24, 1980 the first steps of its economic liberalization policies aimed at export-led growth. Then in August 1989, restrictions on capital movements and on foreign borrowings were abolished. The result was a transition to an extremely liberal capital accounts regime, even more liberal than that of developed countries, which went as far as encouraging black money operations.

In this section, stylized facts of the Turkish economy before and after the financial crisis will be examined in order to determine the effects of the high speculative inflows on different aspects of the economy.

### A. *Effects on Current and Capital Account*

Table I (line 8–9) shows that a jump in short-term capital inflows took place in 1990. A jump in portfolio investment occurred in 1992. Short-term capital inflows were negatively affected by the Gulf crisis of 1991 and by the financial crisis of 1994. In 1995–96, just after the second crisis, short-term capital was again encouraged to flow in. The short-term capital inflows-GNP ratio jumped to 2.1 in 1995 and 3.7 in 1996 which has been the record level in the post-financial liberalization period. The appreciation of real exchange rate (line 27), and fall of international competitiveness have been major outcomes of the excessive inflow of capital. The



extremely high current account deficit in 1993 and the diminishing export/import ratio can be seen from Table I (line 1–5). The current account was positive in 1994 due to the 169 per cent devaluation rate (line 26), but again became highly negative in 1995–96 (line 5).

Export performance is highly dependent on the exchange rate and wages in Turkey. The reason is that “export-led industrialization” policy which has been pursued in Turkey since 1980, has not been a complete success since the increase of exports was not related to new capital formation and improvement in the productive capacity of industry between 1980 and 1988. Thus, one can only speak of an “increase of export” which is mostly linked with a shift of industrial capacity toward international markets via a significant contraction of wages and real devaluation (Kepenek and Yentürk 1996; Yentürk 1992). In fact, as can be seen from Table I (line 23), the share of private investment in tradable sectors (such as agriculture, industry, and mining) out of total private investment has a decreasing trend in contrast with export-led industrialization policies.<sup>5</sup>

#### B. *Effects on Aggregate Demand*

Three main indicators can be taken into consideration when analyzing the effect of the high speculative inflows on domestic consumption trends:<sup>6</sup> the growth of credit stock, the index of the real exchange rate and the share of imports of consumer goods.

As will be analyzed below, under the effect of the monetary aggregates, the main characteristic of the banking sector in Turkey after 1989 has been the poor supervision of the monetary authorities allowing banks a big mismatch of maturity between their assets and liabilities. The resulting problem has been an increase in bank credit to the private sector which has been higher than the increase in their total deposits. As seen in Table I (line 13), the coefficient of growth in credit stocks to the growth in deposits from 1990 to 1994 is over 1. Turkey’s large increase in credit stock is a case of a lending boom. Furthermore, credit expansion has taken the form of consumer credit and has encouraged private consumption spending.

High speculative capital inflows increase domestic consumption through appreciation of the real exchange rate. Table I (line 27) shows that the index of real exchange rate has a declining trend after 1990, meaning an appreciation in the exchange rate. Table I (line 2) shows also the perilous rise in the share of imports of consumption goods indicating an increase of the aggregate demand. In fact, the share of imports of consumer goods which was 2.1 per cent in 1980 rose to 8.7 per cent in 1989 and is 15.6 per cent in 1996.

<sup>5</sup> See Yentürk (1998) and Boratav, Türel, and Yentürk (1996) for the causes of the falling rates in the investment of tradable sectors.

<sup>6</sup> See Ulengin and Yenturk (1999); for the impact of capital flows on aggregate spending categories.

### C. *Effects on Investment*

Since 1980 the instability in GNP growth rate has been the main indicator of instability in the real sector. Almost every period of accelerated growth has been followed by a period of stagnant growth (line 25). This instability is an indication that structural transformation is still problematic. The real sector and investments stand out as the main weakness of the economy.

As mentioned in Section I, higher interest rates affected by speculative capital inflows discourage real investment decisions in developing countries, and appreciation of the real exchange rate also creates a change in relative prices in favor of non-tradable sectors. In order to see the effect of high interest rates and appreciation of the exchange rate on investment of real sectors, we will analyze the trend marked by private sector tradable investment<sup>7</sup> in total private investment.

As seen in Table I, private investment in the tradable sectors in Turkey has been in decline since 1980, shifting more toward non-tradable sectors (line 23) along with the shift in non-tradable prices (line 24). Furthermore, high financial gains encouraged the real sector to invest in speculative activities. For example, an examination of the aggregated balance sheet of the 500 largest industrial firms shows that financial revenues make up the biggest part of total revenues for the last five years (ISO 1996).

However, profits projections and investment decisions in export-oriented industries have been on the decline compared to inward-oriented industries (Yentürk 1998). This outcome is the reverse of the expected results from politics implemented since the 1980s which aimed at integration with the world market.

### D. *Effects on Public Account*

In Turkey, the public sector borrowing requirement (PSBR) represented around 5 per cent of the GNP before 1990. It peaked at 10 per cent between 1990 and the crisis of 1994. The share of public budget deficit to GNP was around 3 per cent before 1990. It went up to 7 per cent in 1993 (line 14, 15). The fall in the PSBR and narrowing of the budget deficit during 1994–95 arose mainly from the repression of wages (line 17). In 1996 the enlargement of both the PSBR and the budget deficit are worth considering.

Interest payment to GNP showed an upward trend after 1990; it continued to increase after the 1994 crisis (line 16) and began to take up the largest part of public expenditure while current and investment expenditures lessened (Yentürk 1995). The main reason was the emergence of deficit financing by borrowing which, in turn, increased the deficit (Boratav, Türel, and Yeldan 1995; Önder et al. 1993). Thus, the primary surplus before 1990 was transformed into a primary

<sup>7</sup> Private sector tradable investment includes private investment in agriculture, in manufacturing, and in mining

deficit between 1990 and 1994 (line 18). In 1994–95 interest payments were double those in 1990, and in 1996 they were triple.

Together with financial liberalization which took place after 1989 in Turkey, the structure for financing the public deficit changed such that the share of domestic borrowing exceeded that of foreign borrowing in financing the public deficit. The share of domestic borrowing in financing the PSBR exceeded 80 per cent in 1989 and reached a record level of 87 per cent in 1990. In 1994 the share was still very high around 78 per cent (line 21). This fact shows that the public sector began to finance the deficit through domestic agents that increasingly borrowed from abroad. In other words, the direct borrowing of the public sector from abroad has been replaced by indirect borrowing from abroad via domestic agents (Altunkemer and Ekinçi 1992).<sup>8</sup>

The domestic debt stock-GNP ratio was 6.3 in 1989 and rose to 13.9 in 1994. In 1996 it reached 18.4 (line 19). The domestic debt stock ratio was high enough to put pressure on the ratio of interest rates and treasury bill rates (line 29–30). The maturity of financing shows a short-term characteristic similar to the increase in the short-term capital inflows after 1989. Treasury bill stock having maturity between one to nine months covers the biggest part of the total domestic debt stock (line 20).

The impact of financial liberalization on the public sector was a systematic increase in the public deficit,<sup>9</sup> domestic debt and in short-term domestic borrowing requirements. These caused a move toward high interest rates, enough to create an arbitrage margin both for domestic and external agents (line 31). In 1994 the negative return on hot money created a short-term capital outflow. In 1995 and 1996 the return on hot money was again extremely high.<sup>10</sup>

#### E. *Effects on Monetary Aggregates*

The part of the capital inflow which is not used to finance the current account deficit is accumulated as international reserves. As seen in Table I (line 10), a substantial portion of the surge in capital inflow has been channeled into the accumulation of foreign exchange reserves. The central bank has accumulated about U.S.\$125 million over the last seven year (1990–96). Even after the financial cri-

<sup>8</sup> The substitution of the decrease in public sector direct foreign borrowing by an increase in private sector foreign borrowing can also be seen from OECD (1995) and TCMB (1995).

<sup>9</sup> Yentürk (1995) where a Granger causality test was applied to the net foreign assets and budget deficit figures (seasonally adjusted with both of the variables stationary and integration of order zero) in order to analyze the relationship between the surge in capital inflows and the budget deficit, and its direction. The results showed a strong causal relationship between net foreign assets and budget deficit in Turkey for a five-month lagged structure (OLS) and for the period of January 1990–August 1995.

<sup>10</sup> See also Boratav, Turel, and Yeldan (1995) and Sak (1995) showing that the Turkish rate of return on hot money was higher than that on the international rate for the period after financial liberalization.

sis of 1994, international reserves kept growing. The upward trend of international reserves in Turkey is worth considering since the resulting problem is the enlargement of monetary aggregates.

One of the main problems the Turkish economy has faced since 1989 has been the pressure that capital inflows have exerted on monetary aggregates. This can be observed in Table I (line 11 and 12) which shows the growing trend in the share of foreign exchange deposits in broad money and in broad money itself. In fact, one of the main reasons for the central bank's inability to realize a monetary program after 1990 has been the uncontrolled increase in foreign assets and the existence of currency substitution (Ekinçi 1991). High currency substitution shows a decreased confidence in the domestic currency and is the primary cause of high real interest rates. The ratio of M2Y (currency and demand and saving deposits) to reserves is a broad measure of liquid monetary assets that can be converted into foreign exchange. This ratio is high in Turkey showing that an igniting factor can create a self-fulfilling panic among bank depositors (Calvo, Leiderman, and Reinhart 1996; Sachs, Tornell, and Velasco 1996). During the period between capital account liberalization and the 1994 financial crisis, Turkey's M2Y was three times bigger than its level of international reserves. This ratio is 5 in Mexico, 3 in Brazil, and 1.5 in Chile (Calvo 1996). The ratio in Turkey is high enough to show that reserves are in the danger zone.<sup>11</sup>

A serious imbalance in the private banking sector also needs to be mentioned. After 1990 the poor supervision by the monetary authorities has resulted in a serious mismatch in the maturity between assets and liabilities. Short sale transactions have become the rule rather than the exception. As a result, since the 1994 devaluation some private banks have been declared bankrupt. Because of short positions, credit stock has increased much more rapidly than deposits (Table I, line 13). This has spurred domestic demand and inward-oriented growth, and is an indicator of a lending boom and a vulnerable banking sector.

### III. THE CRISIS OF 1994: CAUSES AND LESSONS

As previously stated, the first point to note is that a surge in capital inflows played an important role in the worsening of the macroeconomic conditions both for the current account and public deficit, in appreciating real exchange rate and increasing the interest rates, and in enlarging the money supply and credit stock. These factors lie behind the instability that generated a crisis of such magnitude.

The second and key point is the government's role during the 1994 financial crisis. In fact, the mishandling of the capital inflows and the mismanagement of the

<sup>11</sup> Sachs, Tornell, and Velasco (1996) which compares the reserve adequacy (M2/international reserves) of twenty developing countries and found that Turkey was in the danger zone for 1990-94.

crisis increased the magnitude of the instability existing in the Turkish economy since the beginning of 1990.

The third point is that between 1995 and 1996, a number fundamentals were not corrected, and some of these immediately returned to their unsatisfactory pre-crisis conditions. This brings up the following question: Will Turkey have another financial crisis?

#### A. *Dealing with Capital Inflows*

As mentioned in Section I, one of the main policy options vis-à-vis speculative capital inflows is the sterilization of the liquidity by the central bank. However, the policy pursued in Turkey has not offset the liquidity. Since 1989, the massive capital inflows have been used as a source for public expenditures by issuing short-term domestic debt instead of being sterilized by the central bank. Furthermore, the fact that the Central Bank of Turkey is not independent of political authority, and that it does not possess paper to intervene in the money market have been structural problems contributing to the enlargement of the monetary base relative to the increase in capital inflow (Gökçe 1994; Gültekin 1994). Moreover, Turkey did not implemented any tax on short-term capital inflows during 1990–94 either to limit temporary speculative bubbles or to lengthen the maturity of the flows.

Indeed, Turkey has not pursued the necessary policy intervention for sterilization and the taxation of short-term capital inflows as used by some Latin American countries which experienced external debt crises after 1980 due to a high inflow of speculative capital. As will be analyzed below, the main reason was the Turkish government's political decision to increase its popularity vis-à-vis all social categories.

The use of short-term capital inflows as a source for public expenditures helped the government to increase its current and interest expenditures without carrying out any tax reform in order to raise revenues. In fact, while interest revenues were exempted from taxation and corporate income taxes were trending downward between 1989 and 1993 (Kepenek and Yentürk 1996), an augmentation of current expenditure and personnel expenditure was realized after 1989 (Table I, line 17).

Wage erosion between 1980 and 1989 was so profound that a "correction" was inevitable after 1989, mostly for sociopolitical reasons which were revealed just before the 1989 elections. The wage explosion in the private sector was achieved through the reduction of input costs. Since input costs are the main determinant of profits in Turkey, the wage explosion did not decrease the profitability. In the manufacturing sector between 1980 and 1989, when the share of input cost out of value added increased, the share of wages dropped and the mark-up rates remained approximately constant. After 1989 the mark-up rate of the manufacturing sector increased since the wage explosion was highly compensated by a decline in the input cost. In sub-sectors with an upward trend in the mark-up rate, there was an

inverse relation between wages and input cost. In other words, there was a trade-off between wages and input cost (Yenturk 1995).<sup>12</sup>

The major input cost in manufacturing industries is real exchange rates. Therefore, the existing trade-off is between wages and real exchange rates. One can roughly say that before 1980 and after 1989 the trade-off was between overvalued exchange rates and higher wages, and during the period of 1980–89 the trade-off was between devaluation and lower wages. During the period of financial liberalization, high capital inflows were the only possibility to lower the cost of currency.

Consequently, the surge of capital inflows into Turkey has had differing impacts on the internal division of the surplus. One impact has been the increasing share of finance and the profits of the banking sector in GDP with the contribution of the dramatic rise of interest revenue and the fall of financial taxes. Another impact has been the increasing mark-up rates and profitability of manufacturing sectors with the help of real exchange rate appreciation which has offset the wage explosion through a fall in input costs.

In short, during the financial liberalization period, Turkish governments mismanaged capital inflows not only because they employed non-interventionist policies but also because they sought to increase their popularity through income transfers to all social categories.<sup>13</sup> In other words, they pursued financial policies that have not been sustainable in the middle term.

#### B. *The Management of the Crisis*

A short-term analysis of the 1994 crisis needs to take into consideration the mismanagement of the government. In 1993 the share of interest payments in GNP was around 6 per cent, and political authorities began to state openly that one of the most important short-term economic policy aims was to lower nominal interest rates. The two main reactions to this policy were external and internal.

*The external reaction.* The credit rating agencies Standard and Poor's and Moody's were involved in this reaction. In January 1994, Moody's reduced Turkey's credit rating from Baa3 to Ba1, signifying a shift from "quality investment" to "speculative investment." Shortly thereafter Standard and Poor's reduced Turkey's credit rating from "BBB" to "BBB–" which also implied a negative evaluation concerning investment prospects (Önis 1996). Both of these downgradings provided negative signals to investors resulting in a loss of confidence that created an outflow of short-term capital.

*The internal reaction.* The internal reaction was an increasing demand for for-

<sup>12</sup> Other research which shows growing mark-up rate in conjunction with financial liberalization in Turkey is Boratav, Türel, and Yeldan (1994). For a discussion of the issue in its international context, see Boratav, Türel, and Yentürk (1996).

<sup>13</sup> Önis (1996) emphasized the effect of the political sphere which he described as a weak coalition based on a populist platform.

eign currency. When the political authorities made the decision to lower interest rates, the Treasury relied on the central bank, since the budget deficit was very high (Özatay 1996). Heavy injections of liquidity into the economy and lowered interest rates increased the demand for foreign currency. Expectations of devaluation were also running very high because of the appreciation of the Turkish lira and the high current account deficit.

By the end of 1993, the political authorities were expecting to limit the demand for foreign currency firstly by selling international reserves, and secondly by orienting speculative capital toward the Istanbul Stock Exchange Market (ISEM). Neither of these expectations was realized for two fundamental reasons:

- (1) Big banks learned from government officials that there was to be a high devaluation in the immediate future. This was a major policy error that encouraged big banks to buy all the foreign currency sold by the central bank. The weak coalition had no power to stop the flow of information from the government to the big banks. Moreover, the weak coalition was not able to coordinate officials of the central bank and the Treasury. For example, the Treasury stopped giving government paper to the central bank<sup>14</sup> in order to prevent the central bank from increasing interest rates. Consequently, the central bank was not able to conduct open market operations during the first quarter of the 1994.
- (2) The trading volume on the ISEM was very limited compared to the inflow of speculative capital. In 1993 the aggregate volume of trading on the ISEM reached U.S.\$52 billion while gross speculative capital inflows reached approximately U.S.\$150 billion. Speculative capital inflows, given their size and volatility, led to artificial bubbles in the ISEM that ended up inflating stock prices. The bubble in the ISEM started to inflate in March 1993, then in the first quarter of 1994, the ISEM composite index fell 50 per cent in dollar terms (Yeldan 1996).

In January 1994 the exchange rate was around 19,000 TL/U.S.\$ . The central bank's international reserves were U.S.\$7 billion, which after heavy intervention in order to satisfy the demand for foreign currency, fell to U.S.\$3 billion in April 1994. Despite the heavy intervention, a high devaluation was inevitable and the exchange rate fell to 38,000 TL/U.S.\$ in April 1994.

On April 5, 1994, the Turkish government announced a new stabilization package which was based on sharp expenditure cuts and the introduction of a wealth tax in order to correct the economy's fundamentals. To limit the rush to foreign currencies and to fund domestic short-term government debt, the Treasury was compelled in May 1994 to offer 400 per cent annual interest rates.

The attempt to decrease interest rates without correcting the fundamentals

<sup>14</sup> The Treasury has to give government paper to the central bank to cover the exchange rate losses of the bank which stem from the Treasury's foreign exchange accounts (Özatay 1996).

caused a jump in the interest rates. There was also the effect of the local elections in March 1994 which increased the populist pattern of policies. The consequences of the crisis were very severe: triple digit inflation, a contraction of output, an erosion in real wages, and an increase in unemployment.

#### IV. AFTER-CRISIS MANAGEMENT: TOWARD ANOTHER CRISIS?

The analysis of the period after May 1994 shows that the effects of the April 5 stabilization package were temporary and limited to the balance of payments, to the international reserves and real exchange rate, to the monetary aggregates, and to public expenditures and interest rates.

The stabilization package did not contain any radical policy reforms for dealing with short-term speculative capital inflows. Turkey still continued to offer high return on short-term inflows in 1995 and 1996. As will be shown below, soon after 1994 the economy once again was confronted with the problems of domestic currency appreciation, extremely high interest rates, a rapid rise in the trade deficit and the threat of dollarization.

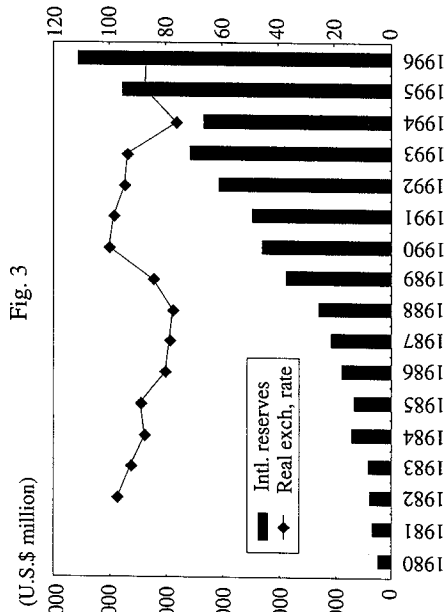
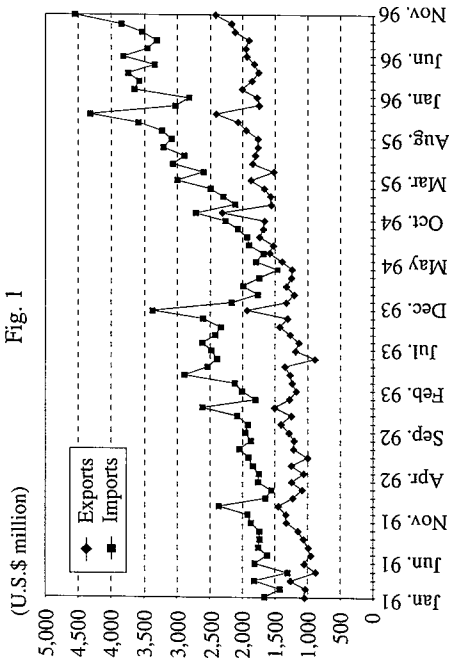
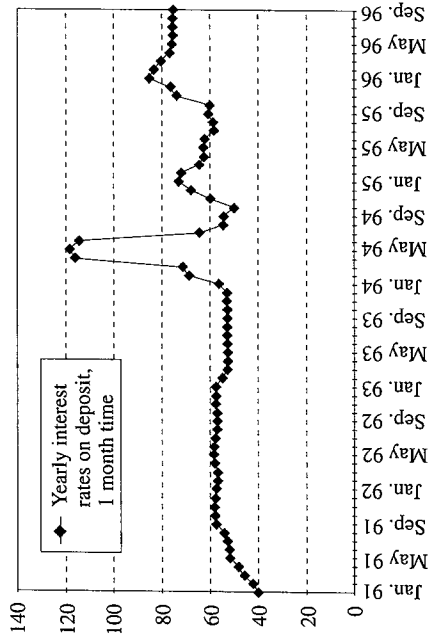
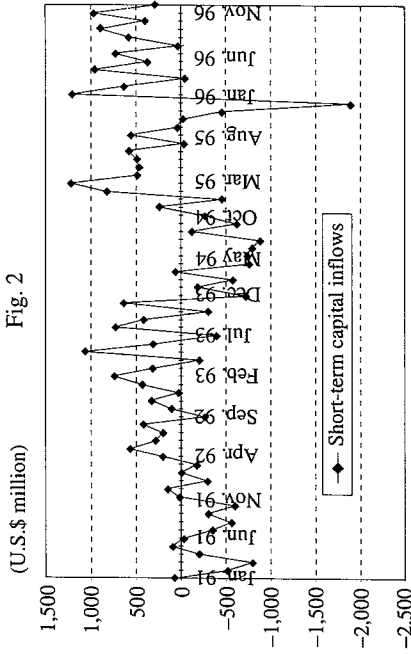
The April 5 stabilization package relied upon expenditure cuts and an additional wealth tax to decrease the budget deficit. These brought a temporary surge in revenues during 1995. However, the stabilization package was far from being a long lasting structural tax reform. The analysis below will show that this was the main cause for having a high budget deficit again in the second half of 1996.

Figure 1 presents the evolution of the trade deficit before and after the 1994 financial crisis. While the trade deficit was high due to the upward trend in imports during 1993, in 1994 the real devaluation of the Turkish lira increased export performance and slowed down imports. However, the situation was reversed in the following years and the trade deficit reached a record level in 1996. The main reason was that the April 5 stabilization package did not contain any policy reforms for dealing with short-term speculative capital inflows and for preventing the appreciation of the Turkish lira.

In fact, Figure 2 shows that short-term capital inflows in 1995–96 exceeded the inflows of the pre-crisis period, resulting in the appreciation of the exchange rate on the one hand and a surge in the international reserves on the other. The appreciation of exchange rate and accumulation of international reserves after the financial crisis can be seen in Figure 3.

Even after the crisis, the government was not able to limit inflows and guard against speculative bubbles. This was due to the lack of the necessary precautions in the stabilization package needed to generate long term and sustainable revenues. The government was obliged to rely on short-term capital inflows in order to pay for short-term debt services. Turkey continued to offer high rates of return on speculative inflows due to the appreciated exchange rate (Figure 3) coupled with high





Sources: Turkey, Prime Ministry, State Planning Organization, *Main Economic Indicators, Turkey, 1995*; The Central Bank of the Republic of Turkey, *Quarterly Bulletin*, various issues; idem, *Monthly Statistical Bulletin*, various issues.

interest rates (Figure 4) during 1995 and 1996. The vicious circle created by the payment of short-term debt services with new debt continued to be the main problem of the economy.

Figure 4 shows the government's attempt to decrease interest rates in the second half of 1993, and the necessity of a radical increase in the second half of 1994 to stem the crisis. After the crisis, interest rates were kept at a higher level than before the crisis. But as in the pre-crisis period, during the second half of 1996, the government repeated its attempt to reduce interest rates without correcting the budget deficit.

The April 5 stabilization package put into effect an additional wealth tax in 1995. The result was a temporary surge in revenues during 1995. However, the weak coalition government was not able to enact the necessary tax reforms, mainly because of the reaction of the financial and industrial sectors. Figure 5 shows the decreasing trend of the budget deficit during 1995 as well as the growing budget deficit after August 1996 as was the case before the crisis.

Figure 6 shows that the share of interest payment as a part of budget expenditure was approximately 50 per cent during the second half of 1996. Since interest payments took up an unprecedented share of total budget expenditures, the portion for wages and public investment fell rapidly during 1995 and 1996. The package gave rise to a significant shift in income distribution and intensified a redistribution away from wage earners and toward financial rentiers and largest industrial firms that shifted their operations from industrial to financial activities.

An analysis of the cyclical trend of wages in Turkey shows an increase once every January. But wages increased twice in 1993: once in January and again in March. This fact proves again the populist policies before the crisis. The main losers in the crisis and the populist policies were the wage earners. The continuous decrease in the share of wages can be seen in Figure 6.

The high degree of currency substitution up to April 1994 calmed down during 1995. But 1996 again experienced a dollarization of the economy (Figure 7). The increasing importance of foreign exchange in the economy restricted the central bank's ability to pursue necessary monetary policy in 1996, and the central bank again lost control over the exchange rate which practically became an exogenous variable. The exchange rate became closely linked with the real economy and current account as had been the case before the crisis.

Another interesting event that occurred before the crisis and recurred after it was the expansion of credit. Figure 8 shows that in 1993 the credit stock of deposit money banks was higher than their total deposits due largely to their open position. After the crisis, trends reversed back to normal with deposits being higher than credits. In the second half of 1996, the stock of credit was again considerably higher than deposits indicating a lending boom (Figure 8).

Fig. 6

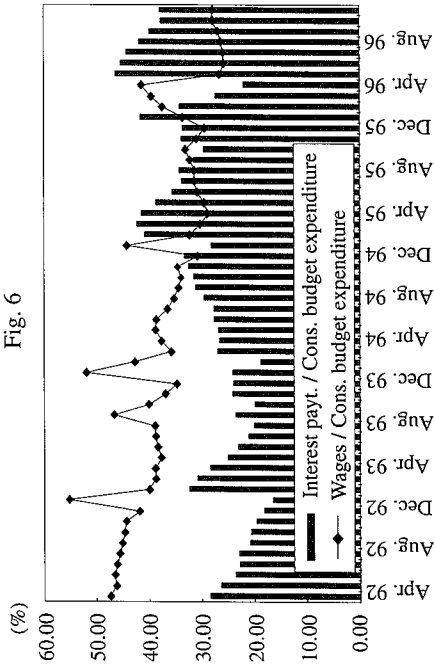


Fig. 5

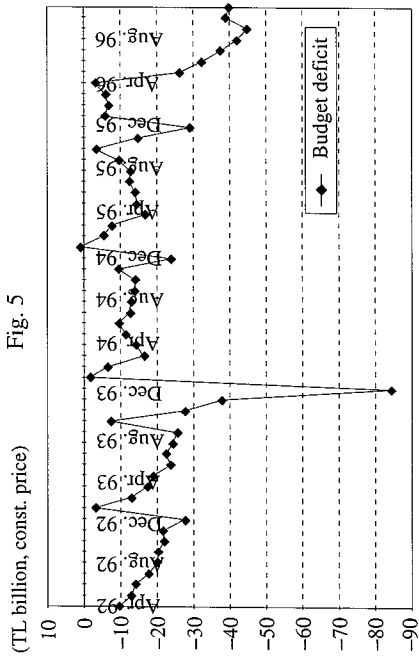


Fig. 8

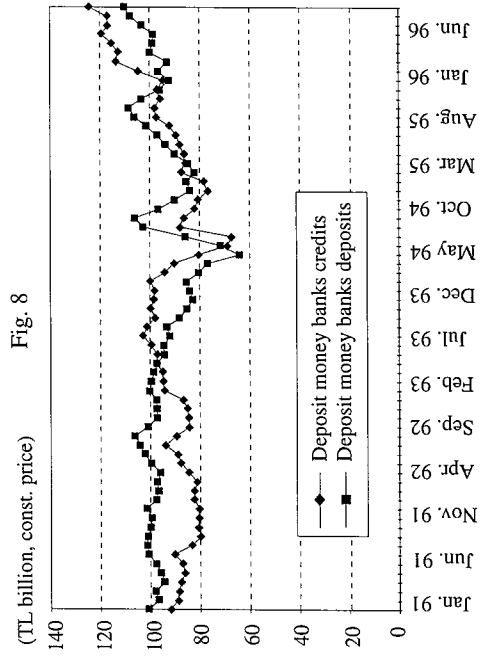
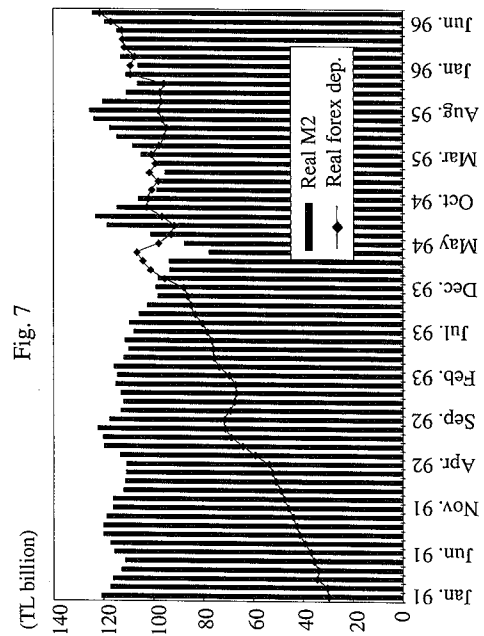


Fig. 7



Sources: Turkey, Prime Ministry, State Planning Organization, *Main Economic Indicators, Turkey, 1995*; The Central Bank of the Republic of Turkey, *Quarterly Bulletin*, various issues; idem, *Monthly Statistical Bulletin*, various issues.

## CONCLUSIONS

A surge in speculative capital inflows after financial liberalization played an important role in aggravating the macroeconomic conditions of Turkey's current account and public deficit, and in the appreciation of the real exchange rate, the increase in interest rates, and in the growth of the money supply and stock of credit. Along with these, the government's mishandling of the inflow of hot money and the mismanagement of the crisis played a crucial part in the financial crisis of 1994.

Turkey presents a very interesting case in the mishandling of capital inflows not only because of the government's non-interventionist policy but also because of its attempt to increase popularity by creating transfers to all social categories. The distinguishing feature of the Turkish case is that the public sector used the growing liquidity provided by speculative inflows to finance public expenditures. Meanwhile rentiers took maximum advantage of the high interest rates on treasury bonds, and large industrial firms maintained high non-operational profits through rentier-type activities. Moreover, the exemption of interest revenues from taxation and the decline in corporate income tax benefited financial and large industrial groups. Labor, in turn, benefited from high wages both in the public and private sector. The appreciation of the exchange rate was another factor benefiting industry as it lowered the input cost of imports and compensated for rising wage in industry.

Regarding the mismanagement of the crisis, the Turkish case shows that an attempt to decrease interest rates without correcting fundamentals will produce a jump in the interest rates and a drop in international reserves. An attempt to artificially lower interest rates brought on the external reaction of international institutions reducing the country's credit rating. The counterpart internal reaction was the rush to foreign currencies. The consequences were numerous: interest rates that were even higher than before, triple-digit devaluation and inflation, a contraction of output, an erosion in real wages, and an increase in unemployment.

A close analysis of the Turkish financial liberalization experience exposes the danger of excessive speculative capital inflows creating both current account and public account instabilities. The Turkish case also illustrates the dangers of populist policies in an environment of tightly integrated financial markets.

Evidence of the post-crisis period shows that Turkey continues to be highly dependent on capital inflows, but rather than being used to pay for growing current expenditures, they are being used to finance the country's growing interest payments and debt servicing. The panorama of the Turkish economy in the post-crisis period, especially after the second half of 1996, exhibits big macroeconomic instabilities with a high public deficit coupled with falling interest rates, a high current account deficit coupled with real appreciation of the Turkish lira, a high currency substitution, inadequate reserves, and a lending boom.

The central question is whether Turkey will have another financial crisis? The country's macroeconomic instability signals a future financial crisis particularly if policymakers move again toward populist policies. When trying to evaluate the possibility of moves toward populist policies, one needs to look at the political instability that has existed since the first half of 1996: a weak coalition of the Welfare Party (RP) and the True Path Party (DYP)<sup>15</sup> between June 1996 and June 1997 was followed by another weak coalition of the Motherland Party (ANAP), the Social Democratic Party (DSP), and the Democratic Turkey Party (DTP) which took office in June 1997 to prepare the country for new elections in 1998.<sup>16</sup> As in the case of most pre-election periods, the nature of existing politics may increase populist policies which may well ignite a new financial crisis.

<sup>15</sup> See Appendix.

<sup>16</sup> ANAP + DSP + DTP coalition lost power after a no-confidence vote on November 25, 1998.

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## APPENDIX

### *Chronology*

- 1963–77: Import substitution period.
- 1978–79: Period of crisis without adjustment.
- January 1980: Announcement of a package of stabilization and structural adjustment programs to deal with the economic crisis of 1978–79.
- September 1980: Military coup.
- 1980–83: Structural shift from import substitution to the outward orientation of the economy. Period of military rule.
- 1983: First general elections after the military coup. ANAP comes into office.
- 1987: General elections. ANAP wins the election (1987–91).
- 1983–91: Government of the ANAP.
- August 1989: ANAP's decision to lift restrictions on capital movements.
- 1991: General elections.
- 1991–95: Coalition government of the DYP + SHP.
- 1994: Financial crisis and April 5 stabilization package.
- 1995: General elections.
- 1996–97: Coalition government of the RP + DYP.
- 1997–98: Coalition government of the ANAP + DSP + DTP.

### *Leading Parties in Turkey*

1961–80 (military coup in 1971, military regime 1971–73)

- AP: Adalet Partisi (Justice Party), right of center, in power 1961–70 and 1975–80.
- CHP: Cumhuriyet Halk Partisi (Republican People's Party), left of center, in power 1973–75 (in coalition with MSP).



- MSP: Milli Selamet Partisi (National Salvation Party), Islamist party, in power 1973–75 (in coalition with CHP).
- 1980–86 (military coup in 1980, military regime 1980–83)
- ANAP: Anavatan Partisi (Motherland Party), right of center, in power 1983–91 and 1997–98 (in coalition with DSP and DTP).
- DYP: Doğru Yol Partisi (True Path Party), right of center, in power 1991–95 (in coalition with SHP), and 1996–97 (in coalition with RP).
- SHP: Sosyal Demokrat Halkçı Parti (Social Democratic Populist Party), left of center, in power 1991–95 (in coalition with DYP).
- RP: Refah Partisi (Welfare Party), Islamist party, in power 1996–97 (in coalition with DYP).
- DSP: Demokratik Sol Parti (Social Democratic Party), left of center, 1997–98 (in coalition with ANAP and DTP).
- DTP: Demokrat Türkiye Partisi (Democratic Turkey Party), right of center, 1997–98 (in coalition with DSP and ANAP).