Prospects for Economic Reform in Turkey

Apr 29, 2002

Brief Analysis

Turkey's recovery from the economic crisis of February 2001 has so far been very successful. Fundamental reforms have been undertaken and strict fiscal discipline has been implemented. Furthermore, this process is, to a large degree, irreversible. For the recovery to be truly successful, however, it is essential that Turkey's relations with the European Union (EU) be promoted and that foreign direct investment be encouraged.

The Background of the Crisis

The Turkish economic crisis of February 2001 was not the result of any one particular factor, such as the disagreement between the president and prime minister over economic policy. It was, in fact, long in the making and stemmed from policies carried out by successive governments. In the 1980s, Turkey experienced impressive growth in exports while maintaining a very low level of national debt. In the 1990s, however, political competition and growing pressure on the government to spend resulted in large government deficits financed by issuing bonds. The ratio of debt to gross domestic product (GDP) grew increasingly worrisome, as did annual inflation rates ranging from 60 to 100 percent. Furthermore, many of the public banks were used as a kind of "second budget" for accommodating political needs. This cycle of overspending went on for years because of the initially low debt levels.

By 1999, the government's debt was equal to 60 percent of GDP, and the economy was shrinking 6 percent per year. This grave situation forced the government in 2000 to embark on an economic plan with very strict fiscal discipline as well as structural reforms.

The aim was to lower inflation, which was still between 60 and 70 percent annually. Initially, the government attempted to fix the exchange rate, using it as a nominal anchor that could break the cycle of expectations for inflation. Unfortunately, inflation did not fall as expected in 2000, and the exchange rate was not truly fixed. A speculative assault on the Turkish lira ensued, and the central bank was forced to sell six billion dollars worth of currency in a single day -- a strategy that clearly could not be sustained. The exchange rate had to be floated, and the lira lost half its value. Many companies had borrowed abroad to avoid the high interest rates on loans in lira, and so they suddenly owed twice as much in lira terms, which they were not able to pay. With companies unable to pay back loans, the banks were in crisis. The government had to take over nineteen banks and absorb their debts, which brought the national debt to some 80 percent of GDP. Clearly, Turkey needed a drastic new economic plan.

The Economic Plan

The economic plan undertaken by the Turkish government has two main aspects. First, drastic macroeconomic steps are being taken to ensure that the economy regains stability. The government has instituted a tough fiscal policy aimed at creating a primary surplus of 5.3 percent of GDP -- that is, a surplus before paying interest. So far, the fiscal goals for every month have been met in full. Ambitious goals and strict implementation are crucial to demonstrating the seriousness of the Turkish government and its willingness to bear the necessary cost of reform. Another macroeconomic measure was to leave the exchange rate floating, because no fixed rate would have had credibility following the drastic devaluation that occurred in February 2001. This step has had a very significant effect in aiding exports and making imports more expensive. While Turkey had a deficit of $10 billion in its balance of payments current account in 2000, the year 2001 showed a surplus of $3 billion.

The other main aspect of the plan is the implementation of fundamental and far-reaching structural reforms that have been discussed in Turkey for years but never implemented. To date, no less than twenty-one structural-reform laws have been passed, encompassing a wide variety of issues. The banking system has been completely reformed, with laws protecting public banks from government interference and institutionalizing the independent oversight of the private banking sector. Furthermore, the crucial step of ensuring true independence of the central bank has been established by law. Government support for the agricultural sector was reformed as well. Direct assistance to poorer farmers replaced subsidies on prices, which had mainly benefited the wealthy farming sector. Other sectors -- especially energy, telecommunications, and civil aviation -- have been deregulated.

A key point in the implementation of the plan was that, for the most part, Turkish society rallied around it and accepted the need for tough measures. One significant reason for this support was the perception that the plan was fundamentally Turkish and not imposed on it from the outside (unlike recent attempts at economic reform in Argentina). While the International Monetary Fund (IMF) has had an important role in discussions regarding the plan, Turkey wanted to undertake every single element on its own terms. For instance, the IMF and Turkey debated the country's goal for inflation. The IMF suggested a goal of 20 percent annually, but Turkey insisted on a more realistic one; consequently, the goal was set at 35 percent. Today, the IMF and Turkey are committed to a period of three years to implement the various steps, which gives the reform process an added degree of stability.

Prospects

As a result of what has so far been a successful implementation of the economic reform plan, the panic surrounding the exchange rate has passed, and there are signs of recovery in other key areas as well. Although much of the social toll is still ahead, especially for the unemployed, Turkey is on the right path and has retained its international economic credibility. Naturally, there is a danger of political instability -- something that has characterized Turkey for many years -- but the vast legislation that has been passed ensures that, for the most part, the process is irreversible. Moreover, the wide margins in the plan provide a safety net in the case of serious instability, especially in the Middle East. Turkey must remain steadfast in its commitment to the strict goals it has set, and its new legislation must be translated into a change of norms and behavior.

The most crucial elements in making the process successful are the solidification of Turkey's relations with the EU, and the setting of a definite date for negotiations concerning its admission into the EU. As many precedents show, clear progress in that direction would give great credibility and impetus to reforms in Turkey, which are already structured to conform to EU standards. Such progress would also create a large surge in foreign direct investment, a critical element in encouraging much needed growth at rates higher than the present 3 to 5 percent per year. Good relations with the EU would enable Turkey to strengthen its position as a bridge between Europe, Central Asia, and the Middle East.

This Special Policy Forum Report was prepared by Natan Sachs.

Policy #620

RECOMMENDED

BRIEF ANALYSIS

Bennett’s Bahrain Visit Further Invigorates Israel-Gulf Diplomacy

Feb 14, 2022

◆

Simon Henderson

(/policy-analysis/bennetts-bahrain-visit-further-invigorates-israel-gulf-diplomacy)

BRIEF ANALYSIS

Libya’s Renewed Legitimacy Crisis

Feb 14, 2022

◆

Ben Fishman

(/policy-analysis/libyas-renewed-legitimacy-crisis)

BRIEF ANALYSIS

The UAE Formally Ceases to be a Tax-Free Haven

Feb 14, 2022

◆

Sana Quadri,
Hamdullah Baycar

(/policy-analysis/uae-formally-ceases-be-tax-free-haven)

TOPICS

Energy & Economics (/policy-analysis/energy-economics)

Gulf & Energy Policy (/policy-analysis/gulf-energy-policy)

REGIONS & COUNTRIES

Turkey (/policy-analysis/turkey)