OCCASIONAL PAPER 242

Turkey at the Crossroads

From Crisis Resolution to EU Accession

Prepared by a team led by Reza Moghadam

INTERNATIONAL MONETARY FUND
Washington DC
2005

OCCASIONAL PAPER 242

Turkey at the Crossroads

From Crisis Resolution to EU Accession

Prepared by a team led by Reza Moghadam

INTERNATIONAL MONETARY FUND
Washington DC
2005

Production: IMF Multimedia Services Division

Cataloging-in-Publication Data

Turkey at the crossroads : from crisis resolution to EU accession / prepared by a team led by Reza Moghadam—Washington, D.C. : International Monetary Fund, 2005
p. cm.—(Occasional paper) ; 242

Includes bibliographical references
ISBN 1-58906-386-4

1. Turkey—Economic conditions. 2. Turkey—Economic conditions—Statistics. 3. Inflation (Finance)—Turkey. 4. Debts, Public—Turkey. 5. Labor market—Turkey. I. Moghadam, Reza. II. Occasional paper (International Monetary Fund ; no. 242
HC492.T87 2005

Price: US$25
(US$22 to full-time faculty members
and students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel.: (202) 623-7430 Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: http://www.imf.org

recycled paper

Contents

Preface		**vii**
I	**Overview** *Mark Griffiths and Reza Moghadam*	**1**
II	**Economic Growth in Turkey, 1960–2000** *Ashoka Mody and Martin Schindler*	**3**
	Recent Growth and Volatility Trends	4
	Correlates of Growth	5
	Cross-Country Regression Analysis	9
	Sources of Policy Volatility	13
	Conclusions	15
III	**Turkey's Inflation Process** *Oya Celasun and Donal McGettigan*	**17**
	The Importance of Inflation Expectations	17
	What Determines Inflation Expectations?	19
	Conclusions and Challenges	20
IV	**Balance Sheet Developments Since the Crisis** *Christian Keller and Chris Lane*	**22**
	The Effect of Crisis and Recovery on External Assets and Liabilities	22
	Resolution of the Crisis and Recovery of Balance Sheets in Each Sector	24
	Main Links Between Sectoral Balance Sheets and Associated Risks	30
	Conclusions and Policy Implications	32
V	**How Much Debt Is Too Much?** *Christoph Klingen*	**33**
	Main Features of Turkey's Public Debt	33
	Deterministic Debt Sustainability Exercise	35
	Stochastic Debt Sustainability Exercise	35
	Fiscal Track Record Approach	36
	Empirical Debt Sustainability	36
	Fiscal Dominance of Monetary Policy	37
	Other Considerations	38
	Conclusions	38
VI	**Progress and Challenges in Public Debt Management** *Cheng Hoon Lim*	**39**
	Improved Debt Structure	41
	Challenges Ahead for Debt Management	42

VII Lessons from an Empirical Model of Fiscal Policy in Emerging Markets **43**
Xavier Debrun

Debt Sustainability and the Primary Surplus 43
The Empirical Model 43
Key Results 44
The Case of Turkey 46
Conclusions 48

VIII Sustainability of the Fiscal Adjustment **49**
Ernesto Ramirez Rigo

Fiscal Adjustments 49
Defining a "Successful" Adjustment Episode 50
Conclusions 53

IX Bank Restructuring and Financial Sector Reform **54**
Mats Josefsson and David Marston

Crisis Outbreak and Containment 54
Bank Restructuring Strategy 55
Outcome of the Bank Rehabilitation Program 58
Challenges Ahead 59
Lessons Learned 62

X Labor Market Developments **64**
Mathew Verghis

Labor Supply 64
Labor Demand 67
Labor Market Regulation 69

XI Conclusions **70**
Donal McGettigan and Reza Moghadam

References **72**

Boxes

9.1 Elements of the Bank Recapitalization Program 57
9.2 The Imar Commission Report 60
9.3 Priority Areas for Legal Reform 61

Tables

2.1 Real Per Capita GDP Growth, 1960–2000 5
2.2 Growth Accounting, 1961–2000 6
2.3 Summary Statistics, Selected Variables 7
2.4 Cross-Country Growth Difference Regressions 11
2.5 Additional Cross-Country Growth Difference Regressions 11
2.6 Decomposition of Turkey's 20-Year Growth Differential 12
2.7 Decomposition of Turkey's Decadal Growth Differentials 14
2.8 Cross-Country Difference Regressions with Assorted Dependent Variables 14
2.9 Cross-Country Fiscal Volatility Regressions 15
3.1 Determinants of Inflationary Expectations 20
4.1 Extent of Liability Dollarization in Turkey's Economy, end-2003 24
4.2 Foreign Currency Mismatch in the Banking Sector 25

4.3 Gross Government Debt (consolidated budget debt stock) 27
4.4 Currency and Interest Rate Composition of Central Government Debt 27
4.5 Foreign Currency Position of the Government Sector 28
4.6 Foreign Currency Position of the Real Sector (corporations and households) 28
4.7 Foreign Currency Position of the Corporate Sector 29
4.8 Selected Financial Ratios of the Corporate Sector 29
4.9 Selected Profitability Ratios of the Corporate Sector 30
4.10 Main Domestic Foreign Currency Assets and Liabilities of the Banking Sector, end-2003 31
5.1 Main Features of Turkey's Debt 34
6.1 Currency and Interest Composition of Domestic Central Government Debt 40
6.2 Maturity of Debt 41
6.3 Outstanding Total Debt of Central Government by Lender 41
7.1 Panel Estimates of the Fiscal Policy Equation 44
7.2 Alternative Measures of Feasible Primary Surpluses 46
8.1 Summary of Primary Surpluses 50
8.2 Central Government Operations and Composition of Adjustment 52
8.3 Estimate of Composition of Adjustment 53
9.1 Precrisis Vulnerabilities in the Banking System, December 2000 55
9.2 Operational Restructuring of Ziraat and Halk 55
9.3 Structure of the Banking System 56
9.4 Financial Indicators for Private Banks 57
9.5 Loans Restructured Under the Istanbul Approach, as of April 2004 58
9.6 Assets and Liabilities of Ziraat and Halk 59
10.1 International Competitiveness 65
10.2 Population Growth and Shares by Decade 66
10.3 Educational Attainment 67
10.4 Labor Force Participation and Employment in 2003 67
10.5 Output, Employment, and Productivity Growth 68

Figures

2.1 Real Per Capita GDP 5
2.2 Real Per Capita GDP Growth 5
2.3 Per Capita GDP Growth Volatility 5
2.4 External Trade 8
2.5 M2/GDP Ratio 8
2.6 Fiscal Discretionary Volatility 9
2.7 Inflation 9
2.8 External Debt 9
2.9 Partial Scatter Plots of the Growth Differential Against Differentials in Selected Variables 12
3.1 Inflation: The Long View 18
3.2 Recursive Coefficients of Equation (1) 18
3.3 Additional Recursive Coefficients of Equation (1) 19
3.4 Determinants of Inflationary Expectations: Recursive Coefficients 20
4.1 International Investment Position by Sector 23
4.2 Short-Term International Investment Position by Sector 23
4.3 Foreign Currency Share in Total Debt, end-2002 24
4.4 Deposits in the Banking Sector 25
4.5 Average Maturity of Deposits 26
4.6 Liquid Assets (including reserves) as a Share of Deposits 26
4.7 Government Securities as a Share of the Banking Sector's Total Loan and Security Portfolio 26

4.8 Operating and Net Profits of Corporations 30
4.9 Domestic Banking Sector's Claims on Public Sector Assets 31
7.1 Fixed Effects and Total Government Revenues 44
7.2 Revenue Ratios and Effective Tax Rates in Selected Emerging Market Economies 45
7.3 Successful Fiscal Adjustments in Emerging Market Economies 47
7.4 Probability Distribution of Fiscal Adjustment in Emerging Market Economies 47
8.1 Fiscal Policy Stance 51
9.1 Offshore Loans as a Share of Total Bank Assets 61
10.1 Adult Population, Labor Force, and Employment 65
10.2 Productivity and Real Wages in Private Manufacturing 66
10.3 Gross Fixed Private Investment 68

Preface

This Occasional Paper analyzes the transformation of Turkey's economic performance under its reform program supported by the International Monetary Fund, and sets out guideposts for the reform agenda that lies ahead. The paper was prepared by a team led by Reza Moghadam. The authors—Oya Celasun, Xavier Debrun, Mark Griffiths, Mats Josefsson, Christian Keller, Christoph Klingen, Chris Lane, Cheng Hoon Lim, David Marston, Donal McGettigan, Ashoka Mody, Ernesto Ramirez Rigo, Martin Schindler, and Mathew Verghis—include staff who have worked closely on the IMF program in Turkey, together with members of a number of the IMF's functional departments, in particular the Research Department, as well as World Bank staff.

The analysis is based on data available as of July 2004. However, more recent data do not alter the thrust of the analysis.

The authors would like to thank Michael Deppler, Susan Schadler, and Odd Per Brekk for their guidance and advice on these studies, and also for deepening our understanding of the economic issues facing Turkey more generally. We are also grateful to the Turkish authorities and to participants in seminars held in Ankara and Istanbul for discussions and comments, which have improved the papers. Chanpheng Dara provided excellent research assistance throughout, while Julie Burton, Connie Strayer, and Alimata Kini Kabore ably assisted in preparing the manuscript. The External Relations Department edited the manuscript and coordinated production of the publication.

I Overview

Mark Griffiths and Reza Moghadam

Almost five years after the 2000–01 economic crisis, the fortunes of the Turkish economy have been transformed. The economy has grown rapidly for three successive years, inflation has fallen from 70 percent at the end of 2001 to single digits, both nominal and real interest rates have dropped sharply, and the government debt ratio has fallen significantly, improving prospects for debt sustainability. Maintaining and advancing these gains will be the key policy challenge in the coming years. Against this backdrop, this Occasional Paper reviews policy performance in the key areas of growth, inflation, debt, fiscal and financial sector reform, and labor markets. The analysis aims both to assess the effectiveness of reforms pursued since the crisis and to provide guideposts for the future direction of economic policy.

Improving Turkey's growth performance has been a key objective of the 2001–04 reform program, through both macroeconomic stabilization and structural economic reform. For Turkey, higher growth can contribute significantly to debt sustainability, raising living standards toward European Union (EU) levels, and reducing unemployment. Chapter II documents Turkey's growth record and the factors that explain it. Performance has been slightly better than the world average, especially since 1980, mainly because of increased openness to trade, financial market liberalization, and broader economic reform efforts. But Turkey could have done much better than it did. One key factor holding back the country's growth and increasing its volatility has been the lack of discipline in fiscal, monetary, and financial policies. This has destabilized the economy and reduced its trend growth rate. Looking ahead, the analysis suggests that Turkey has the potential to grow at a rate similar to those of the East Asian economies. Indeed, the recent decline in inflation should help boost the growth rate in the future. However, maintaining policy discipline and ongoing structural reforms will be essential to sustain high growth and reduce volatility.

Reducing high and persistent inflation has been another focus of reform policies aimed at enhancing Turkey's medium-term economic performance. Inflation first took off in the 1970s, peaking at more than 100 percent with the second oil price shock, and then rising again in the mid-1990s. The uniqueness of this experience lies not so much in the high level of inflation itself but in the fact that Turkey managed to live with these high rates for so long, rather than exploding into hyperinflation or launching a successful disinflation effort. With such high inflation over such a long period of time, there was a concern that price-setting had become more backward-looking, which would have complicated the task of reducing inflation. Instead, Chapter III finds that much of this persistent inflation was self-fulfilling: the inflation process was driven more by expectations of future high inflation than by formal backwards indexation. Fiscal policy turns out to be a key determinant of these expectations, so the reform program's focus on generating sustained, high primary surpluses has been central to the success of disinflation.

Balance sheet weaknesses in the financial and corporate sectors have contributed to Turkey's propensity to fall into crisis. Chapter IV documents these preexisting weaknesses and shows how they were magnified by the depreciation of the Turkish lira in 2001 and the increase in interest rates during the crisis. The chapter also shows how private sector balance sheets have since been restored, in part because of the economic recovery and success in macroeconomic stabilization, but also because some of the vulnerabilities have been transferred to the government, which has taken on greater foreign currency and interest rate risk. Although balance sheets have improved considerably and risks have fallen, the analysis shows that Turkey still remains vulnerable, especially while dollarization remains so extensive. This again points to the need for continued low inflation, which should encourage the demand for lira-denominated assets, and reduce vulnerabilities.

The weakness of the government's balance sheet has also been a source of instability for Turkey's economy. For this reason, the reform program has stressed efforts to ensure the sustainability of the debt and improve its structure. Chapter V surveys the literature on the appropriate level of public debt for emerging market economies such as Turkey, and concludes that projecting debt sustainability is not enough. Turkey's external debt ratio is well above levels considered safe for emerging markets, while its high level of public debt raises concerns about fiscal dominance, which could undermine the effectiveness of monetary policy in reducing inflation. These considerations suggest the importance of targeting a significant reduction in government debt. But achieving such a reduction will take many years. In the meantime, effective management of this debt is essential to ensure that it is safely rolled over and that its structure is made more resilient to shocks. Chapter VI reviews the authorities' debt management strategy, and gauges their success in issuing securities that more closely match investor needs, widening the investor base, deepening the liquidity of benchmark bonds, and improving the Treasury's risk management.

Improving the government balance sheet depends on reducing Turkey's government debt, and fiscal adjustment and sustained primary surpluses are essential to accomplish this. Chapter VII estimates the factors that determine primary surpluses across countries, and finds that Turkey's fiscal adjustment since 2000 has been impressive, and marks a significant break with past performance. However, the risk is that this break cannot be sustained, and that Turkey's primary surplus will revert to the lower levels predicted by the cross-country analysis. To prevent this, structural fiscal reforms will be needed to sustain this adjustment.

Chapter VIII complements this analysis by looking at Turkey's history of fiscal adjustment in more detail. It finds that the adjustment since 2000 has relied mainly on tax increases. Spending on investment has been cut, but this has been offset by increased current expenditure. Based on the experience of other countries, such an adjustment could prove difficult to sustain. The emergence of a stronger and more disciplined government, together with efforts to curtail quasi-fiscal operations in state enterprises and spending by extrabudgetary funds, should help. But a redirection of the adjustment toward cuts in current spending, and less reliance on temporary tax increases, would help make the current fiscal adjustment easier to sustain.

Reform of the financial sector has also been at the heart of the program. Such reform has been essential both to prevent any recurrence of the weaknesses that precipitated the 2000–01 crisis and added to the government's debt burden, and also to foster increased lending and recovery in the real sector. After describing the outbreak of the banking crisis and the measures the authorities took to contain it, Chapter IX explains the reforms that have been introduced, including the restructuring of state banks and the recapitalization of private banks. This strategy has largely succeeded in strengthening the banking system and maintaining the confidence of depositors. Even so, both asset recovery and the resolution of intervened banks have been slow, and this has increased the costs of the crisis. Further reforms are needed to enhance the effectiveness of banking supervision and asset resolution.

Chapter X considers recent developments in the labor market, particularly Turkey's low employment rate, the increase in unemployment, and low labor force participation rates, especially for women. Increases in labor productivity have helped Turkey maintain its competitiveness and reduced pressures on inflation, but at the cost of weak employment growth. One obstacle to employment growth is the cost of complying with recent legislation on statutory employment protection. The cost of such compliance is more than twice the average of the nations of the Organization for Economic Cooperation and Development (OECD). These new regulations have helped entrench the existing dual labor market structure, making it harder for new entrants to the labor force to find work in the well-paid formal sector. Labor market reform may be needed to ensure that recent improved growth performance translates into reduced unemployment.