

Turkey's Adjustment Experience, 1980-85

Economic growth and stabilization, achieved through outward-looking policies, implemented in a favorable sociopolitical climate and supported by external assistance on a large scale

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Beset by a severe economic crisis, social unrest, and political instability, in 1980 Turkey launched a far-reaching stabilization and structural reform effort, which set the stage for a rapid export-led economic recovery and a significant correction of external and domestic imbalances. Although not yet completed, the Turkish adjustment—traced through 1985 in the present article—illustrates that the success of such an effort depends not only on the adequacy of economic policies but also on the sociopolitical climate and external assistance. In Turkey, on balance, these three fundamental criteria appear to have been met.

Background

In the early 1970s Turkey achieved rapid economic growth, while maintaining a moderate rate of inflation and a surplus in the external current account. In the wake of the first oil crisis, the government persevered with an ambitious inward-looking development strategy and sought to shelter the economy from the deterioration in the terms of trade. During 1973-76 the growth of real GNP averaged almost 8 percent a year, paced by an increase in real fixed investment of some 16 percent yearly. This was achieved, however, at the cost of mounting internal and external imbalances. The deterioration in public finances was particularly acute: in 1977 the public sector borrowing requirement had reached the equivalent of more than 11 percent of GNP, compared with 2 percent of GNP in 1973. Excess demand, fueled by expansionary fiscal and monetary policies, contributed to a considerable weakening in the balance of payments and to a rise in inflationary pressures. The current account moved from a surplus of $0.7 billion in 1973 to a deficit of $3.1 billion in 1977, reflecting the sharp rise in the oil import bill coupled with stagnation in exports and workers' remittances. The deficits were financed mainly with short-term borrowing. With rapidly shrinking external reserves, Turkey became less and less able to meet mounting import and debt-service payments, which resulted in the accumulation of arrears and a virtual drying up of normal sources of financing.

In 1978-79 the authorities made several attempts to arrest the deterioration of economic conditions. In spite of debt reschedulings and the provision of some external assistance, these attempts met with little success. The operating losses of state economic enterprises (SEEs) rose sharply and the public sector borrowing requirement remained high. Wage settlements likewise were excessive. Adjustments of the exchange rate and interest rates, meanwhile, failed to keep up with a sharp acceleration in the rate of inflation; external competitiveness weakened further and financial disintermediation (whereby money assets were replaced by nonfinancial assets) proceeded apace. In these circumstances, the narrowing of the current account deficit by more than one half between 1977 and 1978-79 was forced by the lack of external financing and accomplished chiefly through a drastic curtailment of imports. In turn, widespread shortages of essential inputs led to a drop in industrial output and exacerbated the rate of inflation. In 1979, the average rate of inflation escalated to more than 70 percent, while real GNP fell for the first time in more than two decades.

Parallel with the economic deterioration, Turkey underwent a major political and social crisis. Weak left-of-center and right-of-center coalition governments rapidly succeeded one another, unable to cope with growing labor strife and urban terrorism.

Sociopolitical conditions

It was against this background that in January 1980 a two-month old minority government unveiled a comprehensive economic policy package based on an outward- and market-oriented approach, breaking with the inward-looking *étatist* strategy of the previous five decades. However, civil unrest continued through most of 1980, as evidenced by close to 200 politically motivated murders a month, while labor negotiations became increasingly confrontational, often involving prolonged strikes and lockouts.

The breakdown of law and order was halted by a military takeover in September 1980. From the outset, the military government endorsed the economic policies of the previous government (retaining key members of the former economic team) and announced its intention to return the country to civilian rule at the earliest opportunity. In November 1982, a new constitution was approved by referendum, and as mandated by the constitution, a president was elected for a seven-year term with extensive authority. Despite some limitations on political parties and candidates, in November 1983 the first

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parliamentary elections were held since the advent of military rule. The new government –which since then has withstood additional electoral tests in the context of an apparently broader political participation–stepped up the pace of structural reform.

In spite of a temporary suspension of some civil liberties, in particular immediately after the military intervention, since September 1980 Turkey has enjoyed a considerable degree of political and social stability. Since its inception in January 1980, successive administrations–both civilian and military–have been firmly committed to the adjustment program, notwithstanding occasional slippages in implementation. Economic policies have been subject to intense public debate; however, except for groups adversely affected by certain measures, the program seems to have been supported, or at least tolerated, by large segments of the population.

External assistance

In support of the program, in June 1980 the Fund approved a three-year stand-by arrangement for SDR 1,250 million (625 percent of Turkey's quota at that time) which was fully utilized, followed by a one-year stand-by for SDR 225 million (75 percent of quota); the latter was cancelled and replaced in April 1984 by another arrangement of the same magnitude. In all, over the period 1980-85, the Fund made available SDR 1.7 billion (of which SDR 1.5 billion was utilized), while the World Bank extended $1.6 billion in five consecutive structural adjustment loans–besides sizable project loans. Turkey also received concessional balance of payments credits in excess of $1.5 billion from official sources, under the auspices of the Organisation for Economic Co-operation and Development (OECD) and from Saudi Arabia. Over the program period, balance of payments assistance from the Fund, the Bank, and bilateral sources totaled more than $5 billion. In addition, more than $6.5 billion in short-and medium-term obligations, including interest payments, falling due in 1980-84 (some of them restructured previously) were restructured through the OECD and by private creditors.

Structural reform

Domestic pricing. In 1980 the government freed private sector prices and sharply adjusted prices of basic commodities and services produced by SEEs and state monopolies. Except for a few items whose prices continued to be subsidized, SEEs were instructed to set prices on the basis of cost developments. Subsidies on agricultural products and inputs were also reduced considerably.

Interest rates. After several small increments, time deposit rates were decontrolled in July 1980, allowing commercial banks to determine rates by agreement among themselves. Since December 1983, the central bank has reviewed and set ceilings on deposit rates at least every three months taking into account fluctuations in the rate of inflation; on the lending side, banks were allowed to set nonpreferential rates freely. Since around mid-1981 and except for parts of 1983 and 1984, key time deposit and lending rates have been positive in real terms.

Wage determination. In September 1980 the authorities introduced an incomes policy that has been followed until the present. Centrally determined wage increases on the basis of yearly inflation targets–but lagging behind actual price developments–became mandatory for the public sector and have been used as guidelines in the private sector.

Exchange rate policy. Following a 33 percent devaluation of the Turkish lira in January 1980, the central bank began to adjust the exchange rate with increasing frequency so as to compensate for differences in inflation rates at home and in major industrial partner countries; since May 1981 adjustments in the nominal rate have taken place daily. Over the 1981-85 period, the lira was depreciated in real terms on average by about 4 percent a year, although subject to some short-run fluctuations connected with efforts to dampen inflationary pressures--particularly in the later part of 1984.

Foreign trade and investment. By the end of the 1970s, Turkey had a highly restrictive import regime characterized by quotas, licensing, tariffs, tariff-like charges, and an advance deposit requirement. These restrictions were relaxed significantly in 1980-81, and a further major liberalization took place in 1984 when most imports were freed from licensing. By the end of 1985, quantitative restrictions had been removed, many tariff rates were lowered, and deposit requirement rates reduced to a low level. Fiscal and financial export subsidies, which had been intensified in the initial phase of the adjustment program, were trimmed starting in 1984; also, export restrictions (licensing and price controls) were abolished in 1984. Restrictions on direct investment inflows were eased considerably.

Exchange and payments. Early in the program, most multiple currency practices and bilateral payments agreements were terminated, and foreign exchange regulations affecting commercial banks and exporters were eased. In January 1984, the exchange and payments system was liberalized in several important respects: domestic banks were allowed to engage in foreign exchange operations within broad limits; the surrender requirement was reduced substantially on export earnings; foreign exchange deposits, yielding market interest rates, could be opened and used without limits; and restrictions on foreign travel and other invisible transactions were eased and simplified.

Financial sector. Between 1983 and 1985, the liquidity and reserve requirement system was simplified and made more effective: legally required ratios were unified and lowered, the time period permitted for compliance was shortened, and interest payments on reserves were abolished. Preferential credit facilities were reduced. Major banking reform legislation was completed in April 1985, with provisions on capital requirements, contingency reserves, accounting and reporting standards, deposit insurance, branch banking, and ownership and management requirements. Also, a number of institutional measures were taken to develop capital markets.

Nonfinancial public enterprises. From the outset of the program, the authorities acted not only to adjust the prices of SEEs toward covering production costs, but also enforced a hiring freeze and slowdown of wage increases. The concomitant reduction in financing needs permitted a sharp cutback in bank lending and budgetary transfers to SEEs. In October 1983, the legal basis for SEE reform was established, requiring SEEs to be run along commercial lines. By the end of 1984, SEEs had lost almost all preferences accorded previously as regards taxes, tariffs, and credits. In May 1986, the government obtained legislative authority to sell SEEs to the private sector.

Taxation. In 1981, personal income tax brackets were raised sharply to compensate for inflation, while marginal tax rates were restructured providing for a gradual reduction of all rates over a four-year period. The corporation income tax was unified for all corporate taxpayers, including SEEs. In 1984, there were substantial cuts in the rates of withholding taxes on financial income and transactions. In January 1985, Turkey substituted a 10 percent value-added tax for production taxes and other duties.

Demand management

Whereas steady and significant progress was made in implementing structural measures, demand management was applied unevenly. Following a restrictive stance in 1981-82, financial policies were relaxed until 1985 when they became somewhat tighter again.

As a result both of expenditure restraint and of some rise in tax effort, the ratio of the consolidated central government budget deficit to GNP was more than halved between

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Turkey: selected economic indicators, 1977-85

	1977	1978	1979	1980	1981	1982	1983	1984	1985
				(Annual percentage change)					
Real GNP	3.9	2.9	−0.4	−1.1	4.1	4.6	3.3	5.9	5.1
Implicit GNP deflator	24.5	43.8	71.1	103.8	41.9	27.5	28.0	50.1	43.6
Interest rate (percent per annum)[1]	4.8	6.6	9.0	10.8	34.5	37.5	30.0	44.8	45.9
Real broad money (M2)	0.6	−7.9	−10.2	−22.6	21.6	33.1	7.6	−0.2	12.5
Terms of trade	−0.6	−7.0	−0.3	−22.7	−8.6	−0.6	−6.0	0.6	−1.2
Real effective exchange rate[2]	1.0	−3.8	12.7	−22.8	1.9	−11.4	−1.9	−2.1	−0.1
				(In billions of dollars)					
External current account balance	−3.1	−1.3	−1.4	−3.4	−1.9	−0.9	−1.9	−1.4	−1.0
Merchandise exports, f.o.b.	1.8	2.3	2.3	2.9	4.7	5.9	5.9	7.4	8.3
Balance of payments assistance[3]	—	0.3	0.3	1.0	0.8	1.2	0.8	0.9	0.2
				(In percent of GNP)					
Public sector borrowing requirement[4]	11.3	10.5	8.5	10.2	6.5	6.1	6.4	8.1	5.2
Debt service ratio (percent of foreign exchange earnings)[5]	23.3	26.2	23.5	24.0	22.4	25.2	28.0	24.8	29.3

Sources: Data provided by the Turkish authorities; and Fund staff estimates.
[1]After-tax six-month time deposit rate.
[2]Weighted by the geographic distribution of Turkey's 1980 merchandise exports to major industrial countries. An increase indicates appreciation.
[3]Gross disbursement of general purpose balance of payments loans from the IMF, World Bank (SALs), and other official sources.
[4]Borrowing requirement of the central government, local governments, and nonfinancial SEEs.
[5]Amortization of medium- and long-term obligations plus interest payments, after debt relief.

1980 and 1982, from over 5 percent to 2 percent. The financial position of SEEs also improved. Thus, the public sector borrowing requirement fell by more than 4 percent of GNP, facilitating a tight monetary policy stance. In the latter part of 1982, however, financial policies began to ease. In the wake of a financial crisis in the middle of that year—brought about largely by interest-rate deregulation in the absence of safeguards against unsound financial practices and protection of bank deposits—monetary control was eased. Encouraged by a temporary deceleration in the rate of inflation, in 1983 the authorities lowered time deposit rates significantly.

As inflation reaccelerated, from the end of 1983 onwards, on various occasions the authorities sought to reinstate monetary tightness through a more active interest rate policy, reductions in rediscount operations and increments in the legal liquidity ratio. These steps, however, were not sufficient to offset the liquidity injection associated with the improved balance of payments position, rapid accumulation of newly opened foreign exchange deposits—left outside the scope of monetary control—and ongoing financial innovations.

The main obstacle to sterilizing the liquidity buildup stemming from external sources and from financial reforms was the deterioration in public sector finances. Failure to take adequate budgetary action to compensate for the impact of tax rate cuts led the consolidated budget deficit to rebound to nearly 5 percent of GNP by 1984. The slippage in the budget was largely corrected in 1985, when the introduction of the value-added tax contributed to a reduction in the budget deficit to the equivalent of around 2 percent of GNP. Meanwhile, there were further gains in the profitability of nonfinancial SEE operations, with the operating surplus of enterprises rising from virtually nil in 1980 to about 4 percent of GNP in 1985, while the net inflow from the consolidated budget (i.e., transfers less direct taxes), in excess of 4 percent of GNP, turned into a small net outflow.

Economic results

Restrictive demand management led to a rapid deceleration of the inflation rate from 104 percent in 1980 to about 28 percent in 1982. Spurred by the decontrol of time deposit rates and the downturn in the rate of inflation, real broad money balances increased by two thirds between 1980 and 1982. The revival of financial intermediation facilitated a significant recovery of fixed capital formation and output. Following a two-year contraction, real GNP growth exceeded 4 percent in both 1981 and 1982; real private fixed investment rose above 5 percent in the latter year. Despite a marked deterioration in Turkey's terms of trade and weakening in import demand abroad, the external current account deficit was cut from $3.4 billion in 1980 to $0.9 billion in 1982, as export volume more than doubled and workers' remittances and other income from services increased significantly. The foreign balance contributed almost one half of real GNP growth in 1981-82.

In 1983 there was a setback in overall performance. Real GNP growth fell by more than 1 percentage point and the external current account deficit rose to $1.9 billion owing in part to a weather-related shortfall in agricultural production and a weakening of export prices. In addition, relaxation of financial policies contributed to an acceleration of domestic demand growth, thus exacerbating the external imbalance, while some necessary price adjustments were postponed until after the November elections.

In 1984, the delayed price adjustments in combination with a stepped-up depreciation of the lira, removal of export restrictions and sustained surge in domestic demand, resulted in an inflation rate in excess of 50 percent. Real GNP growth rebounded to nearly 6 percent partly on the strength of an export-led expansion of industrial output. With the enhanced competitiveness of the lira and the liberalization of the trade regime, the external

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current account deficit fell to $1.4 billion. By the end of 1984, gross foreign exchange reserves of the banking system had reached an unprecedented level of $3.1 billion, equivalent to nearly four months of imports.

In 1985–the first year without debt relief and without a stand-by arrangement with the Fund since 1978–Turkey made further progress toward adjustment. Buoyed by a continued rise in merchandise exports and a strong growth in tourism, the current account deficit was reduced further, to $1 billion or 2 percent of GNP, while economic growth remained at 5 percent. The introduction of the value-added tax contributed to a surge in the annualized rate of inflation to close to 60 percent in the first quarter; however, by the end of the year, the rate of inflation fell below 40 percent. At end-1985, total external debt stood at $25.4 billion (equivalent to almost one half of GNP), of which $6.6 billion constituted short-term obligations–one half in the form of emigrants' deposits.

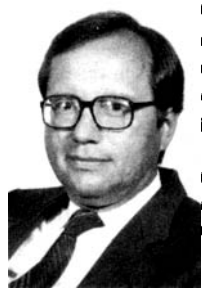
Overall, the Turkish recovery was underpinned by a dramatic growth and diversification of exports of goods and services (construction, transport, and tourism). Between 1980 and 1985, the share of merchandise exports in GNP had more than tripled, to an unprecedented 15 percent. Although aided to an extent by Turkey's geographical location, successful market penetration can be ascribed chiefly to the application of appropriate policies--notably, a flexible exchange rate and external liberalization. The share of Turkish exports in total exports of non-oil developing countries to industrial countries rose from less than 1 percent to near 2 percent and to Middle East partner countries from 4 percent to 20 percent during this period.

International capital markets reacted favorably to Turkey's external performance. In addition to project-related borrowing and trade credits, Turkey obtained spontaneous medium-term balance of payments support loans totaling $1 billion over the period 1983-85 from commercial banks abroad. At the same time, however, multinational firms did not expand operations significantly in Turkey; in spite of the liberalized treatment of incoming foreign investment, their perception seemed to be that the economic environment was not yet sufficiently stable.

The least tractable aspect of the adjustment effort centers on the program's social consequences. Here, data are limited. Arguably the increase in the recorded rate of unemployment (from about 15 percent to over 16 percent) between 1980 and 1985 stemmed largely from a structural decline in agricultural employment and a marked deceleration in the growth of demand for Turkish workers abroad, rather than from economic policies. Indeed, during the program period, the annual growth in nonagricultural employment averaged almost 3 percent, notwithstanding the freeze on public sector hiring. Further, while average gross real wages are estimated–on the basis of data on a limited sample of the workforce–to have fallen more than 3 percent yearly since 1980, the real take-home pay of workers (after taxes and transfers) is estimated to have increased yearly by about 3 percent in the private sector and by close to 5 percent in the public sector.

Conclusion

The adjustment program adopted by Turkey in 1980 has been reasonably successful in reducing the external disequilibrium, bringing down the rate of inflation and restoring a satisfactory growth rate, despite a sharp deterioration in the terms of trade and weakening in foreign demand. This performance–when compared with a number of less successful experiences elsewhere–is attributable to the combination of three basic elements that were present in the Turkish case. First, apart from some slippages in policy implementation–in particular as regards demand management in 1983-84–the Turkish program consisted of a fairly comprehensive, consistent, and well-sequenced set of stabilization and structural measures. Second, these economic policies were implemented in a stable social and political climate that evolved shortly after the beginning of the program; moreover, with minor exceptions, the authorities were deeply committed, while the population, albeit with some reservations, tacitly endorsed the adjustment program. Third, the program was supported with external assistance by multilateral institutions, official sources, and commercial banks, in an amount broadly commensurate with the financing need and the policy effort. ■



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