The Turkish Economy in Crisis

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Preface

This book originated as a special issue of the *Turkish Studies* journal, produced with the great skill, knowledge, and coordinating efforts of Ziya Öniş. One of Turkey’s most impressive accomplishments has been its dramatic economic development, but during 2001 and 2002 the economic crises facing Turkey were clearly the worst in at least half a century.

While the foundation of Turkey’s economy remains strong, the problems can be traced back to a mixture of domestic shortcomings and international conditions. It is of the greatest importance to analyze the roots and solutions of these crisis, which have had the greatest impact on the Turkish people. Although the worst aspects of the crises were already over by 2003, these experiences require serious thought and reform in order to avoid a recurrence.

In particular, we wish to thank the support given this project by Attila Aşkar and Mete Soner, President and Dean of the College of Administrative Sciences and Economics, Koç University, and also the financial assistance provided by the College of Administrative Sciences and Economics for the workshop at which most of the papers were presented. Since 2003 marks the university’s tenth anniversary, it seems appropriate to dedicate this book to that event.

We wish to thank especially Elisheva Rosman, Özgül Erdemli and Ehud Waldoks for their hard work on this book. We also wish to acknowledge the able assistance of Evren Tok and Gamze Sezer and to thank Vicky Johnson of Frank Cass for her assistance in publishing this project.

B.R.

_Summer 2003_
Development in Turkey during the postwar period has occurred in the context of democratic institutions and representative government. Breakdowns of democracy have typically accompanied periods of economic crisis, notably in the late 1950s and the late 1970s. Nonetheless, military interludes have been relatively short-lived and the democratic order has been restored after a brief period of transition. This pattern makes an interesting contrast with Brazil, for example, where a military government had been institutionalized for a period of 20 years following the simultaneous collapse of the import-substitution model and democracy in the mid-1960s. Hence, compared to the dominance of bureaucratic authoritarian politics during crucial periods of strategy shift in both East Asia and Latin America, Turkey has managed to combine moderate growth and significant industrial transformation within a broad framework of democratic institutions.\(^1\)

Yet, a closer and a more critical investigation raises serious questions concerning the quality of economic development and the performance of the democratic regime in the postwar Turkish context. Turkey managed to sustain moderately high rates of economic growth over a period of five decades. While this performance could not be described as inadequate by the standards of middle-income economies in general, it was certainly not the kind of growth that would lead to a steady convergence with the per capita income levels prevailing in the developed world, particularly in the presence of high population growth.\(^2\) Turkey, unlike the East Asian “NICs” (newly industrialized countries) such as South Korea and Taiwan, failed to establish its credentials as a major catch-up story. What is also striking is that the pattern of growth has been associated with high-income inequality, rather reminiscent of Latin American styles of development.\(^3\)

Moving to the political realm, Turkey’s nascent democratic order has also displayed some serious deficiencies. A neo-patrimonial political culture together with clientelistic patterns of interaction involving the state and key segments of society have been identified as enduring features of the Turkish political system.
Thus, Turkey’s performance in the economic and political realms is heavily interrelated. The performance of the democratic regime has clearly been inadequate in terms of generating high rates of economic growth on a sustained basis. What seemed to underlie this inadequate performance was the failure to effectively manage the severe distributional conflicts—with different groups in society aiming to obtain a greater share of the “rents” associated with easy access to state resources.4

Indeed, “populist cycles” and periodic fiscal crises of the state have emerged as persistent features of the Turkish economy ever since the Menderes era of the 1950s. “Populism” in the present context is defined as using state resources and “manipulating economic outcomes in ways that disproportionately benefit select groups and classes, whose strength and support the elite relies on to maintain its rule.”5 Democratically elected governments, then, have typically initiated populist cycles in order to establish broad electoral support. The resultant fiscal disequilibrium and high inflation have, in turn, been followed by a balance of payments crisis and an inevitable encounter with the International Monetary Fund (IMF). The difficulties inherent in applying a severe monetary contraction and deep cuts in government expenditure in the midst of a major economic crisis resulted in the collapse of the democratic regime and its replacement by military rule. In the absence of distributional constraints, military rule has been effective in terms of restoring macroeconomic stability. However, restoration of democracy has eventually brought to the surface the accumulated distributional claims, thus marking the upward trend in the populist cycle. One should note, though, that military interludes have created temporary stability at the expense of further instability in the future. Such episodes have helped to undermine trust on the part of key social actors and have also prevented the institutionalization of the party system, leading to discontinuity and fragmentation—which contribute towards instability.6

The endemic nature of populist cycles clearly highlights the weakness of Turkish democracy in providing effective governance of the economy. Populist cycles and the ensuing crises have been costly in the sense that they have reduced the rate of growth below what would otherwise have been the case. Moreover, in a rather ironic and yet typical Latin American fashion, populist cycles have been associated with high, rather than low, inequality. A central problem in this context concerns the question of whether the system can release itself from the exigencies of short-term politics and clientelistic patterns of interaction and devote resources to areas desperately needed for building competitiveness and long-term improvements in the distribution of income.
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<td></td>
<td>Balance of payments crisis originating from the current account, primarily caused by domestic imbalances.</td>
<td>Balance of payments crisis, originating from the current account, caused mainly by domestic imbalances.</td>
<td>Balance of payments crises, originating mainly from the capital account, caused partly by domestic imbalances.</td>
<td>Balance of payments crisis caused by successive speculative attacks and massive outflows of capital leading to the collapse of growth and heavy unemployment in 2001. Both internal and external imbalances are important.</td>
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<td>Origins</td>
<td>Fiscal imbalances; steady appreciation of the real exchange rate; export stagnation and rising trade deficit.</td>
<td>Fiscal imbalances; steady appreciation of the real exchange rate; export stagnation and rising trade deficit; distorted production and trade structure caused by ISI.</td>
<td>Fiscal imbalances; steady appreciation of the real exchange rate; export stagnation, import boom, outflow of short-term capital.</td>
<td>Primarily originated from disequilibrium in the banking sector (private banks in 2000 and public banks in 2001); a strong link may be formulated between disequilibria in the banking sector and fiscal imbalances.</td>
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<td>External dimension</td>
<td>Peripheral; falling world demand for agricultural products in the latter half of the decade.</td>
<td>Successive oil shocks have contributed to the crises; oil shocks largely aggravated the problem created primarily by domestic imbalances.</td>
<td>Significant over-dependence on fragile short-term capital inflows following premature capital account liberalization in August 1989.</td>
<td>Highly volatile external environment characterized by recurrent crisis in emerging markets and reversible capital flows, especially after the Asian crisis of 1997. Export performance negatively affected by the Russian crisis and weak global demand. Rendered the economy highly vulnerable to a crisis.</td>
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<td>1958/59</td>
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<td><strong>International actors in the post-crisis context</strong></td>
<td>IMF is the dominant actor in the post-crisis period. A typical short-term stabilization program.</td>
<td>Both IMF and the World Bank are heavily involved; official assistance through the OECD is also important.</td>
<td>IMF is the primary actor; EU is also involved through the Customs Union.</td>
<td>IMF is the critical actor both in the pre- and post-crisis era; the role of the EU is decisive for the first time. IMF and EU anchors are increasingly interrelated. World Bank is also involved as a secondary actor.</td>
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<td><strong>Political consequences</strong></td>
<td>Collapse of the democratic regime. Restoration of democracy occurs over a relatively short period of time.</td>
<td>Collapse of the democratic regime; longer military rule; restoration of full or unrestricted party competition occurs over a longer period.</td>
<td>Democratic regime remained intact; an implicit link could be formulated between the negative effect of 1994 crisis, the rise of political Islam and indirect or “postmodern” military intervention in February 1997.</td>
<td>A decisive turning point, the democratic regime proved to be highly resilient in the face of the crisis; the impact of the changed international environment and the presence of a powerful EU anchor are significant.</td>
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It is also interesting that major policy changes in Turkey have not been initiated on the basis of a broad social consensus. Rather, such changes have taken place in a top-down fashion, often in response to influences originating from the international economy. The adoption of the neo-liberal model in 1980 is a striking example of this pattern of top-down and externally induced restructuring. In retrospect, the role of the Turkish state in the economic domain has been reactive as opposed to the proactive role that the state has performed in the historically more successful cases of South Korea and Taiwan.\(^7\)

Given this broad background, some interesting structural shifts become evident in the trajectory of Turkey’s political economy in the era of financial globalization following the complete liberalization of the capital account in August 1989. The duration of populist cycles has been reduced and crises have become more frequent (with successive crises taking place in 1994, 2000, and 2001) in an environment characterized by unrestricted exposure to highly volatile short-term capital flows (see Table 1).

Consequently, towards the end of the 1990s, Turkey found itself confronted with a serious low growth-high inequality syndrome. Although crises have become frequent, they have not been accompanied with an explicit breakdown of the democratic order (see Table 1).\(^8\) The changing international order of the post-cold war era, the cultural context of neo-liberal globalization—with its increasing emphasis on the extension of civil and human rights—and, most important of all, the political conditionality associated with European Union (EU) membership, have all been instrumental in excluding the possibility of an authoritarian exit as an easy way out of the economic impasse. The party system experienced serious fragmentation for a variety of reasons, and—within a fragmented democratic order—weak and unstable coalition governments failed to provide effective governance in an environment where the option of authoritarian exit was excluded by definition and the economy was exposed to the instability of global capital markets.

From a comparative perspective, the recent Turkish experience clearly highlights the difficulties that countries located in the middle—in-between the two extremes of authoritarianism and established democracy—face in terms of adapting themselves effectively to the intrinsically unstable environment of open capital account regimes. Clearly, this is not a problem unique to Turkey but is confronted by many other “emerging markets”—Argentina being the most typical recent example.\(^9\)
PREMATURE CAPITAL ACCOUNT LIBERALIZATION 
AND THE DEBT TRAP: THE ECONOMIC AND 
POLITICAL BACKGROUND TO THE TWIN CRISES

Turkey began implementing neo-liberal reforms in 1980. The program initiated in 1980 was one of the first of its kind and was devoted to both short-term stabilization and long-term structural adjustment. Based on close collaboration between the IMF and the World Bank and involving the application of “cross-conditionality,” it was radical and far-reaching. At the same time, it was a gradualist program that envisaged, if not in a totally systematic manner, a stage-by-stage liberalization and integration into the world markets. In the early 1980s, Turkey obtained a record five consecutive structural adjustment loans from the World Bank. It may appear rather paradoxical today, but during the mid-1980s key international organizations highlighted the Turkish experiment as a model case of successful adjustment. Perhaps the most striking achievement of Turkish neo-liberalism concerned the dramatic increase in exports and a structural shift in favor of manufactured exports in a comparatively short space of time. Turkey has also been able to sustain reasonably rapid economic growth—in the order of four to five percent per annum during its first decade of neo-liberalism.\(^{10}\)

After a decade of rapid economic growth, the momentum of the reform process was in decline towards the end of the 1980s. Two critical turning points, which are important in terms of understanding the origins of subsequent imbalances and the increasingly unimpressive economic performance during the 1990s, are September 1987 and August 1989. September 1987 marked the return of unrestricted party competition and the distributional pressures naturally associated with this process. The inability of democratically elected governments to contain severe distributional pressures that had been largely repressed in the early years of the 1980s manifested itself in the form of larger fiscal deficits and higher rates of inflation. In worsening economic conditions, the Turkish government conceived large inflows of capital as a key mechanism to restore growth and did not focus on basic structural deficiencies in the economy, namely large fiscal imbalances. The August 1989 measures completed the last stage in the liberalization of the capital account and the establishment of the full convertibility of the Turkish lira, which resulted in a dramatic increase in inflows of short-term international capital. Arguably, Turkey was able to evade a crisis at the end of the 1980s, but at the expense of a highly fragile pattern of debt-led economic growth—which resulted in successive financial crises in the post-1990 era.\(^{11}\)

Central to the economics of recurrent financial crises in Turkey is an extraordinarily high ratio of public sector borrowing requirement (PSBR) to gross national product (GNP). This is not a novel issue in Turkey as the problem
also existed in the 1970s. However, financial liberalization largely altered the process whereby public deficits have traditionally been financed. The establishment of domestic capital markets presented the government with the opportunity to borrow domestically. As a result, domestic debt started to increase. While Turkey had a domestic debt stock close to zero in 1987, this grew continuously and reached 25–30 percent of GDP by 2000.

High real rates of interest emerged as a striking feature of the Turkish economy during the 1990s. The size of the government’s financial requirement compared to the size of the domestic financial system was at the heart of these high real interest rates. The growth in the government’s financial requirements outstripped the increase in the size of the financial system. This naturally increased the burden on the financial markets, and—in turn—the domestic financial system responded by adjusting prices. Therefore, Turkey’s high and downwardly rigid interest rates are a direct outcome of the government’s demand for funds.

Not surprisingly, the increase in real interest rates has caused an increase in interest payments and hence an increase in budget deficits. The change in the deficit financing policies of governments after 1987 has had a clear impact on deficit dynamics. Indeed, one can detect an important change in the nature of PSBR after the crisis of 1994. In striking contrast to the pre-1994 era, the movements in budget deficits in the post-1994 period are almost completely dominated by interest payments on domestic debt. The impact of financial liberalization in the presence of a large budget deficit was a systematic increase in the domestic debt and short-term domestic borrowing requirements, which caused a move towards higher interest rates. As a result, Turkey has been caught in a vicious circle of increasing deficits and rising interest rates.12

When the government increased its financing requirements via new issues of debt instruments, the commercial sector became the major customer for such securities. The financing policy of the government being based on short-term borrowing led the commercial banks to change their asset management policies. They shifted from direct loan extensions to purchasing government securities. In this way, domestic agents who increasingly borrowed from abroad started to finance public deficits. This indirect form of borrowing by domestic agents replaced direct borrowing by the public sector from international capital markets.

In addition, the deficit-financing policies led the commercial banks to open short positions in foreign currencies. In order to finance their massive investment in government bonds, many Turkish banks made short-term borrowings from international markets against which the government bonds were pledged as collateral. Essentially, banks were borrowing short-term money to hold long-term Turkish government bonds. The high rates of return on government bonds made
the privately-owned banks reluctant to manage the market risks, but as the banks started to operate in short positions in foreign currency-denominated assets, financing policy based on short-term borrowing made the banking sector progressively more vulnerable to foreign exchange and interest rate risks. The fact that the banks involved were typically small and medium-sized banks rendered the situation even more risky. High rates of return coupled with the existing policies, which provided a unique set of tax and regulatory incentives, allowed highly favorable profit margins for the Turkish banks and many of them turned to arbitrage activities to generate a substantial proportion of their profits. An important consequence of these profitable short-term positions has been the increasing trend of dollarization in the banking system. The share of foreign currency-denominated assets and liabilities started to increase, especially after 1987. Prior to the recent crises, the share of foreign currency-denominated assets in total assets rose from 26 percent in 1998 to 38 percent in 1999. Similarly, the share of foreign currency-denominated liabilities rose from 25 percent in 1998 to 48 percent in 1999.13

Looking back, a central lesson to be learned is that Turkey paid the price for premature exposure to financial globalization. Although the capital account was opened fully nearly a decade after the program’s inception, the necessary domestic infrastructure for such a policy had not been created. In the context of a highly fragmented party system, successive coalition governments in the 1990s lacked the capacity and the incentives necessary for undertaking fiscal stabilization and regulation of the banking sector—measures which are critical to the success of both financial and capital account liberalization. Consequently, a lopsided pattern of development occurred whereby economic growth in Turkey has been increasingly dependent on inflows of highly volatile short-term capital. Yet another negative ramification of this concerns the inability of Turkey to attract significant amounts of direct foreign investment, which constitutes an important source of economic development in the current international context. Clearly, it was not democracy per se but the specific populist nature of the Turkish party system that failed to provide an appropriate environment for capitalizing on the benefits and minimizing the losses associated with financial globalization.14

THE CRISES OF NOVEMBER 2000 AND FEBRUARY 2001: INTERNAL DYNAMICS AND SYSTEMIC INFLUENCES

Ever since Turkey implemented one of the very first IMF programs in 1958, frequent encounters with the Fund have been inevitable occurrences due to
periodic macroeconomic crises. More recently, Turkey made a serious attempt to deal with the structural causes of the budget deficits and the chronic inflation process, a context in which the IMF once again was involved as a central actor. In July 1998, the Staff Monitoring Program was agreed with the IMF. This, in turn, initiated a number of targets and precautions related to the budget, monetary policies, and various structural reforms, and also led to a stand-by agreement with the IMF in December 1999.15

The stand-by agreement was certainly ambitious: aiming to bring consumer price inflation down to 25 percent by the end of 2000, 12 percent by the end of 2001, and to seven percent by the end of 2002. It was hoped that the program—through its single-minded emphasis on the disinflation component—would contribute towards the reduction of real interest rates to acceptable levels and the increase of the growth potential of the economy, leading to a more efficient and equitable distribution of resources. A tight fiscal policy, an incomes policy in line with targeted inflation, and monetary and exchange rate policies formulated in line with decreasing inflation were the basis of the disinflation program. A preannounced exchange rate strategy constituted the only novel element in an otherwise rather orthodox program of inflation stabilization.

The program also tried to tackle fundamental structural problems in the key areas of taxation, privatization, banking regulation, and the reform of agricultural price support schemes. Reduction of agricultural support prices and their replacement by direct income support schemes were crucial components of the program since the support prices involved were substantially above the EU norms and, consequently, the agricultural sector continued to be a major source of disequilibrium in the Turkish economy.

During the early months of 2000, there appeared to be considerable optimism concerning the prospects for stabilization and reform in Turkey. To a significant extent this optimism was the outcome of the EU’s Helsinki summit, which took place during the same month as the signing of the IMF stand-by agreement. The endorsement of Turkey’s candidacy for full membership at the Helsinki summit of the European Council provided a powerful incentive for undertaking both political and economic reforms. Furthermore, by the end of the 1990s, governments had discovered that progressively smaller amounts of resources were available for populist redistribution once the principal sum and interest on domestic debt had been paid out. Stated somewhat differently, the fiscal crisis of the state appeared to have reached its limits, forcing the politicians and the public at large to seriously reconsider the feasibility of continuing on a populist trajectory.16

A superficial glance at Turkish politics also seemed to point towards a certain change in the underlying political culture and behavior. Coalition governments in
Turkey, both in the late 1970s and the early to mid-1990s, have been associated with instability and lacked the credibility and commitment to undertake serious fiscal adjustment. The new coalition government formed after the general elections of April 1999, incorporating the left nationalist Democratic Left Party (Demokratik Sol Parti—DSP) under the leadership of Bülent Ecevit, the radical-nationalist Nationalist Action Party (Milliyetçi Hareket Partisi—MHP) under Devlet Bahçeli, and the right-of-center Motherland Party (Anavatan Partisi—ANAP) under Mesut Yılmaz, gave the impression of having significant commitment towards implementing a far-reaching program of disinflation and reform. This appeared to be a rather paradoxical development given the wide ideological spectrum that characterized the coalition government. It was also a puzzling development in the sense that the two dominant partners of the coalition, DSP and MHP, drew their support primarily from low-income segments of society or, in other words, from the losers of neo-liberal globalization. Finally, the fact that an IMF program was concluded for the first time in Turkish history without the presence or influence of a major crisis seemed to provide additional support for these optimistic assessments.

The performance of the coalition government in office, however, failed to match the optimistic mood that prevailed in the early months of 2000. In time, it became apparent that the coalition government lacked cohesion and that its commitment to the economic program was half-hearted. Serious conflicts emerged during the year between the second dominant member of the coalition, the ultra-nationalist MHP, and the two other partners over key aspects of economic policy. In particular, the MHP opposed central elements of the economic program that involved the reduction of agricultural subsidies and the sale of state assets in telecommunications. Reduction of agricultural subsidies generated resistance on income distributional grounds, while the sale of the majority of the shares in the state telecommunications enterprise to foreign investors was considered unacceptable on the grounds of the alleged strategic importance of the enterprise and the loss of national sovereignty entailed by this decision. Perhaps the attempts on the part of the MHP to block the implementation of key aspects of the program were not surprising given that the party drew its support primarily from the rural poor; implementing the program would seriously jeopardize its future electoral prospects.

The coalition government agreed to implement the economic program in the face of major external pressure—originating from both the international financial community and the EU—in an environment where the fiscal situation was diagnosed as unsustainable. This, however, did not mean a deep commitment to reform on the part of all coalition partners, and the half-hearted nature of the commitment became increasingly apparent by the summer of 2000. This, in turn,
progressively undermined investor confidence and constituted one of the underlying sources of the speculative attack and the massive exodus of short-term capital in November 2000.

A key point to emphasize in this context is that a coalition government itself is not necessarily a source of instability. Many examples exist, notably in Western Europe, of coalition governments being able to achieve the cohesion and cooperation needed for effective governance of the economy. By 2000, though, Turkey had not reached that stage of political development. One should bear in mind that the ideological distance between the principal coalition partners was considerably wider than most of their Western European counterparts. Furthermore, it was also clear from the experience of the post-1999 era that the basic orientation of political parties in Turkey had not fundamentally changed over time. The parties continued to act as patronage networks serving narrowly based sectional interests as opposed to serving the interests of broad segments of the society as a whole. This narrow focus also prevented them from playing a more constructive role in terms of policy implementation.\footnote{17}

Leading into the November 2000 crisis, other elements were also involved. In retrospect, it is clear that the program had failed to generate enough credibility on the part of market participants. This was, in part, due to the insufficient cohesion of—and commitment by—the coalition government. Yet, the rise of the current account deficit during the course of 2000 was also a factor that progressively undermined investor confidence and raised deep questions concerning the sustainability of the program. The steady increase in the size of the current account deficit originated from the fact that the interest rates dropped too rapidly in the initial stages of the program. This, in turn, helped to sustain a consumption boom and made it difficult for the authorities to control the overall demand, resulting in a major surge in imports with negative repercussions on the current account.\footnote{18}

Domestic politics, then, was at the heart of the crisis. Yet, an account of the crisis would be seriously incomplete if it failed to take into account the crucial role of external dynamics. Like Turkey, other middle-income countries also experienced full account liberalization and faced a rather unstable and demanding environment in the context of the 1990s. Certainly, the international financial environment had become much more volatile and the investors far more risk-averse following the Asian crisis of 1997. In this kind of environment, even minor policy disturbances could have dramatic ramifications in terms of undermining investor confidence—leading to sudden and large-scale withdrawal of capital from individual economies.

The inherent instability of the international financial environment was aggravated further by specific developments in the context of the year 2000.
Turkey suffered from higher energy prices, higher euro as well as higher interest rates on external borrowings in 2000, which rendered the task of policymakers increasingly more complex. Adverse developments in Argentina were also important in terms of influencing investor confidence.

More specifically, the IMF itself—the key institution involved in the Turkish stabilization and reform program—should share a significant part of the blame for the outbreak of the two successive crises. The fact that the crises occurred in the midst of an IMF program is in itself rather surprising, but clearly demonstrates that even in the presence of IMF support the program failed to inspire sufficient confidence on the part of market participants. Furthermore, IMF action is open to criticism on the following grounds. First, the IMF failed to provide an adequate mix of conditions and incentives for program implementation. Given the demanding conditions imposed, the scale of assistance provided was rather inadequate. The measure of assistance was also inadequate, given the scope of adjustment required. The problem was, in part, due to the IMF lacking significant information. For instance, the IMF did not have full information concerning the range of the disequilibrium in the public banking sector and, hence, the true depth of fiscal disequilibrium in Turkey. Indeed, the information became available just prior to the February 2001 crisis. This may be identified as a serious deficiency considering that the disequilibrium in public banks emerged as a central contributor to the 2001 crisis. This problem reflected the absence of accountability and transparency as key deficiencies of Turkey’s domestic political order. Yet, it also reflected insufficient investment on the part of the IMF in terms of acquainting itself with the specific characteristics of individual countries and acquiring the relevant information. The IMF had a standard model and tried to apply it in a number of countries, irrespective of its lack of information concerning the political and institutional environment prevailing in those countries. Hence, the February 2001 crisis constituted a classic case of asymmetric information.

Furthermore, it has been argued—quiet convincingly—that the IMF could have prevented the initial November crisis, which was essentially a liquidity crisis. One of the main tenets of the stabilization program was the “no sterilization rule” as a safeguard against possible monetary indiscipline in order to add credibility to the disinflation program. The conditions engendered by this approach restricted the monetary autonomy of the Central Bank by forcing it to operate like a quasi-currency board, allowing the interest rate to be freely determined by the market while leaving the control of monetary policy in the hands of capital flows. Given the inflexibility of the IMF in this respect, the Central Bank appears to have adhered too rigidly to the program. As a result, Demirbank—the main private bank involved in the 2000 crisis—effectively lost
all of its capital in two days. Arguably, through a more flexible approach, the Central Bank could have injected liquidity into the system at the right moment to prevent the collapse of Demirbank and, hence, block the outbreak of the crisis itself. Although the Turkish version was a softer version of such experiments, it clearly highlighted a more general problem associated with the controlled exchange rates and currency board-style experiments typically implemented as part of IMF programs in many other countries. The evidence suggests that, on the whole, such experiments tend to be unsuccessful. Even when they are successful in the short run, they tend to be unsuccessful in the long run—as illustrated vividly by the recent Argentine crisis.21

In retrospect, the IMF could have paid explicit attention to the sequencing of reforms. Rather than placing the primary emphasis on the elimination of the budget deficit in the first instance, the restructuring of the banking sector could have received immediate attention. There exists a certain consensus that the 2000 and 2001 crises in Turkey were essentially banking crises, though these were clearly related to underlying fiscal imbalances. The November 2000 crisis was primarily a crisis of the private banking sector whereas the February 2001 crisis stemmed from the disequilibrium in key components of the government-owned banking sector. Thus, a perennial failure to properly regulate the banking sector was at the heart of both crises, a failure which reflected—to a significant extent—the deficiencies of the domestic political system. The IMF, however, was also partly responsible for the under-regulation of the banking system.

Admittedly, the formation of the key regulatory agency—the Bank Regulation and Supervision Authority (BRSA)—constituted a key component of the IMF program in 1999. Indeed, the organization became operative prior to the November crisis. In retrospect, the Fund was rather over-optimistic concerning the ability of such a new institution to play an effective role over a short period of time in a highly problematic banking sector. The ability of such an agency to play a constructive regulatory role was severely hampered by the presence of private banking lobbies that resisted any kind of regulation. Bank regulation also faced resistance from politicians and policymakers who conceived of private banks as a major means of government financing and the public banks as a serious source of rent distribution for building up and sustaining electoral support. Whilst the IMF was justified in its emphasis on the need to create strong regulatory institutions in Turkey, it clearly underestimated the political and institutional problems of constructing autonomous and effective regulatory institutions in the Turkish context. In other words, attempting to engineer reforms in a top-down fashion without paying sufficient attention to problems of political legitimacy tends to reduce the likelihood of effective implementation and the overall viability of the IMF-sponsored reform process.
At a deeper level, one could accuse the IMF of failing to deal with the systemic origins of recurrent financial crises in the “semi-periphery” of inherent imperfections in the global financial markets. Hitherto, the IMF has been impervious to such criticisms and has failed to pay adequate attention to proposals involving internationally coordinated capital controls over short-term capital flows. In spite of the fact that the IMF has been going through a process of transformation in recent years—notably in the aftermath of the Asian crisis, it has clearly not been sympathetic to proposals along the lines of the “Tobin tax” to limit short-term capital flows at either the global, regional or national levels. Turning to the Turkish context and considering the risks of program failure, given the depth of disequilibrium and the magnitude of adjustment required temporary controls over outflows of short-term capital could have been an effective instrument. The fact that the IMF did not pay any attention to such instruments as part of its overall program design in Turkey, or elsewhere for that matter, is clearly an issue that deserves serious criticism.

LOOKING BEYOND FEBRUARY 2001: THE ECONOMIC AND POLITICAL CONSEQUENCES OF THE CRISES

The economic crisis experienced by Turkey in February 2001 proved to be a far deeper crisis than the one in November 2000. Indeed, it constituted the deepest economic crisis faced by Turkey in modern times. The striking magnitude of the crisis may be illustrated by the fact that GNP in real terms declined by 9.4 percent during the course of the year. The result was a dramatic drop in per capita income from $2,986 to $2,110 per annum and a massive increase in unemployment by 1 million people. The crisis, moreover, had a deep affect on all segments of society. Unlike the 1994 crisis, highly educated and skilled employees also lost their jobs in large numbers. Small- and medium-sized businesses were severely affected, resulting in widespread bankruptcies and layoffs. The crisis also led to a major increase in the number of people living below the $400 per month poverty line and the $200 per month subsistence line.

At a more fundamental level, the two consecutive crises helped highlight the total exhaustion of a model of development based on clientelistic ties and patronage networks. This model was the root cause of the problems involving chronic inflation, massive build-up of domestic and external debt as well as unusual levels of corruption by international standards. Hence, the crises marked a drastic loss of legitimacy on the part of the Turkish state. The lack of trust on the part of the public concerning the politicians and the political parties in general
—already a strong sentiment prior to the crises—was amplified considerably in the aftermath.

Considering the intensity of the economic collapse experienced, it was somewhat strange to observe that the crises themselves failed to produce a collapse of the government in power or a major dislocation in society. Occasional protests by civil society associations were observed, but these, though, were certainly not comparable to the massive and violent waves of social protest that accompanied the Argentine crisis of 2001. From a comparative perspective, the Turkish experience deserves attention in the sense that the country’s social fabric proved to be quite resilient in the face of a major economic collapse. This was, in part, due to the unusual size and strength of the informal economy, which provided a natural escape route for those who lost their jobs in the formal labor market. The presence of strong informal networks involving the family and other informal mechanisms of social support performed a stabilizing function, helping to prevent massive social and political dislocation. Clearly, the informal sector constitutes an element of social capital and a source of short-term stability in the Turkish context. The very strength of the informal economy, however, prevents an urgency to undertake reforms designed to enlarge the size of the recorded economy and result in more resources for the government and a more efficient economy in the long run.

The fact that the social fabric has proved to be quite resilient so far should not lead one to excessive optimism. In the past, populist cycles also ended with crises. Nonetheless, the economy managed to recover from these crises in a relatively short period and a growth trajectory was soon established. In the current context, given the size of the debt burden that has accumulated over a number of years, restoring growth may not be as smooth as in the previous post-crisis episodes. If growth fails to recover over a period of a few years and stagnation becomes the norm, then it would be increasingly more difficult to prevent major social and political instability along the lines recently experienced by Argentina. Restoration of growth, therefore, is a crucial consideration, both for debt repayment and maintaining social harmony.

On a more optimistic note, the outbreak of crises has accelerated the reform process in Turkey. Following the February crisis, the authorities took significant steps towards strengthening the role and augmenting the autonomy of key regulatory institutions such as BRSA. It is certainly too early to judge the performance of institutions like BRSA, given the length of the period under consideration and the absence of sufficient concrete evidence. There is no doubt, however, that BRSA, for example, has been playing an active role in the restructuring and reform of the banking sector, which was clearly not the case in the pre-crisis period. Indeed, some commentators have gone as far as to suggest
that the IMF deliberately refrained from preventing both crises in Turkey as a means of breaking down opposition to reform. This line of argument, though, appears to be rather far-fetched. What is significant for our purposes, however, is that the reform process initiated by the 1999 program significantly accelerated during the post-crisis setting.25

It is quite striking that the same coalition government which had, in part, been responsible for the outbreak of the two crises played an instrumental role in the passing of a record number of laws through parliament over a period of 18 months. The legislation involved covered not only the economic sphere but also embodied major changes in the political sphere designed to enlarge democratic rights and freedoms in highly critical and sensitive areas. In fact, the sheer number of laws passed during 1999–2002 appears to be remarkable, especially judged by the standards of Turkish coalition governments.26

At a superficial level, it may be difficult to reach a firm verdict on the performance of the coalition government given the ambiguities highlighted. A closer investigation, though, suggests quite clearly that the main impetus for reform originated from external actors. In the absence of powerful pressures for change applied by both the international financial community and the EU, major factions of the domestic political elites would continue to resist reform in both the economic and political arena as long as a crisis-free environment prevailed. Successive crises clearly increased the power and influence of key external actors such as the IMF and the EU in pushing through major economic and political reforms.

Turkey was clearly in a more fortunate position than Argentina in the sense that it was supported by two rather powerful external anchors. The IMF was certainly much more generous to Turkey after the February crisis.27 This was largely due to the geo-strategic importance of Turkey from the point of view of US foreign policy interests. Indeed, the events of September 11 seemed to have accentuated Turkey’s geo-strategic importance for the United States. Furthermore, there existed a powerful EU anchor in the Turkish context—especially after the Helsinki decision of 1999—which was absent in the Argentine context. By recognizing Turkey’s candidate status, the EU created a powerful and institutionalized framework for dialogue and change in line with the economic and political conditions needed to satisfy the Copenhagen criteria. Argentina’s alternative to the EU was LAFTA (Latin American Free Trade Agreement), a much looser form of regional integration and clearly a weak external anchor by the standards of the EU.

Indeed, what is fascinating to observe is that the economic crises accelerated the pace of reforms needed for Turkey’s eventual EU membership. The material incentives associated with EU membership seemed all the more attractive in the
midst of a deep economic crisis. As a result, it became progressively easier to generate popular support for EU membership, in spite of the rather problematic conditions attached to such membership. This, in turn, provided a favorable environment for passing difficult reforms on sensitive issues—such as the extension of cultural rights for the Kurds and the abolition of the death penalty—with relative ease despite the presence of a powerful “anti-EU coalition.”

The military-security establishment and the MHP constitute the leading elements of a highly organized and vocal anti-EU coalition. This coalition is not opposed to EU membership per se but is strongly opposed to key conditions associated with full EU membership—both in the economic and political spheres—because the fulfillment of such conditions would undermine national autonomy and threaten the unity of the Turkish state. Given the underlying strength of the anti-EU coalition in Turkey, many of the key reforms would not have passed through parliament, at least not in the near future, were it not for a major economic crisis. In fact, a close inspection of the post-February 2001 developments clearly indicates that the MHP has been extremely active in its attempts to block key elements of the reform agenda. Moreover, the anti-EU coalition is likely to play an important role in the near future in terms of challenging the remaining components of EU-related reforms, notably in the political sphere.

Developments in the post-crisis period are also interesting in the sense that the international financial community itself regards a permanent EU anchor as a crucial element guaranteeing the stability and durability of the reform process in Turkey. The underlying logic here is that the IMF only constitutes a temporary anchor—its intervention being effective only as long as an economic crisis persists. For these reasons, the pressures emanating from the EU and the international financial community have been mutually reinforcing processes that constitute a powerful engine for change in Turkey.

Finally, the crisis itself has helped promote a new kind of political actor in the person of Kemal Derviş. Derviş was recruited from the World Bank and appointed as the minister responsible for the economy with the explicit objective of pulling the economy out of crisis. From a comparative standpoint, the appointment of Derviş signifies the emergence of a new kind of politics in the era of financial globalization. In this context, a key individual can play a critical role in terms of forming a bridge between the domestic political sphere of the country concerned and the interests of the international financial community—or what could be described as “transnational capital.”

Considering his particular background, the manner in which Derviş positioned himself in Turkey’s domestic politics as a “social democrat” is quite interesting and paradoxical. Clearly, Derviş seems to understand social democracy as a
necessary part of building a broad-based, pro-reform coalition that incorporates the winners of the reform process and tries to compensate the losers to a certain extent. This, though, begs a number of questions. First, would it be possible to construct such a broad-based coalition around an advocate of neo-liberal reforms when many conceive of him as an agent of the IMF and the international community? Second, and perhaps more significant, would it be possible to sustain such a broad-based coalition if the material benefits of the reform process fail to accrue to broad segments of society, at least in the short run? These questions highlight the serious dilemmas that seem to confront any attempt to construct a broad, pro-reform coalition in an unequal society. These problems are not likely to disappear in the post-crisis era.

OVERCOMING THE LOW GROWTH-HIGH INEQUALITY SYNDROME: THE CHALLENGES AHEAD AND THE NEED FOR A LONG-TERM STRATEGY

A major dilemma facing the Turkish economy in the post-crisis era is how to restore rapid and sustained economic growth in an environment characterized by heavy debt burden—which has accumulated over the years. Long-term growth, however, depends critically on building up domestic capacity and improvement in the country’s competitiveness in international markets—issues which are only tangentially addressed by IMF programs. Overcoming fiscal imbalances and high inflation as well as implementing key regulatory reforms constitute necessary but not sufficient steps in this context. Historically, in Turkey the state has been a dominant entity. The existence of a powerful state tradition, however, does not necessarily produce a “hard state” in the purely economic sense of the term. Indeed, the Turkish state, in spite of its significant contribution to economic development over time, manifested elements of a soft state, as the events leading to the most recent set of crises clearly testified. A key challenge, therefore, is to transform the state from a soft state to an effective, market-augmenting “competition state” in the economic realm whilst softening the “hard state” in the political realm through a process of democratic reform. The need for such a transformation is clearly apparent from an examination of the comparative data on certain key indicators of international competitiveness and economic performance.

A crucial element of success evident from the early stages of the Turkish neo-liberal experiment involved a radical improvement in export performance combined with a structural shift in favor of manufactured exports. Turkey satisfies the criterion of being classified as an NIC, with more than 75 percent of its exports falling into the category of manufactured exports (Figure 1). Yet, a
closer examination reveals that Turkey lags behind the first generation Asian NICs and other types of NICs in terms of the technology content of its manufactured exports measured by the ratio of technology-intensive exports as a ratio of total manufactured exports (Figure 1). One may clearly interpret this as a sign of weak competitiveness.

A disproportionate share of Turkish manufactured exports continues to be based on such traditional categories as textiles and clothing, iron and steel, and manufacturing of foodstuffs and beverages. In order to break this pattern of dependence on traditional manufactures and achieve diversification towards exports with high technology content, societies need to direct resources towards human capital and research and development. Comparative data unambiguously illustrates the deficiencies of the Turkish economy with respect to these fundamental categories when judged by the standards of both the Asian NICs and industrialized countries (Figures 2 and 3). Educational expenditure is particularly significant, not only for increasing competitiveness but also in terms of creating a favorable environment for foreign direct investment and improving income distribution over time.

This naturally brings us to an area where Turkey has clearly failed to capitalize on one of the positive features of neo-liberal globalization: the availability of a large pool of foreign investment. Foreign direct investment (FDI) would not only generate more capital for economic development but would also help to raise export competitiveness. Data presented in Figure 4 clearly illustrates Turkey’s striking inability to attract FDI on an adequate scale compared to other emerging markets in different parts of the world. Research on this issue points towards a multitude of factors that have contributed to the restriction of FDI flows to Turkey. These are—in descending order of importance—political instability, high inflation, uncertainty, deficiencies of the legal system, high tax rates, problems in the financial system, inadequate infrastructure, and pervasive levels of corruption. Undoubtedly, the success of the reform process and rapid progress towards EU membership are likely to play a positive role in this respect. Building domestic capacity in key areas such as education and technological innovation is also likely to create an environment which would be attractive not only for foreign investors but also for the country itself in terms of attracting the right kinds of FDI, involving high technology content and significant linkages with the rest of the economy.

Defense constitutes one area where significant economies are possible. Arguably, the geo-strategic threats facing Turkey in the current regional and international context are somewhat exaggerated and Turkey’s defense expenditure is high by international standards (Figure 5). Indeed, lack of transparency and accountability, which applies to all aspects of government
FIGURE 1
COMPOSITION OF EXPORTS AND TECHNOLOGY CONTENT OF MANUFACTURED EXPORTS (1997)


FIGURE 2
RESEARCH AND DEVELOPMENT EXPENDITURE AS % OF GNP (MOST RECENT BETWEEN 1987–97)

FIGURE 3
EDUCATION EXPENDITURE AS % OF GNP (1997)


FIGURE 4

expenditure in Turkey, applies with equal force to the case of defense expenditure. Most commentators would argue that published figures on defense expenditure as a proportion of GNP provide a severe underestimate of the true magnitudes involved. Hence, the peace dividend for Turkey is undoubtedly high given the need to generate resources with higher payoffs in such critical areas as civilian technology generation, human capital formation and investment in health. It is obvious, however, that proposals involving sizable cuts in defense expenditure will encounter serious opposition from the powerful military establishment. Nonetheless, we would expect issues relating to defense expenditure to come under increasing scrutiny as Turkey approaches EU membership and deeper issues pertaining to the role of the military in Turkish society gradually come to the forefront of public debate.

Clearly, the issues raised in this section are ultimately political issues in the sense that the ability to tackle these problems effectively hinges on the capacity of the domestic political or party system to alleviate the pressures of short-term politics and clientelistic patterns of interaction. The Turkish political system is undoubtedly undergoing a process of change in response to powerful domestic and external pressures. Whether this change will be sufficiently rapid in terms of supporting the economic transformation of the Turkish state in the directions outlined within the space of the next few years is rather difficult to predict, especially when writing in a state of flux during the fall of 2002.
THE NEED FOR A PERMANENT EXTERNAL ANCHOR: POLITICAL ECONOMY AND THE SIGNIFICANCE OF EU MEMBERSHIP

It is hard to visualize a decisive break with populist cycles and a transformation of the state in the direction of democratic and accountable competition state in the absence of a powerful EU anchor. Hence, the evolution of Turkey-EU relations and the kinds of signals provided by the EU are likely to have a crucial bearing on Turkey’s economic performance over the course of the next decade. Indeed, relations with the European Community (EC) and, more recently, with the European Union have exercised a critical influence over Turkey’s political economy throughout the postwar period. The EC/EU has emerged as Turkey’s principal trading partner and source of foreign investment over the years. Currently, more than 50 percent of Turkey’s foreign trade is with the EU. Turkey, along with Greece, was one of the earliest contenders in the EC/EU enlargement process—both countries acquiring associate membership status in the early 1960s. Whilst the EC/EU has been crucial to Turkey’s development experience over the years, the relationship has been a complex and—at times—a mutually disappointing relationship, traditionally dominated by the interplay of economic, political, and security considerations as well as fundamental issues concerning culture and identity. 

From a purely economic point of view, Turkey’s aspirations to become a full member of the EC/EU have met with resistance. This is due both to Turkey’s size and its relative underdevelopment, which pose possible threats—notably in terms of mass migration of labor to high-wage economies of the European core. More recently, political considerations appear to dominate purely economic constraints as the EU has placed a growing emphasis on democratization and human rights. In the context of the 1990s, the crucial development concerns the signing of the Customs Union (CU) Agreement, which became formally operative by the end of 1995. In retrospect, the CU has been instrumental in accelerating the process of trade liberalization in Turkey and exposing Turkish industry to greater external competition. The CU has also created an additional benefit in the sense that it facilitated significant regulatory reforms in the course of the 1990s, notably in the areas of competition policy and intellectual property rights—measures which helped to bring Turkey to global norms of competition. Arguably, weak coalition governments would not have implemented these measures had the EU not demanded them as conditions for activating the CU.

The CU, however, constituted a weak form of integration in the sense that it involved opening Turkey to greater competition but fell considerably short of enabling full membership. Stated somewhat differently, the CU represented a rather unbalanced mix of conditions and incentives. In that respect, the decision
of the EU Council to offer the full-membership perspective to Turkey in December 1999 was an important turning point with potentially far-reaching consequences for the Turkish political economy. For countries like Turkey with significant legacies of clientelistic politics, a powerful external anchor is a necessary—albeit not a sufficient—condition for undertaking and consolidating major internal reforms. With full membership in sight, the mix of conditions and incentives became far more favorable. Indeed, the Helsinki decision has facilitated the emergence of a vocal pro-EU coalition in Turkey and has clearly contributed towards the acceleration of the reform process in both the economic and the political spheres—despite considerable opposition. Some of the reforms that passed through parliament in August 2002 would certainly have been unthinkable a few years ago.

Nevertheless, the process is far from complete. Looking to the future, the success of Turkey’s economic reforms is likely to be an important consideration in the country’s graduation to full membership. Arguably, however, purely political considerations relating to issues such as the Cyprus dispute and the quality of democracy might prove to be formidable obstacles on Turkey’s trajectory to this membership. To a certain extent, the ability to create a virtuous cycle depends on the capacity of the political system to satisfy the Copenhagen criteria and achieve step-by-step integration with the EU prior to full membership. This would be made possible by capitalizing on opportunities provided by the EU in such diverse areas as education and technological development. The EU could certainly help in accelerating this process by improving the mix of conditions and incentives further in Turkey’s favor, a situation which it could effect through improved financial assistance, a more balanced approach towards the resolution of the Cyprus dispute, and support for civil society organizations that form the backbone of the emerging pro-EU coalition. It is fair to say that the role that the EU played in Turkey has been less constructive compared to the role it played in the earlier wave of southern enlargement and the latest wave of eastern enlargement.34

CONCLUDING OBSERVATIONS

Recurrent populist cycles have been a dominant element of the Turkish political economy in the postwar period. Populist cycles, which have inevitably culminated in macroeconomic crises, have been costly to the Turkish economy and have reduced the rate of economic growth below what would otherwise have been the case. The duration of populist cycles has become shorter and crises have become more frequent during the era of open capital account regimes. One may explain this apparent paradox as the combined outcome of the underlying
weaknesses of the democratic regime at home and premature exposure to financial globalization. Capital account liberalization in Turkey has been engineered prior to the establishment of a stable macroeconomic environment and a strong regulatory framework for the banking sector. Premature financial and capital account liberalization in the absence of an adequate institutional infrastructure had major negative ramifications. The result was a pattern of a highly fragile debt-led growth which was heavily dependent on domestic borrowing to finance the large fiscal deficit and inflows of short-term capital. This inherently unstable pattern of growth amplified the risks of speculative attacks and, hence, vulnerability to successive crises. The latest of these recurrent crises experienced in February 2001 constituted the deepest crisis experienced by Turkey in the modern era.

There exist certain signs that the underlying continuities in the Turkish political economy are in the process of being dismantled under the impact of powerful pressures for change originating from the international financial community and the EU in recent times. The deep crisis experienced by Turkey in 2001 has clearly helped to accelerate this process. Change, however, is unlikely to proceed in a smooth manner. With the option of the authoritarian exit largely excluded from the political agenda, countries like Turkey face serious dilemmas in establishing the basis for rapid and sustained economic growth in the presence of fragile democratic institutions. The existence of acute distributional pressure and unrestricted exposure to the highly unstable environment of global financial markets make the prospects for rapid and sustained growth in such countries highly problematic. Comparative analysis clearly highlights the difficulties that Turkey faces in developing an effective competition state. Success in this context is likely to depend on the strength of a broad-based, pro-reform coalition and a powerful permanent external anchor. In this respect, the nature of Turkey-EU relations is likely to exercise a decisive influence over the evolution of the Turkish political economy in the coming years.

NOTES

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1. For detailed investigations of Turkey’s postwar development experience, including discussions of different policy phases and the nature of the crises leading to major policy shifts, see Yakup Kepenek and Nurhan Yentürk, Türkiye Ekonomisi [Turkish Economy] (Istanbul: Remzi Yaymevi, 2000); Roger Owen and Şevket Pamuk, A History of Middle East Economies in the Twentieth Century (London:


3. Five decades of continuous growth have helped generate a large and diversified economy. Recent evidence suggests that Turkey is the 22nd largest economy in the world. Yet its standing on a per-capita income basis is much less impressive, with Turkey occupying only the 89th position. This information is based on figures in World Bank, “Entering the 21st Century,” World Development Report 1999/2000 (New York: Oxford University Press for the World Bank, 2000). These figures suggest growth has not been sufficient to pull standards of living up to developed country standards in the presence of rapid and sustained population growth. For recent demographic trends in Turkey, see TÜSİAD, Türkiye’nin Fırsat Penceresi: Demografik Dönüşüm ve İzdişümleri [Turkey’s Window of Opportunity: Demographic Transformation and Projections for the Future] (İstanbul: Türk Sanayicileri ve İşadamları Derneği, 1999). A striking trend in this context concerns the slowdown of population growth during the 1990s. Nonetheless, Turkey enjoys a disproportionately high share of young people, which has major social and political ramifications. Furthermore, we observe a country characterized by a striking dualistic structure with a rather developed western part coexisting with the underdeveloped east. It is a country highly developed by the standards of the majority of countries in its surrounding regions and yet one significantly lagging behind the EU standards and even the standards of the late Mediterranean entrants to the Community when judged on a per capita income basis.


5. This definition is borrowed from David Waldner, State Building and Late Development (Ithaca and London: Cornell University Press, 1999), p. 34. Waldner uses the term “popular sector incorporation” instead of “populism.”

6. One may argue that the military interlude in Turkey has—in a very unintentional manner—contributed to the deinstitutionalization and fragmentation of the party system in Turkey as well as to the rise of political Islam in Turkey during the course of the 1990s. Hence, we have clear evidence suggesting that short-term stability generated by a temporary authoritarian exit has resulted in greater instability in the future. See Ziya Öniş, “The Political Economy of Islamic Resurgence in Turkey: The Rise of the Welfare Party in Perspective,” Third World Quarterly, Vol.18, No.4 (1997), pp. 743–66

7. For a comparative analysis of the role of the state in the development experience of Turkey and the East Asian NICs, see Ziya Öniş, State and Market: The Political

8. One may defend this statement on the grounds that the democratic regime clearly did not collapse in the aftermath of the 1994 crisis as it had done earlier in the context of previous economic crises. Nonetheless, one can form an indirect link between deteriorating economic conditions and the rise of political Islam in the mid-1990s, which subsequently resulted in the quasi-military intervention in February 1997 that toppled the coalition government-dominated by the Islamist Welfare Party—out of office. Hence, one can argue that the decisive break with the past in this respect occurred in 2001 and not in 1994. Clearly, an explicit EU anchor played a central role in this context.


10. For a detailed and critical investigation of Turkish neo-liberalism in the 1980s, see Tosun Aricanli and Dani Rodrik (eds.), *The Political Economy of Turkey: Debt, Adjustment and Sustainability* (London: Macmillan, 1990). Turkey’s growth performance during the 1980–87 period was superior to its performance in the 1988–98 period. Real GNP growth emerged as 4.66 percent for 1980–87 and 4.12 percent for 1988–98 respectively. One also has to take into account the fact that growth recorded during the second phase was an extremely fragile pattern of debt-led growth, which was clearly unsustainable. The validity of this observation is clearly confirmed by looking at the average growth rate for 1999–2001, which has been recorded as-3.3 percent. A fair comparison of the two decades, however, should explicitly recognize the depth of exogenous shocks in the 1990s that exercised a negative influence over the performance of the Turkish economy, taking into account the impact of the Gulf War, the war against the PKK that lasted until early 1999, the earthquake in 1999, and the successive emerging market crises in the late 1990s.


12. On the underlying causes of fiscal disequilibrium in Turkey during the 1990s, see Izak Atiyas and Şerif Saym, “A Political Economy Perspective on Turkish Budget Deficits,” *Boğaziçi Journal*, Vol.12, No.1 (1998), pp.55–80. One should also emphasize that Turkey was in a state of virtual civil war with the PKK between 1984 and 1999. The intensification of the armed conflict naturally resulted in the diversion of resources to defense, contributing to higher fiscal instability and lower economic growth than would otherwise have been the case.


On the costly nature of “distributive politics” or “populist redistribution”—resulting in heavy interest burden on domestic public debt with an associated squeeze on critical areas of investment during the 1990s—see Atiyas and Saym (1998), pp.55–79. The key point to emphasize is that distributive politics did not involve a systematic transfer of resources to the poorest segments of society as part of a coherent social policy.

On the nature of the political parties in Turkey—emphasizing their role as patronage dispersion mechanisms as well as the lack of intra-party democracy—see Barry Rubin and Metin Heper (eds.), *Political Parties in Turkey* (London and Portland, OR: Frank Cass, 2002). The collection of essays contains detailed information on the ideology, operation and leadership styles of all the major political parties in Turkey.


The financial assistance provided by the Fund in December 1999 totaled approximately $4 billion extended over a period of three years. This was clearly not commensurate with the scale of adjustment involved in the banking sector. In retrospect, the severe information problem manifested itself in the Fund’s underestimation of the scale of duty losses in public banks and the problem of financing these in the interbank market. See Alper and Öniş, (2002[a]).


23. On the impact of the 2001 crisis on poverty, see the contribution by Fikret Şenses in this volume (pp. 92–119).

24. For a comprehensive attempt to estimate the size of the underground or informal economy in Turkey over time on the basis of a variety of different methodologies, see Fethi Öğünç and Gökhan Yılmaz, “Estimating the Underground Economy in Turkey,” The Central Bank of Turkey Research Department Discussion Paper (2000). Various estimates suggest that the ratio of underground economy to official economy is of the order of 1:5 to 1:4 in recent years, which is certainly a large figure by international standards.

25. One should note, however, that resistance to reforms both in the economic and political spheres remained intact in the aftermath of the February crisis. Indeed, major clashes occurred between the newly appointed Economy Minister, Kemal Derviş, and the MHP, key members of the coalition, over a number of key issues of reform. One striking example of this kind of conflict occurred in the context of reforming the Telekom board, one of the key conditions for the $15.7 billion IMF financial rescue package. The MHP was determined to maintain its control over the company and insisted on choosing four of the seven board members. The major conflict between Derviş and the Transport Minister, Enis Öksüz, resulted in a certain loss of confidence and led to a delay in the IMF loan. The financial arm of the IMF was decisive in resolving the issue, however. The board was reappointed two weeks later and the episode ended with the resignation of the transport minister. One could identify several other instances, which were similar to this kind of conflict. What is interesting for our purposes is that the strength of the IMF, in line with the scale of assistance it provided post-crisis, played a key role in breaking the resistance to reform.

26. It is interesting to note that almost all of the key pieces of legislation in the economic sphere involving financial sector reform, agricultural reform, and privatization designed to satisfy both IMF conditions and the EU’s Copenhagen criteria—both in the short-and medium-term—were accomplished by August 2002. In addition, major reforms have been accomplished in the political arena. For information on this issue, see <http://www.ikv.org.tr/turkiye-ab/gunce/Tablo_5.htm>. The proper implementation of these reforms, however, is another issue.

27. The scale of IMF involvement increased after the February 2001 crisis. During the course of 2001 and 2002, Turkey managed to attract a total of $24.5 billion of IMF assistance. This clearly highlights the validity of the earlier criticism that the scale of assistance provided to Turkey as part of the 1999 program was of a rather limited magnitude given the scale of ex post facto adjustment involved.
28. Private financial institutions have been placing great emphasis on the achievement of EU-related reforms and—notably—EU-related political reforms in the post-crisis era. See Lehman Brothers report as a typical example: Lehman Brothers, “Cliff Hanger,” Focus Turkey (Nov. 30, 2001).


32. For a comprehensive investigation of the evolution of Turkey-EU relations in the postwar context, see Meltem-Müftüler-Baç, Turkey’s Relations with a Changing Europe (Manchester: Manchester University Press, 1997).


On two occasions, first in November 2000 and then in February 2001, foreign and domestic investors pulled out enormous sums of money from the Turkish market within a matter of days. This rush to withdraw funds came about a year after Turkey introduced a disinflation program predicated on an exchange rate-based stabilization (ERJBS), which was designed and supported by the International Monetary Fund (IMF). The Turkish government weathered the crisis in November with the financial support of the IMF and was able to hold on to the exchange rate peg. Three months later, however, turmoil in the market forced the government to abandon the peg. In the months that followed, the currency collapsed, bankruptcies became widespread, unemployment soared, and Turkey faced the worst economic contraction it had seen in decades.

This contribution argues that investor panic played a key role in both the November and February financial crises. In the case of the November crisis, panic was caused by the policies of the newly created banking supervision agency and the subsequent liquidity problems of a mid-sized bank. In February, it was the prime minister’s statement that Turkey was in the midst of a “political crisis” following his disagreement with the president that triggered financial panic. The argument that financial panic was a prominent cause of both Turkish crises is in contrast to the common ex post facto analysis, which claims that the crises were simply disasters waiting to happen because of Turkey’s weak economic fundamentals. Without question, certain economic weaknesses—the widening current account deficit, currency overvaluation, and delays in the implementation of certain structural reforms—existed, but they were hardly severe enough to provoke a financial crisis of the magnitude faced by Turkey.

Financial panic does not occur in a vacuum. I argue that the fragility of the banking sector was a key factor shaping the outcome of the “panic attacks” mentioned above. Turkey’s bank fragility was associated with what I call “external illiquidity,” meaning maturity and currency mismatches between bank assets and liabilities. The December 1999 disinflation program, with its pre-announced exchange rate peg, was introduced against the background of the
open capital account and certain bank weakness, which were significantly exacerbated during the first ten months of the program’s implementation due to the presumed exchange rate stability. As discussed below, there are serious dangers involved in combining an open financial market, a pegged exchange rate, and a fragile banking sector. Herein lay the gamble in Turkey’s disinflation strategy. Yet, despite the risks, the Turkish program need not have failed so soon, if ever.

This contribution compares the making of the Turkish financial crises with three major financial crises in the 1990s—namely, the Mexican peso crisis in 1994, the Thai crisis in 1997 that triggered the Asian turmoil, and the Brazilian crisis in 1999. The comparison will demonstrate that the Turkish crisis is not a unique case among the recent financial crises in emerging market economies. In all four cases, investor sentiment changed suddenly. This was due primarily to the herd behavior of market participants and their self-fulfilling expectations. The fact that Turkey’s exchange rate peg collapsed before the IMF’s envisaged move to a flexible exchange rate regime requires another line of comparison with similar ERBS strategies that lasted much longer. In this regard, I compare the circumstances under which Turkey adopted the exchange rate peg with those of Brazil’s Real plan in 1994 and Russia’s ERBS strategy in 1995. Brazil and Russia prove to be fitting comparisons as they, like Turkey, are both countries that experienced a severe banking crisis during the first year of their respective anti-inflation programs. Unlike what happened in Turkey, however, the banking crises in Brazil and Russia did not develop into full-fledged currency crises.

The first section presents an analytical framework of how the coexistence of banking fragility and financial panic intersect under a fixed exchange rate regime, ultimately resulting in a currency collapse. The second section describes the emergence of financial vulnerability in Turkey before and after the introduction of the stabilization program, and contrasts it to the situations in Brazil (1994–95) and Russia (1995–96). The third section discusses the role played by financial panic in Turkey, Mexico, Thailand, and Brazil, and leads to the conclusion.

BANKING FRAGILITY, FINANCIAL PANIC, AND CURRENCY COLLAPSE: ANALYTICAL CONSIDERATIONS

The episodes of currency turmoil in the 1990s generated a great deal of debate among economists over the determinants of these crises, which were characterized by the sudden and sharp reversal of capital flows and led to the collapse of pegged exchange rate regimes. Explanations of financial crises
distinguish between crises caused by deterioration in economic fundamentals and those that result from a prompt change in investors’ expectations about the government’s ability to maintain a fixed (or semi-fixed) exchange rate.

The first perspective stresses undisciplined fiscal and monetary policies, which eventually become inconsistent with a fixed exchange rate regime. In this so-called “first generation” model of financial crises, the central bank’s expansionary monetary policy (usually through monetization of the fiscal deficit) and/or an unsustainable current account deficit are the primary culprits responsible for the liquidation of domestic currency holdings by market participants in anticipation of devaluation. The important point here is that a financial crisis can be anticipated by looking at the deterioration of macroeconomic fundamentals.¹

In contrast, the second explanation for the onset of a financial crisis—the one adopted in this essay—emphasizes the unanticipated nature of the crisis. This line of argument focuses on the characteristic herd instinct of the market—that is, the sudden reaction of investors to the actions of other investors—rather than on a country’s economic fundamentals. Proponents of the latter perspective argue that a financial crisis can be thought of as a shift in investors’ expectations about devaluation or default that, in turn, makes the defense of the peg excessively costly for the government. This shift may lead to a financial panic that can be described as an “adverse equilibrium outcome” in which short-term creditors withdraw their loans from a solvent borrower in a very short period of time.² Similar to what happens during a run on the banks, the change in market sentiment usually takes the form of a self-fulfilling prophecy in which each creditor believes that other creditors will stop lending, thus validating the negative expectations. A key issue here is that because of informational limitations and the absence of coordination among investors, foreign lenders cannot distinguish between borrowers from the same country and treat them all as equally risky.³ The implication is that during a financial panic, the financial system of a country as a whole can be illiquid but solvent—that is, it has a positive net worth but cannot obtain funds from elsewhere.

The sudden loss of investor confidence in a country’s economy involves some indeterminacy and is usually triggered by an extraordinary event or an extraneous shock. Yet, for such an event to prompt a change in market sentiment, the country must already be in a “crisis zone.” In other words, it must already be vulnerable. This vulnerability can be defined as a situation which, following Chang and Velasco, I call “external illiquidity.”⁴ External illiquidity arises when the short-term foreign currency obligations of a country’s financial system exceed the amount of foreign currency at the central bank. In such circumstances, investors may wonder whether they can convert their
domestically denominated currency into foreign currency at the present pegged exchange rate before the central bank loses so many reserves that it stops defending its currency and devalues.

External illiquidity usually originates in the financial system, particularly in the banking sector. As noted in several recent studies, currency and banking crises in developing countries are usually twin events. The key link between banks and currency crises can be seen when banks’ temporary liquidity shortages of foreign currency generate vulnerability to a sudden reversal of capital flows. A liquidity shortage in foreign currency occurs when domestic banks borrow in foreign currency (whether in the form of deposits or loans) and use these liabilities primarily to fund longer term and illiquid investments in domestic currency that cannot be readily converted to cash. Banks’ liquidity problems are usually characterized by both a currency mismatch (bank liabilities associated with capital flows are denominated in foreign currency, while loans are denominated in domestic currency) and a maturity mismatch (foreign currency deposits by foreign investors are short term, while loans are medium or long term).

External illiquidity emerges when banks “over-borrow” in foreign currency. Over-borrowing usually results from a combination of two factors. The first factor is the liberalization of both the domestic financial system and the capital account. Capital account liberalization entails abandoning the regulations intended to control capital flows in and out of the country. This “twin liberalization” is likely to result in excessive short-term borrowing by both banks and non-bank financial institutions as the amount of resources available to the financial sector surges. As noted by a number of scholars, short-term capital flows are much more volatile than long-term flows and more prone to a sudden reversal during a financial panic. It has been argued that the prudential regulation and supervision of banks’ short-term international borrowing can be an effective check on over-borrowing. Establishing effective regulation and supervision, however, may prove to be difficult and incomplete, as institutional change cannot usually keep up with the high levels of international capital flow following capital account liberalization. The second factor that figures in bank over-borrowing in foreign currency is the fixed exchange rate regime. The apparent stability of the exchange rate peg leads banks to overlook currency risk and induces them to borrow heavily in foreign currency without hedging their exposures. Moreover, fixing the exchange rate within the framework of an ERBS program usually leads to a consumption boom during the initial phase which, in turn, triggers a sudden expansion in bank credit and a rapid increase in the stock of short-term foreign currency liabilities.

As noted above, external illiquidity generates financial vulnerability to a sudden change in investors’ sentiment, but the vulnerability itself is not enough
to trigger a financial crisis, nor does it determine the timing of the crisis. An extraneous event is necessary to trigger a financial panic and cause a “sudden stop,” which can be defined as a massive reversal of capital inflows and a refusal by investors to roll over their short-term credits for banks or the government.\textsuperscript{11} When a sudden stop of foreign capital takes place, banks are forced to liquidate their long-term investments at highly discounted prices in order to raise the cash needed to pay off their investors. Soon, a systemic risk in the banking system is likely to emerge in which even a well-managed bank can quickly exhaust its cash reserves and become insolvent, thereby validating the initial expectation of a run. Because of systemic links, the run could spread to the entire banking and financial sectors. Under these circumstances, extreme pressure on the exchange rate appears and a rapid loss of official reserves ensues. The collapse of the exchange rate is likely to occur because stabilizing banks and maintaining the exchange rate become mutually incompatible objectives for the government.\textsuperscript{12} When the fixed exchange rate is abandoned, it usually overshoots. This, in turn, usually causes widespread bank collapses due to costly asset liquidation, an unnecessarily large credit crunch and a sharp decline in economic activity. The economic and financial costs for external illiquidity and some weak fundamentals (especially real exchange rate overvaluation) are greatly magnified as a result of creditor panic. In other words, the punishment is much greater than the crime.

FROM FINANCIAL LIBERALIZATION TO EXTERNAL ILLIQUIDITY

The financial crises under consideration in this contribution (Mexico 1994, Thailand 1997, Brazil 1999, and Turkey 2000–1) were the result of several interrelated factors, but they all shared two main underlying sources: a surge in capital flows preceding the crisis and the presence of a pegged exchange rate regime.\textsuperscript{13} These capital flows were mostly short term and intermediated by the banking system prior to the crisis. The underlying cause of the capital flow surge is fundamentally related to twin liberalization and exchange rate stability. Foreign investors gained full access to the financial markets of these countries as the interest rate ceilings were lifted and various controls and restrictions on capital flows were either abandoned or reduced.

Turkey and Mexico undertook capital market liberalization in the late 1980s. In Turkey, the capital account was fully liberalized by the Turgut Özal government in 1989.\textsuperscript{14} Mexico not only removed most of the restrictions on capital flows in 1989–90 but also privatized state-owned banks and lowered their required reserve ratios to zero, thereby giving them a significant incentive to
borrow from abroad. In Thailand, capital account liberalization during the early 1990s was accompanied by the introduction of special incentives to encourage foreign borrowing. For instance, Thai banks received special tax breaks when they conducted their business in the Bangkok International Banking Facility, which operated exclusively in foreign currency transactions.

The major outcome of financial opening was frequent maturity and currency mismatches in bank balance sheets. Financial vulnerability, however, became pronounced only when it was coupled with exchange rate inflexibility. Turkey is a case in point. As a result of deregulation, Turkish banks increasingly borrowed short-term foreign currency from abroad in the 1990s. Borrowing, however, peaked only during the periods when the exchange rate became subject to heavy government intervention and thus appeared to be stable. A major example of this was the government’s suppression of the value of the Turkish lira (TL) against the dollar in late 1993. The Turkish authorities’ aversion to letting the lira depreciate initially led to a substantial increase in banks’ borrowing in foreign currency and the explosion in banks’ open currency positions (that is, net external borrowing). This eventually resulted in the spectacular collapse of the TL in early 1994. In the five years that followed, Turkish governments maintained a fairly steady policy of devaluation to preserve the real exchange rate. This “managed float” of the TL induced exchange rate uncertainty and, therefore, became a major disincentive for Turkish banks to avoid increasing their foreign currency-denominated liabilities. By the end of 1999, it is estimated that the open positions of private commercial banks amounted to around $13 billion. Even though this was a significant amount—given the flexible exchange rate—the banking sector did not seem to be vulnerable to a reversal of capital flows.

**Turkey’s Stabilization Program and Rising Financial Vulnerability**

In January 2000, with the aim of eliminating high and chronic inflation, the Turkish government launched a stabilization program with the support of the IMF. The key to the disinflation program was the introduction of a new exchange rate regime characterized by a pre-announced exchange rate and a built-in exit strategy, which envisaged a gradual and smooth transition to a flexible exchange rate after the first critical 18-month period. The program entailed tight monetary and fiscal policy as well as the implementation of structural reforms. Of all the structural reforms, the most important was related to the restructuring of the banking system, the timing of which—as will be discussed—had some important consequences for the November crisis.
As noted by several scholars, the major consequence of the stabilization program was that it increased the vulnerability of the banking sector to a capital reversal. The main impact was a sharp decline in interest rates. This fall affected bank balance sheets in two major ways. First, falling interest rates generated a significant rise in credit expansion and aggregate demand. During the first nine months of the stabilization program, banks’ consumer credits tripled. At the same time, bank borrowing from foreign sources reached record levels. Second, as interest rates declined, some banks used short-term foreign credits to purchase excessive amounts of longer term government securities before they fell, as expected, parallel to inflation. These banks tried to make use of very short-term foreign funding to lock in longer term domestic yields and, thus, increasingly relied on short-term domestic financing (repos and interbank loans). As a result, maturity and currency mismatches in bank balance sheets deteriorated. As a sign of this deterioration, banks’ net open positions nearly doubled during the first nine months of 2000.

With the benefit of hindsight, the major difference between the Turkish ERBS program of 2000 and other similar programs was that the former was launched at a time when the country had already been integrated into the global financial system after a decade of an open capital account. On the other hand, Mexico, Brazil and Russia undertook ERBS programs when their links to global financial markets were limited. In each of these latter cases, external illiquidity emerged at least a few years after stabilization and when inflation was eliminated. Mexico’s ERBS program in 1987, for example, preceded capital market liberalization by almost three years. Hence, Mexico attracted very large amounts of short-term capital only after 1990, mostly in the form of portfolio investment, which eventually caused serious vulnerability in the country’s financial system.

Similarly, when Brazil and Russia launched their ERBS programs in the mid-1990s, they had not abandoned all the restrictions and regulations on short-term capital flows. Equally important, during the initial phase of stabilization, the authorities in Brazil and Russia resisted the full deregulation of short-term capital flows. Brazil sought to discriminate between long-and short-term capital flows around the time it launched its anti-inflation program (the Real Plan) in 1994. Short-term equity and debt flows became subject to controls because they were suspected of higher volatility. At the same time, the authorities tried to upgrade incentives for foreign direct investment. Beginning in 1993, Brazilian authorities began to regulate bank borrowing from abroad and restricted foreigners’ purchase of government securities and numerous other types of non-resident transactions. Evidence suggests that Brazil’s efforts to regulate capital flow were effective in changing the composition of capital flow in favor of long-term flows, at least during the critical first year of stabilization. In the long term,
however, the capital controls turned out to be ineffective—as demonstrated by the massive surge in flows that Brazil experienced after 1996.\textsuperscript{24}

In Russia, the government’s attempt to control capital flows centered on the government’s debt instruments, despite the ruble’s convertibility. With the intention of protecting the program from the possible volatility of short-term capital flows, the Russian government greatly restricted foreign investors’ participation in the lucrative GKO (ruble-denominated short-term government securities) market after it initiated its stabilization program in early 1995. Foreign investors were not allowed to purchase more than ten percent of any GKO issue and repatriate the related income. These restrictions were first relaxed in August 1996 and then entirely removed, in part due to IMF insistence but mainly because the government sought to finance its budget deficit at a lower cost by increasing the demand for GKOs.\textsuperscript{25} In sum, keeping some of the restrictions on short-term capital flows during inflation stabilization greatly contributed to successful disinflation in Brazil and Russia. These regulations provided authorities with breathing space during the early phases of their anti-inflation strategy. Turkey, on the other hand, was largely deprived of this option in 2000 because it was extremely difficult to undo its ten-year experience of integration with global capital markets.

It is also interesting to note that both Brazil and Russia experienced a banking crisis in 1995—one year into their stabilization programs. These banking crises, however, did not result in the collapse of the currency, as happened in Turkey. The main reason for this appears to be the absence of external illiquidity in the financial sector. Russian and Brazilian banks did not have currency mismatches, mainly due to restrictions imposed on capital flows. In Brazil, during the aftermath of stabilization, the banks’ main problem became a large volume of non-performing loans, which was an outcome of a credit squeeze associated with the government’s policy of maintaining high interest rates. In Russia, the major factor in the banking crisis was that interest rates remained high relative to the fall in inflation in the first half of 1995, limiting the funds available to some banks.\textsuperscript{26} External illiquidity did emerge in Mexico, Brazil and Russia, but only in the later stage of stabilization when capital controls either lost their effectiveness or were abandoned following the elimination of inflation. Also, the stability brought on by the exchange rate peg played an important part in attracting capital flows—a large part of which were short term.

Financial vulnerability characterized by external illiquidity can be observed in the ratio of short-term foreign debt to the central bank’s reserves. This measure is frequently used to compare a country’s short-term foreign liabilities to its liquid foreign assets available to service those liabilities in the event of a creditor run.\textsuperscript{27} In this regard, a ratio above 1.0 indicates vulnerability to a sharp reversal
of capital flows. Table 1 shows the ratios of short-term debt to foreign exchange reserves in the crisis and non-crisis emerging market economies; short-term debt refers to a country’s debt owed to international banks and due within a year.\footnote{28} 

As the data in Table 1 reveals, the basic difference between the two groups is that all crisis cases (except Malaysia) had a short-term debt/reserves ratio that was greater than 1.0. All non-crisis countries, on the other hand, had a ratio below 1.0, indicating low vulnerability. Note that in Turkey the debt/reserve ratio was close to 1.0 at the end of 1999, indicating some financial vulnerability prior to the launch of the stabilization program in January 2000. With the program’s introduction, financial vulnerability quickly deteriorated and reached 1.30 during the first nine months of 2000. Also note that Turkey’s ratio was dangerously high prior to the country’s previous crisis in 1994. These results present strong support for the argument that external illiquidity is a precondition for subsequent crisis by making an economy vulnerable to panic.

Yet, financial vulnerability does not, in itself, explain the crisis that follows. Even though these risk indicators imply vulnerability to a financial crisis, they do not guarantee its advent. Thailand, Indonesia, and Korea had short-term debt/

\begin{table}
\centering
\caption{Ratio of Short-Term Debt to Central Bank Reserves in Crisis and Non-Crisis Emerging Market Economies (Selected Years)}
\begin{tabular}{llllll}
\hline
\textbf{Crisis cases} & & \textbf{Non-crisis cases} \\
\textbf{Country} & \textbf{Year} & \textbf{Short-term debt/reserves} & \textbf{Country} & \textbf{Year} & \textbf{Short-term debt/reserves} \\
\hline
Turkey & 1993 & 1.82 & Poland & 1997 & 0.17 \\
 & 1999 & 0.91 & & & \\
 & 2000 (Q3) & 1.30 & Hungary & 1997 & 0.46 \\
Russia & 1997 & 1.51 & Czech Republic & 1997 & 0.56 \\
 & 1998 (Q2) & 3.05 & & & \\
Thailand & 1997 (Q2) & 1.51 & India & 1997 & 0.31 \\
Korea & 1997 (Q2) & 2.12 & Philippines & 1997 (Q2) & 0.92 \\
Indonesia & 1997 (Q2) & 1.78 & China & 1997 & 0.22 \\
Malaysia & 1997 (Q2) & 0.60 & Taiwan & 1997 (Q2) & 0.25 \\
Mexico & 1994 (Q2) & 1.72 & Colombia & 1998 & 0.84 \\
Brazil & 1998 (Q4) & 1.21 & Chile & 1998 & 0.57 \\
Argentina & 1999 & 1.33 & Peru & 1998 & 0.78 \\
 & 2000 & 1.54 & Venezuela & 1998 & 0.43 \\
\hline
\end{tabular}
\end{table}

reserves ratios well above 1.0 between 1994 and 1997, but they were not hit by the Mexican “tequila” crisis. Similarly, Mexico was already vulnerable to a financial crisis in 1993, but the peso came under attack only in late 1994. These observations imply that short-term debt in excess of reserves renders a country vulnerable to a financial crisis, but does not necessarily cause it. It is only when financial panic is present that vulnerability is converted into a currency collapse. I now turn to the analysis of financial panic during the recent financial crises in Turkey and draw parallels between them and the crises in Mexico, Thailand, and Brazil.

THE ROLE OF FINANCIAL PANIC IN THE TURKISH CRISSES IN COMPARATIVE PERSPECTIVE

The most dramatic aspect of the Turkish crises was the rapid and unanticipated reversal of private capital inflows. During the first ten months of the stabilization program (January–October 2000), net capital inflows to Turkey amounted to $15.2 billion. In November 2000 and February 2001, the net outflow of capital was $5.2 billion and $6.3 billion respectively. This means that the net swing in private capital flows in one year exceeded a remarkable $20 billion—or ten percent of the GDP (gross domestic product). It is very difficult to attribute this massive reversal of capital flows in such a short period of time to changes in economic fundamentals. Therefore, explanations of the Turkish crises that emphasize the growing current account deficit, the appreciation of the lira, and the overshooting of the inflation target are far from satisfactory. Rather, a sudden swing in investors’ expectations is a more compelling argument.

Unanticipated Nature of the Crisis

The financial crises in Turkey were a surprise to both market participants and analysts. Until the onset of the crisis, foreign investors maintained confidence in the Turkish disinflation strategy. In fact, one can argue that no other Turkish stabilization program has received as much support from foreign institutional investors as the December 1999 program did. This support was sustained in the face of positive economic developments after January and the government’s commitment to the program’s key aspects. As inflation began falling, economic growth returned and the Turkish government adhered strictly to the monetary and fiscal policies set out in the program.

The successful implementation of key aspects of the program, particularly concerning fiscal targets, generated an overwhelmingly positive sentiment towards Turkey in foreign markets. This remained the case until the crisis broke
out. The positive market sentiment can be observed in the assessments of credit rating agencies, the reports of market analysts, and the risk premiums attached to loans to Turkey in the months leading up to November. For instance, Standard & Poor’s and Fitch IBCA—two of the most prominent credit rating agencies—upgraded Turkey’s sovereign risk in April from stable to positive. This rating did not change until after the November crisis. During the first three quarters of 2000, Turkey was one of the most trusted countries among the emerging market economies. Analyses published by leading foreign investment banks also indicate positive sentiments towards the Turkish economy prior to the crisis. Above all, these reports did not raise any serious concern about the rising current account deficit or the partial implementation of certain structural reforms, as some ex post facto studies claim. Shortly before the November crisis, market analysts praised the fiscal measures adopted by the Turkish government for 2000.

It is true that there was a small increase in Turkey’s risk premium after September, which was reflected in the rising Eurobond spread for Turkish government securities. It is also true that there was a slight net capital outflow in September. Both of these developments, however, were related to deepening economic problems in Argentina, which led to an overall increase in the risk premiums of the emerging markets. In any event, the “Argentine effect” on the Turkish market turned out to be temporary and insignificant. Foreign capital returned to Turkey in October and the rise in the country’s spreads did not reach significant percentages.

Similarly, in Mexico (1994) and Asia (1997) the financial crises came as a surprise. As was the case in Turkey, the current accounts of Mexico and Thailand deteriorated prior to the crisis, but foreign investors seemed not to mind and rolled over the short-term debt. Moreover, at the onset of each crisis, interest rate spreads remained, by and large, constant. In Mexico, three months before the devaluation in December 1994, forecasters were expecting the Mexican peso to stay more or less the same in the foreseeable future. Prior to the Asian crisis, the risk premiums attached to loans did not change and capital inflows remained substantial. Moreover, the reports of credit-rating agencies, independent firms, and the IMF did not show any predictions of crisis. The financial risk indicators, such as the rise in short-term debts to foreign exchange reserves, were generally ignored.

An unexpected change in investor confidence can also be observed in the events that led to the Brazilian crisis in January 1999. Unlike the crises in Mexico, Thailand, and Turkey, however, this change took place due to the “contagion effect” of the Russian crisis of August 1998. On the eve of the Russian crisis, Brazil had largely overcome the negative effects of the Asian crisis and investor confidence had returned on a massive scale. In early August, central bank
reserves were extremely high and the interest rate was lower than that prevailing before the Asian crisis. Even though there were some problems with the current account and fiscal deficits, the situation in Brazil looked tolerable and manageable in the summer of 1998 and no one anticipated the collapse of its currency a few months later.\textsuperscript{37}

\textit{Triggering Events}

While conditions of vulnerability can be identified, it is extremely difficult to predict the actual onset of a crisis “since the crisis requires a triggering event that leads short-term creditors to expect the flight of other short-term creditors.”\textsuperscript{38}

The events that triggered financial panic were different in Turkey, Mexico, Thailand, and Brazil. The triggering event in Turkey’s November crisis was the liquidity problems of one bank that quickly spread to the rest of the banking sector. In Mexico and Thailand, it was the modest devaluation of the domestic currency. In Brazil, it was the default announcement of a major state governor set off the panic. These events were preceded by idiosyncratic incidents that took place in each country. In Mexico, the turning point came with the assassination of Donaldo Colosio, the presidential candidate of the ruling Partido Revolucionario Institutional (PRI) in March 1994. In Thailand, the bursting of the real estate bubble caused financial distress for companies that had huge investments in property markets financed by foreign currency loans. In Brazil, contagion from the Russian crisis had a sharp negative effect on market sentiment. In the Turkish case, the policy of a new banking agency was the primary cause for the beginning of the uneasiness in the financial markets.

The fragility of banks (or bank-like financial companies as in Thailand) played an important role in the run-up to each crisis, except in Brazil where banks had effectively hedged their borrowing in foreign-currency-to-exchange-rate risk. Above all, fragility severely constrained central bank policy following the unfavorable incidents and led to a rundown of foreign exchange reserves. The Mexican and Thai central banks were hindered in their defense of the peg by currency and maturity mismatches in the financial sector. Both central banks resisted devaluation until the last moment, while they simultaneously refused to increase interest rates. Instead, the monetary authorities in each country partially monetized the growing bank losses and increased net domestic credit. During the first half of 1997, the Bank of Thailand lent huge sums of money to illiquid and failing financial companies at a time when these companies were on the brink of bankruptcy due to falling real estate prices. Moreover, the Bank tried to increase its reserves by committing them to forward contracts, thereby exacerbating its liquidity position.\textsuperscript{39}
In Mexico, when foreign investors became uneasy following Colosio’s assassination, the central bank tried to compensate its reserve losses by denominated tesobonos, which only helped shift liquidity problems from the private sector to the government. The Turkish central bank also resorted to credit expansion when certain banks were faced with a liquidity squeeze in November. The only difference was that the liquidity injection of the Turkish monetary authorities occurred within a week in late November instead of over several months, as was the case in Thailand and Mexico. Despite this difference, the outcome of each central bank’s policy was the same: private agents quickly converted unwanted domestic currency into foreign currency, causing a drain on the central bank’s foreign exchange reserves.

Each of these four crises involved a self-fulfilling prophecy whereby panicky foreign investors stampeded to the exits. It is unlikely that the financial crises would have occurred if each investor had believed that the other investors would remain calm. In the Mexican case, investors refused to roll over tesobonos after the devaluation and thus pushed Mexico to the brink of default. When the Thai government devalued the baht in July 1997, market expectations about Thailand suddenly changed from positive to negative—leading to a massive withdrawal of funds. In Brazil, the shift in investor confidence took place alongside the outbreak of the Russian crisis when foreign investors “discovered” that both countries had pegged exchange rate regimes and fiscal deficits.40

TABLE 2

<table>
<thead>
<tr>
<th>Incident that marked the onset of financial problems</th>
<th>Central bank response</th>
<th>Triggering event for financial panic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico, 1994 Assination of presidential candidate (March)</td>
<td>Credit expansion, issuance of tesobonos (March–Dec.)</td>
<td>Devaluation (Dec.)</td>
</tr>
<tr>
<td>Thailand, 1997 Bursting of real estate bubble (early 1997)</td>
<td>Bail-out of certain financial companies, forward sales of currency reserves (first half of 1997)</td>
<td>Devaluation (July)</td>
</tr>
<tr>
<td>Brazil, 1999 Russian contagion (Aug. 1998)</td>
<td>High interest rate policy</td>
<td>Governor Franco’s default on debt (Jan.)</td>
</tr>
<tr>
<td>Turkey, Feb. 2001 Nov. crisis</td>
<td>N/A</td>
<td>“Political crisis”</td>
</tr>
</tbody>
</table>
The rush of investors to exit the Brazilian market after August caused Brazil’s central bank to lose one-third of its foreign currency reserves in September alone, while interest rates tripled. The IMF program in November temporarily stopped capital outflow, but did not fully restore investor confidence in Brazil. In a vicious circle, the steep rise in interest rates exacerbated the debt burden of the government, weakening investor confidence further. By the end of December 1998, for the first time in years, Brazil’s reserves were not adequate to cover the country’s short-term foreign exchange liabilities. The collapse of the Brazilian real came in early January when Governor Franco, the governor of Minais Gerais (the second-largest state of Brazil), declared that he would suspend his state’s debt payment to Brazil’s federal government and some other governors followed suit.\footnote{41}

Table 2 summarizes the main points discussed above, including the major incidents that marked the financial difficulties, central bank responses, and the triggering events for financial panic in the cases of Mexico, Thailand, and Turkey.

\textit{The November Crisis}

As noted above, a newly created banking agency played a major role in the making of the November crisis in Turkey. Under pressure from the IMF, the banking legislation of 1999 created the Banking Regulation and Supervision Agency (BRSA), which became operational in late August 2000. In hindsight, one can argue that as a new and independent institution, the BRSA acted too quickly and imposed regulations on the banking sector that were too harsh, causing profound anxiety in the sector. One particularly significant step taken by the BRSA was the decision to put an increasing number of banks under receivership. The owners of these banks were arrested and faced criminal investigation. These developments “greatly added to market nervousness, given the potential for repercussions in the remainder of the sector.”\footnote{42} An equally important BRSA act that intensified anxiety among bankers came in mid November, when the agency asked the banks to reduce their open positions in order to ensure that they be within the legal limits by the end of the year. This generated a growing demand for foreign currency among certain banks.

The most important consequence of the anxiety in the banking sector was a loss of faith among banks towards each other. Emblematic of this loss of confidence was the increasing resistance of banks to lend to those with temporary liquidity shortages in the interbank market.\footnote{43} For instance, first-tier banks cut their lines of credit to Demirbank, a middle-sized bank, during the third week of November—when it became obvious that Demirbank faced
temporary liquidity problems. Demirbank was not an ordinary bank in the sense that it played the role of market maker in government securities and in that it held a substantial amount of Treasury bonds in its portfolio, which were highly leveraged by short-term funds. Cut-off from the interbank market, Demirbank was forced to sell its government bond holdings at a loss to maintain liquidity in the face of the increasing cost of funds. Banks with a similar leverage problem also began to unload their holdings of government paper at discounted rates. However, the number of purchasers declined sharply, forcing certain banks to raise funds in the overnight interbank market. In only a few days, the liquidity shortage spread to the rest of the banking system. As the price of government securities fell, interbank interest rates rose, as did the demand for foreign currency. As a consequence of these developments, the sentiment of foreign investors towards Turkey shifted dramatically. During the last week of November, foreign investors—who were “unwilling to accept Turkish bank risk”—exited the overnight market by unloading government securities from their portfolios. During the first week of the crisis, the amount of capital outflow reached $5 billion. At the same time, panicky foreign banks curtailed their credit lines to Turkish banks, thereby putting them under enormous financial distress and greatly exacerbating the liquidity squeeze.

Under these circumstances—similar to the situation in Mexico in 1994 and in Thailand in 1997—the Turkish central bank faced a dilemma. Under the fixed exchange rate regime, it could either defend the currency peg at the expense of aggravating banks’ problems or it could act as a lender of last resort by supplying liquidity to the banking system. After a brief hesitation, the Central Bank started providing liquidity to troubled banks, breaching its quasi-currency board rules. As a result, the extra liquidity was merely converted into foreign exchange and further drained reserves. On November 31, the Central Bank decided to stop injecting liquidity into the banking system. In the days that followed, the overnight market interest rate soared to over 2,000 percent. The capital outflow stopped only on December 6, when an IMF-led package amounting to over $15 billion was announced. On the same day, Demirbank was taken over by the BRSA and it was announced that all credits of Turkish banks were brought under government guarantee.

In hindsight, several conclusions can be drawn from the November crisis in Turkey. First, it seems that the timing (as well as speed) of banking reform was badly managed by both the IMF and the Turkish authorities. The IMF clearly underestimated the negative effects of overhauling the banking system in the Turkish financial community during the initial critical phase of stabilization. In other words, it was as much the actions of the BRSA as its timing that amplified the liquidity problems in the Turkish banking sector. Most of these negative
effects would have been avoided if banking reform were undertaken towards the end of the program’s second year—that is, when the fall in inflation was secured and exchange rate flexibility took effect.\textsuperscript{47} It is also important to note that the IMF’s insistence on banking reform in Turkey during the early stage of an ERBS program was unprecedented in the Fund’s history. For instance, when Russia launched its ERBS program in 1995 with the support of the IMF, the Fund’s conditions left banking reform to a later stage of the program, and instead focused exclusively on fiscal and monetary policy for disinflation. In this respect, one can speak of an “overload” in the Turkish program, which can be regarded as the crucial mistake of the IMF.

The second lesson to be learned from the November crisis is that at the onset of market turmoil the Turkish banking sector as a whole was highly leveraged and perhaps somewhat undercapitalized, but it was nowhere near being insolvent. The volume of non-performing loans, a major indicator of bank solvency, was insignificant in the overall banking system, particularly in large commercial banks.\textsuperscript{48} As discussed above, the fragility of Turkish banks originated from excessive risk taking characterized by maturity and currency mismatches. Given this serious external illiquidity, the demand for large sums of foreign currency could not be met by the central bank during the panic.

\textit{The February Crisis}

The November crisis had some ramifications for the crisis that occurred three months later. However, as discussed below, the latter crisis was not a natural extension of the former. In the aftermath of the November crisis, confidence in the stabilization program weakened. This was reflected in the rise of Turkey’s risk premium, despite the strong support of the IMF. In December and January, this weakened confidence among market participants also manifested itself in the very short-term basis (mostly overnight) of capital flows and investors’ demands for higher interest.\textsuperscript{49} Financial panic was thus less pronounced during the February crisis because the expectations of market participants were less optimistic about Turkey than they had been prior to November. Nevertheless, prior to the February crisis there were signs of a return to normality. By early February, the situation in the Turkish markets had, by and large, stabilized. The central bank’s reserves were at an all time high, interbank interest rates had fallen to their pre-November levels and the stock market was on the rise.\textsuperscript{50} At the time, Deutschebank—one of the main participants in the Turkish financial market—was not expecting a “currency event” in Turkey.\textsuperscript{51} Thus, only an exogenous shock in the form of an unexpected and extraordinary event could trigger a crisis.
This event came on February 19, when Prime Minister Bülent Ecevit disclosed that he had had a serious dispute with the president during a meeting of the National Security Council and that, as a result, the country was in the midst of a “political crisis.” The announcement immediately translated into the perception in the financial markets that the ruling coalition—and hence the stabilization program—could be unraveling. In the two subsequent days, a major speculative attack on the lira took place as panicky investors (first resident and later non-resident) tried to convert their lira-denominated investments into dollars. Rumor-mongering about the IMF’s demand for devaluation (which later turned out to be true) exacerbated the panic. The sudden and massive demand for dollars caused a tremendous liquidity squeeze for banks as they rushed to the interbank market to raise liras to be used to buy dollars from the Central Bank. Unlike during the November crisis, this time the Central Bank refused to act as lender of last resort and did not provide liquidity to banks. As a consequence, overnight interest rates skyrocketed. When two public banks were unable to meet their lira obligations to other banks on February 21, the interbank payments system ceased to function altogether. The next day, under pressure from the IMF, the government announced the floatation of the lira, bringing the stabilization program to an early end.

Many studies of the Turkish financial crises claim that any number of exogenous events could have triggered the crisis after November, given Turkey’s weak fundamentals. Such deterministic accounts, however, fail to recognize the fact that Ecevit’s behavior was neither preordained nor commonplace. At a time when markets had pinned their hopes on the continuity of the coalition government for the success of the stabilization program, a statement about “political crisis” was the worst possible blow to market confidence. It is true that the financial sector was fragile, that two state-owned banks were short of funds, and that uneasiness in the Turkish markets had not entirely subsided. But there was no reason other than a gargantuan policy mistake to convert these weaknesses into a major crisis. Had it not been for Ecevit’s irresponsible proclamations, the stabilization program would most likely have survived, at least until the transition to exchange rate flexibility.

CONCLUDING REMARKS

This contribution argued that the 2000–1 Turkish financial crises resulted from a vulnerability to financial panic that was generated by external liquidity problems. The Turkish stabilization program carried certain risks from the outset and contributed to financial vulnerability in significant ways. The most risky element of the program was the adoption of a pegged exchange rate regime...
against the background of a modestly vulnerable banking system and at a time when the country was highly integrated in global financial markets. By engendering a lending boom financed by short-term capital flows, the program heightened financial vulnerability during the course of 2000. In light of the above, there was little the government could do in the short term to prevent the deepening financial vulnerability. One might think that some sort of temporary control on capital flows could have mitigated the external liquidity problems. Any control, however, would not only have been difficult to implement but also would likely have caused substantial turmoil in the markets and made the implementation of the disinflation program extremely difficult right from the beginning. Pegging the exchange rate may not have been the best choice of disinflation strategy for Turkey, but an alternative one was not clear at the time.

Turkey lost the gamble it took with the stabilization program, but this outcome was not inevitable. Financial vulnerability reached crisis proportions because it was accompanied by a string of policy mistakes and accidents. The November and February crises could have been avoided if these policy mistakes had not been made. Arguments that attribute the causes of the Turkish financial crises solely to macroeconomic imbalances or exclusively to the design flaws of the stabilization program provide only a partial explanation. Certainly, these factors contributed to the vulnerability of the Turkish economy, but they do not explain the timing and magnitude of the crises. The Turkish turmoil is another testament to the deficiencies of international capital markets.

In the year following the two financial crises, the Turkish economy experienced a severe contraction. Mexico and Thailand also experienced a sharp economic decline following their financial crises, and Brazilian growth slowed down substantially in 1999. All four countries received large emergency loan packages from the IMF, repaid their short-term debts and, thereby, were able to avoid a default. In each country, modest-to-high economic growth returned the following year. When all of these statements and arguments are taken into account, it is difficult to understand the market’s failure to roll over short-term debts as anything other than panic. As international capital markets are susceptible to panic, the solution to financial crises should be sought in international mechanisms—such as an international bankruptcy court—that can deal with creditors and the borrowing country during a financial crisis.56

NOTES

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5. See Graciela L. Kaminsky and Carmen M. Reinhart, “The Twin Crisis: The Causes of Banking and Balance-of-Payments Problems,” *American Economic Review*, Vol. 89 (June 1999), pp. 473–500. One main reason for an emphasis on banks in currency crises is that banks are special actors within the financial sector in almost all countries, but even more so in emerging market economies where banks intermediate most capital flows.


8. As Rodrik and Velasco note: “putting in place an adequate set of prudential and regulatory controls to prevent moral hazard and excessive risk-taking in the domestic banking system is a lot easier said than done. Even the most advanced countries fall considerably short of the ideal, as their bank regulators will readily tell you.” See Dani Rodrik and Andrés Valesco, “Short-term Capital Flows,” Paper prepared for the 1999 ABCDE Conference at the World Bank, April 1999.


13. As Furman and Stiglitz write: “There is overwhelming evidence that financial liberalization increases the vulnerability of countries to crises.” See Jason Furman


16. Turkey survived the Russian crisis in 1999 mainly due to such exchange rate flexibility, which acted as a shock absorber.


18. For details of the program, see the Letter of Intent of the Turkish government to the IMF at <http://www.imf.org/external/np/loi/l 999/120999.htm>.


23. It is ironic that a recent IMF study, which was written around the same time as the Turkish disinflation program was formulated, draws attention to “the difficulties and dangers of running pegged or quasi-pegged exchange rate regimes for emerging market economies with substantial involvement in global markets.” See Mussa et al. (2000), p. 21.

25. The opening of the GKO market to foreigners prompted a rush on Russian securities. By late 1997 over one-third of the GKO market became dominated by foreign investors. For details of the developments in Russia between 1995 and 1998, see Brigitte Granville, “The Problem of Monetary Stabilization,” in Brigitte Granville and Peter Oppenheimer (eds.), Russia’s Post-Communist Economy (New York: Oxford University Press, 2001), pp. 93–129. The reasons for the initial restrictions on foreign investors in the GKO market appear to be twofold: the Russian authorities were concerned about the adverse effects of hot money and the government’s desire “to protect the domestic banking system sector against a rapid fall of yields” (ibid., p. 115).


28. A “crisis” is defined as a situation in which one of two conditions is present: 1) there is a reversal in net foreign capital flows of at least five percent; 2) currency is devalued by 25 percent or more.


34. See DPT (2001); Kadiğolu et al. (2001).


40. There was also some direct and mechanical contagion from Russia to Brazil. The Russian moratorium on its public debt “produced large losses for major Western financial institutions and led them to sell assets in emerging markets to raise funds to cover their losses, thus creating an outflow of capital from those markets. This affected Brazil in particular because the markets for Brazilian equities and Brady bonds [were] the largest and most liquid of emerging markets, and play important roles in global arbitrage strategies.” Cited in Luiz Fernando R.de Paula and Antonio José Alves Jr., “External Financial Fragility and the 1998–1999 Brazilian Currency Crisis,” *Journal of Post Keynesian Economics*, Vol.22, No.4 (Summer 2000), p. 614.

41. Since investors’ principal concern about the exchange rate had been Brazil’s ability to maintain fiscal balance, to pay its debts, and to resist the temptation to pay them through monetization, Franco’s announcement led to the acceleration of capital outflows. See Victor Bulmer-Thomas, “The Brazilian Devaluation: National Responses and International Consequences,” *International Affairs*, Vol.75, No.4 (1999), pp. 729–41.


45. OECD (2001), p. 10. It is estimated that Deutschebank unloaded $750 million worth of government securities in a single day, see Uygur (2001), p. 17.


47. Some authors argue that banking reform should have been implemented prior to the introduction of the program. See Akyuz and Boraatav (2002); C.Emre Alper and Ziya Öniş, “Soft Budget Constraints, Government Ownership of Banks and Regulatory Failure: The Political Economy of Turkish Banking System in the Post-Capital Account Liberalization Era,” mimeograph, Koç University (2001). However, since banking reform takes a long time, its earlier launch would necessarily coincide with the critical first year of the stabilization program. One should also note that IMF policies towards the restructuring of financial companies in Thailand and banks in Indonesia in the midst of the 1997 crisis had disastrous
economic consequences for both countries. For a critique of this and other policies of the IMF, see Joseph E. Stiglitz, Globalization and Its Discontents (New York: W.W. Norton, 2002). For a vivid journalistic account of IMF policies during the Asian crisis, see Paul Bluestein, The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF (New York: Public Affairs, 2001).

50. Ibid.
52. The apparent reason for the dispute was the president’s charge that the Ecevit government was not undertaking the necessary measures to fight corruption among public officials.
54. Among others, see Yeldan (2001).
55. For a discussion of the weakness of public banks, see Alper and Öniş (2001). The liquidity shortage of the two public banks seems to have originated from the Treasury’s failure to cover the quasi-fiscal losses (“duty losses”) these banks incurred through directed lending to various sectors, particularly agriculture.
56. A discussion of this issue, however merited, is beyond the scope of this contribution.