INSTITUTE
FOR
POLICY
REFORM

The Economics of Turkish Trade Policy Reforms in the 1980s

Anne O. Krueger

Arts and Sciences Professor of Economics
Duke University

and

Senior Research Fellow
Institute for Policy Reform

Draft: March 1991

Interactions of inappropriate policies and an understanding of bottlenecks are keys to reforms to improve economic performance. This research addresses the economic causes of the 1980 Turkish economic crisis, and the alternatives the Turkish government might have adopted. It then traces the follow-up policy changes undertaken during the 1980s, and the associated economic responses. The response to the 1980 crisis in Turkey differed from responses to crises in 1958 and in 1970 by addressing the underlying causes of the economic crises: measures taken in 1980 included liberalizing foreign trade, departing from the import-substitution strategy, and diminishing the role for state economic enterprises. These reforms reoriented the Turkish economy from an inward-looking, insulated one to an outer-oriented economy in which exports have been a major engine of growth.

The Economics of Turkish Trade Policy Reforms in the 1980s

After the dissolution of the Ottoman Empire, Turkey was led into nationhood by Kemal Ataturk, who had earlier been a key general in the Ottoma army. From a religious empira, Ataturk's vision was to transform the country into a modern, western democracy. To that end, the Roman alphabet replaced the Arabic, the fez was outlawed, universal primary education was set as an important goal, Islamic law was replacled by the Swiss legal code, and Turkey was declared a secular state. By the time Ataturk died, in the late 1930s, his vision of a modern Turkey was widely, but not universally, accepted in Turkey, and the military viewed its role in national life as being Ataturk's continuing representative, protecting the nation from any threats to the success of Ataturk's reforms and overseeing the continuing Westernization of the country.

One of Ataturk's legacies was the introduction of "etatism" as the guiding rationale for economic policy.[2] In operational terms, this meant two things. First, a large group of state-owned enterprises were established which produced goods and services in agriculture (primarily distribution and provision of

The Economics of Turkish Policy Reforms in the 1980s[1]

After the dissolution of the Ottoman Empire, Turkey was led into nationhood by Kemal Ataturk, who had earlier been a key general in the Ottoma army. From a religious empire, Ataturk's vision was to transform the country into a modern, western democracy. To that end, the Roman alphabet replaced the Arabic, the fez was outlawed, universal primary education was set as an important goal, Islamic law was replacled by the Swiss legal code, and Turkey was declared a secular state. By the time Ataturk died, in the late 1930s, his vision of a modern Turkey was widely, but not universally, accepted in Turkey, and the military viewed its role in national life as being Ataturk's continuing representative, protecting the nation from any threats to the success of Ataturk's reforms and overseeing the continuing Westernization of the country.

One of Ataturk's legacies was the introduction of "etatism" as the guiding rationale for economic policy.[2] In operational terms, this meant two things. First, a large group of state-owned enterprises were established which produced goods and services in agriculture (primarily distribution and provision of

---

[1] This paper draws in large part on Anne O. Krueger and Okan Aktan, Turkish Trade Policies in the 1980s and Their Effects, forthcoming, International Center for Economic Growth. I am heavily indebted to Okan Aktan for his collaboration in that project and to the many individuals and organizations who assisted in providing data and information. A list of those individuals and organizations is found in Krueger and Aktan (1990). Special mention should, however, be made of the International Center for Economic Growth, which provided much of the funding for the larger study, and to the Central Bank of Turkey for support of research in Turkey. David Orsmund was a valuable assistant throughout. Thanks are also due to the Ford Foundation for support of the Project on the International Political Economy of Policy reform.

[2] See Okyar (1962) for an excellent account.

inputs), mining, communications, transportation, and manufacturing. This sector, which consisted of State Economic Enterprises (SEEs) established under Ataturk and subsequently, accounted for more than 50 percent of the value of manufactured output, and an even larger fraction of minerals output by the early 1950s. The second operational implication was that the state should actively regulate the activity of the private sector, controlling imports (both to protect against foreign competition and to "protect the value of the Turkish currency"), regulating prices, and otherwise guiding economic activity.[3]

From the 1930s until 1980, this activist "leading" role of the state in economic activity was never fundamentally questioned in Turkey. In part because the SEEs were part of Ataturk's legacy, in part because of a historically deep-seated suspicion of foreign trade[4], inward-looking policies toward foreign trade and economic growth were adopted and carried out with very little internal criticism.[5]

This virtually universal acceptance and support of economic policies had persisted through two major economic crises in Turkish economic life, one in 1950 and the other in 1970. In both those crises, the response had been to take short-term monetary and fiscal corrective measures, leaving the underlying

---

[3]In the 1920s, Ataturk had initially relied upon the market mechanism for economic growth. This policy was abandoned in the mid-1930s when the impact of the Great Depression was felt.

[4]Under the Ottoman Empire, debts had several times mounted to a point where the Ottomans were unable voluntarily to service them. The creditor nations had in effect taken over the collections of customs duties, and generally kept tariffs fairly low. In the 1923 treaty settling Turkish-Greek disputes, control over customs duty collections and rate determination was retained by the foreign powers until 1929 (the Capitulations). This intrusion on sovereignty was greatly resented by Turkish nationalists. Many Turks also blamed this praactice on Turkey's failure to share in the economic growth of Europe.

[5]Among Turkish economists, some voices of criticism were being raised in the 1970s, but these were a small minority of the profession.

approach to trade policy and economic growth through import-substituting industrialization unchallenged and unchanged.

By January 1980, yet another major economic crisis confronted the Turkish Republic. That crisis had already persisted for over three years, and during that time, two efforts - similar to 1958 and 1970 - to stem the crisis had been made, but without lasting effects. In 1980, the government's policy response was significantly different from earlier times: on January 24, 1980, the Turkish government announced a major economic reform program. Many of the policy changes - a change in the exchange rate, major increases in prices of goods and services sold by public sector enterprises, inauguration of a stabilization program backed by the International Monetary Fund - had also been components of earlier packages of measures in 1958 and 1970. Indeed, in 1977 and 1978, stabilization programs had been announced, although they had not been executed for any period of time and had been ineffective. What differed in 1980 from earlier programs were the many statements by high government officials that, in addition to the usual stabilization measures, it was intended to liberalize the economy more generally, including liberalization of the foreign trade regime, departure from the import-substitution strategy, and a much diminished role for State Economic Enterprises. Further, the 1980 measures were said to be only the beginning of the reform program.

This paper addresses the economic causes of the 1980 crisis, and the alternatives the Turkish government might have adopted. It then traces the follow-up policy changes undertaken during the 1980s, anad the economic responses to them. A companion paper, by Ilter Turan, considers the politics of the crisis, the reform program, and its aftermath.

The reform program, judged on its economic merits, has not been successful in all dimensions. One of its purposes was to break inflation, which had reached an annual rate of about 110 percent, as measured by the consumer price index, by the beginning of 1980. Although the rate of inflation subsequently fell to around 30 percent by 1983, it rose thereafter, and stood at rates between 65 and 75 percent in the autumn of 1989 and the winter of 1990. The macroeconomic stabilization objectives, announced in January 1980, were therefore only partially and temporarily achieved, and inflation remains a major economic and political problem.

Nonetheless, the achievements of the Turkish program of economic liberalization and switching to an outer oriented trade regime were remarkable by any standard. The Turkish economy has been reoriented from an inward-looking, insulated, one, to an outer-oriented economy. Exports have been a major engine of growth. Turkey's exports measured in U.S. dollars grew at an average annual rate of 22.2 percent from 1981 to 1985 at a time when world trade was almost stagnant. They continued to grow rapidly in the latter half of the 1980s, reaching U.S.$11.7 billion in 1988. Exports increased from 7.1 percent of GNP in 1980 to 21.3 percent of GNP in 1987.

Turkey had accumulated sizeable debts to official and private creditors in the 1970s, and faced a debt crisis in January 1980 as severe as the crises which were to confront Mexico, Brazil, Argentina, and other heavily indebted countries in 1982-83. While other developing countries struggled and failed to resume growth and restore creditworthiness, Turkish economic growth accelerated and Turkey was creditworthy throughout the worldwide recession of 1980-83 and beyond.

Any analysis of the 1980s reforms must start with an understanding of the context in which reforms took place. Such a context includes both the circumstances of the Turkish economy and Turkish economic policy prior to January

1980, and also the macroeconomic environment within which trade and exchange rate policy had its effects after the January 1980 reforms.

To that end, the analysis starts with an account of Turkish economic policy and performance prior to the start of the reforms. Section 1 briefly chronicles Turkish economic policy and economic growth prior to 1980, with particular attention to those policies and factors that contributed to the economic crisis, as well as to those features of the Turkish economy whose understanding is important in interpreting later events. Section 2 then analyzes the situation as of the late 1970s, and the earlier, 1977 and 1978, failed reform programs. Section 3 next provides an account of the policy reforms undertaken during the early 1980s, the first phase of the reforms. Section 4 then traces policy changes after 1983. Section 5 then provides an overview of the economic consequences of the reforms. A final section evaluates the overall Turkish policy reform experience.

1. The Turkish Economy before 1973

Growth and Structure

Turkey is a country of 55 million people, straddling Europe and Asia. Although Turkish economic growth was reasonably rapid from 1950 to 1975, averaging about 5.5 per cent annually, a high rate of population growth (over 2.5 percent annually) resulted in per capita income growth of just over 3 per cent annually. After 1975, a variety of economic problems resulted in the stagnation of real GNP, and a consequent drop in per capita income in the subsequent five years. By 1980, Turkey was in crisis, with falling output and a very high rate of inflation.[6]

[6]See Krueger and Aktan (forthcoming), Krueger (1975) and Krueger (1986) for a fuller analysis.

Table 1 provides data on the structural transformation of the Turkish economy from 1950 to 1980. As can be seen, agriculture's share of GDP has declined markedly; accompanying this, the fraction of the labor force engaged in agriculture has fallen steadily from 79 percent in 1950 to 63 percent in 1980.[7]

Table 1. Sectoral Composition of GDP, 1950 to 1980

(percentages of GNP, 1968 prices)

	1950	1955	1960	1965	1970	1975	1980
Agriculture	45	42	41	34	29	25	24
Industry	12	13	15	18	20	22	22
Services	43	45	44	48	51	53	54

Source: State Institute of Statistics, Statistical Yearbook, various issues.

The share of industry in GNP rose rapidly over the 1950-1975 period. The government was committed to industrialization through import-substitution and increased investment rapidly. Infrastructure investment, financed in part by foreign aid, provided a basis for the rapid expansion of economic activity. Table

[7]An interesting feature of the Turkish economy, and one that is not well understood is that the ratio of urban to rural per capita income is unusually high. See Dervis and Robinson (1980) for further analysis of this phenomenon.

Table 2. Population and Real GNP: 1950 to 1980

	1950	1955	1960	1965	1970	1975	1980
Real GNP (bil.TL)	40.6	58.7	71.1	90.4	125.4	181.4	206.1
Population (mil.)	20.8	23.9	27.8	31.4	35.6	40.4	44.7
Real GNP/capita(TL)	1951	2460	2558	2879	3523	4490	4611
Percentage annual average change over preceeding five years:							
GNP		7.7	3.9	4.9	6.8	7.7	2.6
Population		2.8	3.1	2.5	2.5	2.6	2.0
Real GNP/capita		4.7	0.8	2.4	4.1	5.0	0.5

Source: OECD, <u>National Accounts: Main Aggregates 1960-87</u> and earlier issues.

2 gives an overview of growth in real GNP and in GNP per capita from 1950 to 1980.

Growth did not proceed evenly over the 1950-80 period. The early 1950s were a period of very rapid growth, reflecting postwar recovery and large infrastructure investments. The heavy investment program was partly financed by government deficits, which resulted in inflationary pressures on the Turkish economy. Despite inflation, the nominal exchange rate remained fixed at its 1946 level. The pressures resulting from excess demand associated with the sizeable fiscal deficit and from the overvalued exchange rate in the face of domestic inflation led to a sharp deterioration in the balance of payments. The government responded initially by instituting and subsequently tightening exchange controls, imposing surcharges and additional duties on imports, and sharply restricting import licensing. There then followed four years of decelerating growth until a balance of payments crisis was reached in 1958.

By 1958, the economic situation had deteriorated drastically. Imports had been reduced by almost 50 percent, and many economic activities were hamstrung by shortages of parts or raw materials. With a harvest approaching, the absence of petroleum imports threatened to prevent agricultural commodities from being harvested and shipped to port. Under those circumstances and after several years of resistance, Government officials signed an agreement with the International Monetary Fund to undertake a stabilization program.

The program was designed to overcome the balance of payments crisis and restore macroeconomic stability. It therefore focussed on an alteration of the exchange rate, changing the price of a U.S. dollar from TL2.8 to TL9 (and elimination of many of the multiple exchange rate practices that had, de facto, developed), simplification of import licensing regulations, and ceilings on domestic credit and monetary expansion.

By any standards, the initial results of the first stabilization program were highly favorable. In the following two years, inflation diminished rapidly, while imports financed by foreign credits received upon agreement to the IMF program permitted a fairly rapid expansion in economic activity.[8] By the early 1960s, growth had again resumed and was sustained at reasonably high rates for most of the decade.

By the end of the decade, however, "foreign exchange shortage" was again impeding growth, as delays for import licenses mounted to more than 12 months and payments arrears were mounting. Exports had failed to grow commensurately with GNP or the demand for imports, and the share of exports in GNP had fallen to 4 percent.

In contrast to 1958, the stabilization program did not wait until economic activity had come to a virtual standstill. In August 1970 the Government entered a second stabilization program with the IMF, devaluing the currency from TL9 per U.S. dollar to TL 15 per dollar and attempting to stabilize the economy. As in the 1958-60 devaluation episode, the intention was to rationalize the trade and payments regime, but the fundamental philosophy of import substitution underlying the regime was not questioned.

In the aftermath of the 1970 devaluation, foreign exchange receipts increased sharply.[9] Export earnings rose, there were some reverse speculative

---

[8]See Krueger (1974), Ch. IV and Sturc (1968) for an analysis.

[9]This sharp increase was the result of a number of factors, including the increased flexibility of the Turkish economy resulting from the preceding decade's growth, but also importantly the remittances of Turkish workers who had emigrated to northern European countries, predominantly Germany, in large

capital flows, and a large inflow of workers' remittances. These resulted in a rapid increase in the money supply, and, in contrast to the aftermath of the 1958 devaluation, inflation accelerated over the 1971-73 period. However, economic growth was rapid, as there was little "foreign exchange constraint".

After the oil price increase of 1973, the government failed to take action, instead leaving the domestic oil price unaltered and permitting the current account to worsen rapidly. The excess of expenditures over receipts was financed by running down foreign exchange reserves and borrowing from abroad. Moreover, since most petroleum imports were on government account, and the government failed significantly to increase domestic oil prices, the government's fiscal deficit also rose sharply after 1975.

This sequence of events gave further impetus to inflation. Simultaneously, the failure of the government to adjust the exchange rate or the domestic price of fuel resulted in sharply reduced rates of increase of export earnings and sharply increased rates of increase in demand for imports. In order to attract workers' remittances and other foreign currency held by Turks in deposits abroad, the Government also embarked upon a convertible Turkish Lira deposit scheme, under which it provided guarantees in foreign exchange to those who deposited their funds with Turkish banks.

Over the next several years, the situation worsened rapidly. Despite occasional exchange rate adjustments, the failure of the exchange rate to be

---

numbers. The government had recognized the sensitivity of these funds to the exchange rate and had provided a special exchange rate and incentives for workers to repatriate their funds. Workers' remittances had already become a major source of foreign exchange earnings by 1968, and continued growing in 1969.However, it was not recognized that workers were nonetheless depositing large sums in German banks, anticipating that the exchange rate might in future be altered. Thus, after the 1970 devaluation, there was a large-scale inflow of funds from Western Europe.

maintained in real terms further discouraged exports; the domestic inflation continued to accelerate; Turkish government debt mounted as the government attempted to finance imports; and convertible deposit accounts mounted. By 1977, delays in obtaining import licenses were increasing sharply; real exports through official channels were falling; and real GNP was recorded to be growing at half the rate of the preceeding three years.

The Trade and Payments Regime Prior to 1980

The two driving forces determining the Turkish trade and payments regime during the 1950-1980 period were the Turkish Government's commitments to industrialization through import substitution and to maintaining a fixed nominal exchange rate despite domestic inflation. Consequently, there was almost always excess demand for foreign exchange. "Foreign exchange shortage" therefore impelled many policy actions, and interacted with the policy of encouraging domestic industry through import substitution.

There were a large number of incentives for new import substitution industries. These included access to preferential credit, tax credits, investment incentives, and preferential access to foreign exchange. In practice the most powerful inducement was the principle, enunciated in the First Five Year Plan, that imports would be restricted when domestic production started, and prohibited when domestic production was adequate to serve the internal market. Since each of these incentives was administered by government officials on a case-by-case basis, the degree of control by the government over economic activity, even in the private sector, was enormous.

Baysan and Blitzer provide estimates of the effective protective rate equivalents of quotas and tariffs for manufacturing industries in 1973 - a year when foreign exchange was relatively easy: protection rates surely became higher in the late 1970s. According to the Baysan-Blitzer estimates, paper and paper products were accorded an EPR of 154 percent; plastic products received effective protection of 358 percent; iron and steel basic industries had an EPR of 203 percent; nonelectric machinery was protected by the equivalent of an EPR of 108 percent, and so on. By contrast, EPRs for agricultural commodities and many minerals products - all exportables - were negative. Even textiles and wearing apparel - exports to some degree during the 1960s and 1970s - received less than 20 percent protection.[10]

As in most developing countries, import substitution policies in Turkey were increasingly economically costly as they continued. The ERP estimates already cited provide one indication. But the rising cost was also reflected in a rapidly rising incremental capital-output ratio (ICOR): according to Balassa's estimates, the ICOR rose from 1.6 in 1963-67 to 2.4 in 1968-72 to 4.7 in 1973-77. In constant 1976 prices, the average investment per job created rose from TL 267 thousand in the 1963-67 period to TL 572 thousand a decade later.[11]

The mechanisms put in place for import licensing under the Stabilization Program of 1958 lasted until 1980. "Import programs" were established which became the basis for regulating imports and protecting domestic manufacturers until after the 1980 reforms. In reaction to the lengthy delays for import licenses which prevailed prior to 1958, and an apparent randomness in their allocation amongst importers of medicines, spare parts, intermediate inputs, and luxury consumer goods, the practice of establishing "Import Lists"

---

[10]Baysan and Blitzer (1988), Table 2.5.

[11]Balassa (1985).

began. Three "Lists" were established.

An important feature of the import regime was that any commodity that did not appear on a list could not legally be imported. Thus, once an item was domestically produced, it was accorded virtually unlimited protection through the simple device of removing it from any import lists. Those commodities that were legally importable were divided among the three lists. One list indicated items that could only be imported under bilateral trading arrangements Turkey had with a number of countries, primarily in Eastern Europe and the Middle East. The "Bilateral List" was rather marginal, although if the authorities deemed that a commodity was available from those sources, they attempted to encourage purchases from bilateral sources by restricting the quantities that could be imported under the other lists. The two remaining Lists were the significant ones. They were the "Liberalized List" and the "Quota" list.

It was intended that imports on the "Liberalized List" be freely importable during the period of the import programme (six months) subject only to the individual obtaining the requisite foreign exchange from the Central Bank.

When foreign exchange stringency once again to appear in the mid-1960s, another feature that was to prevail until the 1980s was added to the trade regime. That was the practice of setting "export subsidy" rates for individual categories of nontraditional exports. As domestic inflation accelerated, the magnitude of these incentives increased. Thus, by 1970, when the exchange rate was still officially TL9 per U.S. dollar[12], a variety of nontraditional exports were subject to effective exchange rates ranging up to TL25 per

[12]The rate for Turkish workers' remittances and for tourism was significantly above the official rate by 1970.

dollar. The practice of setting commodity-specific export exchange rates was replaced in 1975 when export "lists" were established. For each list, a rate of export subsidy was set; all commodities on that list were entitled to that rate. Although export subsidies probably served more as a partial offset to the disincentives to export created by the import regime, the export "lists" were readily at hand as a policy instrument through which exports could be (and were) encouraged in the 1980s.

Thus, by the mid-1970s, the Turkish trade and payments regime was fairly chaotic and heavily biassed toward import substitution and against exports. There were tariffs established at a variety of rates; there were import lists, whose composition was altered every six months; there were delays encountered in obtaining foreign exchange even when import licenses had been received; there were export subsidies, and special tourist rates. Moreover, the rate of inflation was in excess of 50 per cent a year, and devaluations were infrequent, and often less than proportionate to the cumulative inflation since the preceeding devaluation

2. The Economic Situation in the Late 1970s.[13]

The economic situation was already very difficult when Bulent Ecevit became Prime Minister early in 1978. Short-term indebtedness was high, due in part to the build-up of short term CTLDs during the Demirel Government's tenure in office, but also to the shortfall of exports and the drop-off in workers' remittances resulting largely from the overvaluation of the exchange rate. As can be seen in Table 3, the real exchange rate for exports had appreciated 28 percent in real terms since 1975, as a consequence of

[13]This section draws heavily on the excellent account of Okyar (1983).

inflation rates well in excess of the percentage by which the Turkish Lira had occasionally been devalued.

The Ecevit government's diagnosis of the situation appears to have been that unavailability of foreign exchange was restricting imports, which in turn were constraining domestic production levels. The solution, therefore, should be to seek foreign aid and foreign loans to permit an increased import flow, which in turn would increase production and generate more exports. While it was recognized that the fiscal deficit should be reduced somewhat in order to curb inflation, a larger role for government in the economy in the future was anticipated. As aptly put by Okyar:

> "...it appears that the political views and ideological complexion of the left-of-center Ecevit government created almost insurmountable barriers in the way of arriving at a correct diagnosis of the situation, let alone taking decisive measures to counter it. The Ecevit government appeared convinced of the paramount virtues of government intervention in the

Table 3. PPP Nominal Exchange Rate (NER) for Turkey, 1975 to 1989

	NER (TL per dollar)*	Turkish Wholesale Price Index	U.S. Price Index	PPP NER Turkey-U.S.***	G-7** Price Index	7-country PPP NER***
1975	14.36	2.72	53.18	28.07	50.34	26.58
1976	15.92	3.17	56.59	28.42	54.06	27.14
1977	17.92	3.87	60.51	28.03	57.90	26.80
1978	24.04	5.80	64.94	26.92	60.54	25.10
1979	38.14	9.59	73.38	28.42	66.22	26.31
1980	77.78	20.68	85.22	32.05	74.13	27.84
1981	112.42	28.03	94.34	37.84	81.80	32.83
1982	163.66	35.59	96.90	44.51	87.66	40.26
1983	228.14	46.44	98.10	48.19	91.39	44.94
1984	370.87	69.82	100.50	53.38	96.57	51.18
1985	526.18	100.00	100.00	52.62	100.00	52.62
1986	676.53	129.57	97.10	50.70	99.18	51.75
1987	880.39	171.08	99.60	51.25	100.28	51.19
1988	1468.18	287.92	103.60	52.72	103.38	52.71
1989	2155.80	488.20	109.60p	48.38p	106.00p	46.02p
1990****	2450.69	682.69	111.70p	40.10p	n.a.	n.a.

Sources: Official Turkish exchange rate: Table 15a in Data Appendix.
Wholesale prices: International Financial Statistics, April, 1990

Notes: *: Exchange Rates are yearly averages of selling rates.

**: The G-7 countries are Canada, France, Federal Republic of Germany, Italy, Japan, the United Kingdom, and United States. Weights are calculated as the sum of exports and imports from Turkey to each country as a share of Turkey's total exports and imports to the G-7.

***: PPP exchange rates are calculated by taking the ratio of the partner country wholesale price index to the Turkish price index, and multiplying the resulting number by the Turkish official nominal exchange rate.

p : preliminary estimate.

****: Averages of monthly data for January through April.

economy, in the form of creating state economic enterprises or of intervening in the market mechanism, either directly or through subsidies. In addition, it was emotionally inclined towards a self-sufficient, even autarkic view of economic development, which restricted to a minimum the foreign role in the economy. The People's Republican Party had, in recent years, espoused undefined causes and slogans, such as total economic independence and anti-imperialism. The necessity of resorting to IMF cooperation and advice when the Party assumed power early in 1978 made the Ecevit government extremely uneasy and unhappy...In the Turkish government's view, there was nothing structurally wrong with the Turkish economy or with the economic development policies followed in Turkey between 1960 and 1978. The causes of the crisis in foreign payments and the quickening trend in inflation that arose in the middle of 1977 were ascribed to the faulty - but quickly repairable - policies, and the events mentioned above. Correspondingly, all that was needed to restore the situation was additional foreign financing and the rescheduling of short-term debts to help the balance of payments, and a period of restraint in public sector finances to control internal inflation."[14]

The Fund Stand-bys of 1978 and 1979

After discussions with Fund staff, the Fund and the Turkish Government reached a stand-by agreement covering a two-year period, with SDR 300 million to be released over two years in three tranches. The Turkish lira was devalued from TL19 to TL25 per U.S. dollar. Turkey was to be entitled to make purchases under the stand-by subject to observing the following conditions:

- There were ceilings set for successive periods on the net domestic assets.
- Limits were established as to the amount of additional foreign borrowing the Government might undertake.
- Turkey was not to incur any additional arrears in foreign payments.
- Debt rescheduling was to be carried out and completed by November 1978, with provision for eliminating all past arrears.
- Commercial banks would continue to be required to maintain a liquidity ratio of at least 15 percent.
- No new restrictions on international payments, multiple currency practices, bilateral payments agreements with Fund members, or limitations on imports would be introduced.[15]

---

[14]Okyar, P.539-40.

[15]Okyar, op. cit. P. 535.

By September, however, the Turkish Minister of Finance wrote to the Fund, noting that Fund conditions had not been met, and requesting higher ceilirgs than had been negotiated. In particular, Central Bank net domestic assets had risen to TL 229.1 billion, more than 2 percent above the negotiated ceiling of TL 224 billion. There were new arrears in foreign payments, and new restrictions on imports were to be imposed. The Turkish government stated that the need for revision of the program was attributable to the effect of extreme shortages of imports on domestic production levels and on tax receipts. There were also difficulties in debt rescheduling.

While the Fund Board approved modifications to the Stand-by, it apparently did so reluctantly. The Fund staff made clear their difference in viewpoint from the Turkish government, attributing the failure to meet the conditions of the Stand-by to the insufficient profitability of Turkish exports (because of exchange rate policy under continuing inflation), rather than import scarcity.[16] Meanwhile, inflation in Turkey continued to accelerate, rising from an estimated annual rate of 21 percent in January to 57 percent in July 1978. Fund staff also expressed discomforture with the wage increases of 40-80 percent that had been negotiated by Turkish trade unions.

Economic conditions continued to deteriorate. Inflation accelerated, wage settlements were growing ever-larger, import shortages intensified, and double pricing of government controlled commodities such as sugar, cigarettes and cooking oil, became almost standard. The black market exchange rate was almost 40 percent above the official exchange rate by when the third tranche of the

[16]In preference to further devaluation, the Turkish Government had increased export "rebates" in July 1988. In the Fund's view, these ad hoc supplements to the exchange rate were less attractive to exporters than an exchange rate change would have been, in part because there was no assurance that they would continue.

Stand-by (due in November 1978) was not released. As reported by the Economist, by that time the Fund was insisting upon a further 30 percent devaluation, sharp cutbacks in the government's fiscal deficit (including large increases in prices of commodities sold by State Economic Enterprises; these SEEs were incurring large losses at the prices at which they were selling, which were then financed by Central Bank credits). The Ecevit Government, however, was resisting, insisting that social unrest would assume unacceptable proportions if the prices of State Economic Enterprises were increased, and that devaluation would increase import prices. It proposed instead to increase the size of export subsidies.[17]

In March 1979, the Government introduced a somewhat restrictive budget into Parliament, and in April a first meeting was held between the Turks and the Fund regarding the possibility of a second Stand-by. Another devaluation was announced on June 11, 1979, with the exchange rate moving from TL26.5 to TL47.1 per dollar for most commodities. For agricultural goods subject to domestic price supports and imports of petroleum and inputs into fertilizers, the exchange rate was to be TL35 per dollar. A Letter of Intent was finally signed dated June 30, 1979, in which it was requested that the two-year Stand-by of 1978 be cancelled and a new, one-year Stand-by be entered into for SDR 250 million. This time, the Government stated its intention of slowing down the rate of inflation, raised the deposit and lending interest rates by 5.5 percentage points (still well below the rate of inflation), and put new ceilings on net domestic assets of the Central Bank and net central bank

---

[17]Economist, March 17, 1979, P. 13. The Economist reported that for 1977, the government's central budget deficit was 5.6 percent of GNP, while the financing requirements of the State Economic Enterprises were 6.8 percent of GNP. Both of these were financed by borrowing from the Central Bank.

credit to the public sector. The Stand-by was approved by the IMF in July 1979, which paved the way for an OECD consortium package of aid of about $1 billion, and another round of debt rescheduling.

Despite the new aid and the government's commitments, the government failed to curb its expenditures or to reduce its drawing on the Central Bank, with a consequent acceleration in the rate of inflation. Domestic production of many commodities was falling, as imports of raw materials, intermediate goods, and spare parts became unavailable, or obtainable only with long delays or through extralegal channels.

Thus, twice in the two-year period preceding January 1980, the Turkish government had announced a Stabilization Program supported by the IMF and the OECD consortium. Twice, the government's announcement of its intention to adhere to net domestic credit ceilings and other measures had not been realized. Indeed, each announcement was followed by a subsequent worsening of the economic environment. It was in this context that the reform program of January 24, 1980 was announced.

The Pre-Reform Situation[18]

Two questions regarding the 1970s require consideration prior to analyzing the 1980 reforms and their aftermath. The first is an understanding of the factors that contributed to the severity of the crisis and the degree of disequilibrium that arose. The second is those earlier governmental efforts to redress the situation.

---

[18] It should be pointed out that during the late 1970s, Turkey was undergoing a period of profound political instability. There was no majority party in parliament, and coalition governments were weak and unstable. One consequence was civil unrest, which was manifested in a rising rate of political violence. In this context, politicians no doubt perceived the economic crisis to be only one aspect of the country's difficulties.

It is unnecessary here to attempt precisely to delineate the relative contributions of each of several factors that contributed to the severity of the crisis. All analysts agree that there was a failure to adjust domestic spending or relative prices to the 1973 oil price increase, and that continuing growth in the three years following 1973 was financed by running down foreign reserves and borrowing from abroad. All agree also that there were ineffiencies associated with import substitution policies, and that export earnings failed to grow both because of those policies and because of the overvaluation of the exchange rate. In an effort to obtain foreign exchange to keep imports flowing, the government had earlier instituted a Convertible Turkish Lira Deposit scheme (CTLD), which certainly increased the losses of the Central Bank and contributed to accelerating inflation. Fiscal deficits were increased as the government kept the prices of outputs of State Economic Enterprises[19] fixed, which in turn fuelled the inflation and raised Enterprise costs. Turkey was thus caught in a web of policies - government spending, pricing of state enterprises, protection of domestic industry, and overvaluation of the exchange rate - which reinforced the inflationary spiral.

Despite the agreements with the Fund, credit continued expanding, and inflation accelerated. By late 1979, some observers guessed that extra-legal exports might exceed legal ones in value, while smuggling and black market operations were pervasive. Meanwhile, the shortages alluded to above were making everyday life difficult and forcing reductions in production levels in many lines.

---

[19]State Economic Enterprises are parastatal organizations that are engaged in many economic activities in Turkey, including manufacturing, mining, agricultural marketing and distribution, finance, and transportation. In the 1970s, State Economic Enterprises accounted for approximately half of the value added in Turkish manufacturing industry, valued at domestic prices.

By January, 1980, the Turkish economy had been in a state of crisis for almost three years. The rate of inflation was accelerating; factory shutdowns and excess capacity were increasing as imports were increasingly unavailable; foreign exchange reserves were nonexistent and the government was heavily in arrears on foreign debt; and real output was falling. It was in that crisis atmosphere that the policy reforms of January 1980 were undertaken.

3. The Reform Program, 1980-1983

In many regards, the economic situation in January 1980 was not fundamentally different from what it had been since 1977, except in the sense that economic and political deterioration had been in process longer. The major difference from the years 1977-79 was the the Demirel Government chose to adopt a major program of economic reforms, with the support of the International Monetary Fund and the donor community. Under Prime Minister Ecevit, who had earlier been in power, these reforms had been strongly resisted and only undertaken as a last resort.

Focus here is on the overall outlines of the reform program that began with Prime Minister Demirel's announcement on January 26, 1980. That program had the twin objectives of stabilization of the economy (and especially control of inflation) and of economic liberalization. It continued until early in 1983, when the architect of the program - Turgut Ozal - was asked to resign. After an election in the fall of 1983, Ozal became Prime Minister, and a second wave of the reform program, which continues to the present time, began. In the second phase, liberalization was emphasized, with stabilization a strictly secondary objective. In this section, focus is on the first phase of the reforms.

The reform program was developed with the help of a very few people. In conversation, it has been suggested that fewer than ten civil servants and government officials knew of its contents when it was announced. The Plan was announced by Prime Minister Demirel on January 24, 1980, and further explained in a series of meetings with journalists over the next few days.

There were two key, interrelated, objectives: to reverse the downward spiral in economic activity and to stem the inflation. However, unlike earlier policy packages, it was immediately stated that there would be a fundamental change in underlying economic policies. It was intended to strengthen market forces and competition by opening up the Turkish economy to the rest of the world; simultaneously, state controls over economic activity were to be reduced. Moreover, in his initial unveiling of the program, the Prime Minister made clear that the measures he then described would be followed with other policy changes (some of which would require legislation).

There were three major components to the initial program: 1) exchange rate policy; 2) internal price policy; and 3) stabilization policy.[20]

Trade and Exchange Rate Policy. The TL was immediately devalued, and it was announced that, henceforth, exchange rate policy would be more flexible, with more frequent devaluations in the future to maintain the attractiveness of exports. Simultaneously, several other measures were taken to encourage exports and to reduce the restrictiveness of the import regime. The official

---

[20] There were a number of institutional reforms, most of which involved reorganization of governmental committees overseeing economic regulations. See Krueger and Aktan (forthcoming) for a description. In addition, it was announced that interest rates for all credits were raised by two percentage points, that foreign investment regulations would be liberalized to encourage the inflow of foreign capital into all sections of the economy, including those from which it had earlier been effectively discouraged, and that policy regarding petroleum exploration would be significantly liberalized. See Organization for Economic Cooperation and Development (1981), pp. 34-35 for details.

exchange rate was changed from TL45 to TL 70 per U.S.dollar. Although some items continued to be subject to different exchange rates, the earlier multiple exchange rate system was unified considerably.

A variety of other measures were also taken which also liberalized the regime. Banks authorized to hold foreign exchange were authorized to retain up to 80 percent of their receipts, using them to cover acceptance credit obligations and to finance imports of oil, petroleum products, fertilizers, and pharmaceutical raw materials. The allowance for Turks travelling abroad was raised, and trade in gold was substantially liberalized.

In addition, a number of incentives for exporters were introduced or enhanced. Exporters were permitted to retain 5 percent or $10,000 (whichever was larger) of their receipts. Also, all duties on imports used in export production were eliminated, and administrative procedures relating to exports were to be greatly simplified. Provisions were made for subsidized export credits, and export subsidies were retained.

Finally, the import regime was liberalized in several ways. The coverage of the Liberalized List was enlarged, and advance deposit requirements on imports were generally reduced.[21] In addition, the Quota List, which had previously been issued once a year, became semi-annual.

It was made clear that all of these moves were intended as first steps. Further liberalization of the import regime, continuing greater flexibility in exchange rates, and other changes were to follow later. However, except for these statements of intent, the actual changes in the trade and exchange rate

---

[21] For example, for items on Liberalized List I, the advance deposit required of importers fell from 40 to 30 percent, while that for industrialists was lowered from 25 to 15 percent. See OECD (1981).

regime were not dissimilar from those made in the 1958 and 1970 devaluation-stabilization programs. Even compared to the 1978 and 1979 Stand-by announcements, the January 1980 changes in the trade and payments regime were not qualitatively or quantitatively dissimilar.[22] The differences lay in the statement of intent, and possibly, to a smaller extent, in the fact that there was a tendency toward simplification of regulations, rather than a move toward greater complexity of controls.[23]

Pricing Policies. One important element of the program, which was immediately felt by the entire populace, was the removal of controls over State Economic Enterprise prices. This was important for its prospective impact upon the budget deficit. The OECD had attributed the government's overshooting of its expenditure targets in earlier programs largely to rising transfer payments, of which transfers to the SEEs were the largest single component.[24] In turn, ceilings on Central Bank credits had been broken as government fiscal requirements driven by SEE deficits dictated Central Bank

---

[22]The increases in the pricing of commodities produced by State Economic Enterprises were, however, probably significantly larger than earlier increases had been. It could be argued that it was these increases, which are immediately felt by large segments of the population and are politically difficult to implement, that provided the "signal" that the Government was serious in its intent.

[23]Indeed, the fact that it was a minority government that was in power made the prospects for passing legislation to implement many of the government's statements of intent poor indeed. Turgut Ozal, in an interview late in 1981 in Yanki, agreed that the best he could have hoped for as of January 1980 would have been the announcement of an early election which could have given the Justice Party a majority in Parliament. See Barkey (1984) P. 63.

[24]OECD, 1981, p. 18. As already noted, these transfers covered operating losses. Central Bank credits to finance investments are not included in these numbers.

financing.

In the January 1980 program, it was announced that, henceforth, prices of SEE outputs (except coal, fertilizers, and electricity) would be freely determined and government subsidies would no longer be given (with a few exceptions). The average percentage increases associated with the January 1980 announcement were as follows: 100 percent for fuel oil, coal, lignite, railways, maritime transport, and textiles; 45 percent for gasoline; 120 percent for diesel oil and electricity; 75 percent for steel and PTT services; 300 percent for paper; 400 percent for fertilizer; 55 percent for cement, cigarettes, and beverages; and 80 percent for sugar. Measures were also taken removing controls over many prices of goods and services provided by the private sector.

For purposes of analyzing the policy reform package, it is unnecessary to consider the evolution of controls over prices in the 1980s except to note two things. First, the deficits of State Economic Enterprises were greatly reduced in the first half of the 1980s, largely as a result of the liberalization.[25] Second, controls over prices were largely phased out and there were far fewer controls over private sector pricing in the 1980s.

Fiscal and Monetary Policy. One of the twin purposes of the 1980 program was the restoration of macroeconomic balance. The policies undertaken to achieve this goal were fairly conventional. In addition to reducing the deficits of the State Economic Enterprises through raising their prices, measures were taken to make monetary and fiscal policy less expansive. These

---

[25]The reduction in the deficits of the State Economic Enterprises was sizeable, amounting to almost 5 percent of GNP. Fiscal deficits did not diminish as much as State Economic Enterprise deficits were reduced, because government expenditures on infrastructure rose sharply.

included especially the raising of interest rates and the imposition of controls over public sector expenditures.

It may be noted that the program was announced - without the support or overt influence of the International Monetary Fund - in January 1980. The Government of Turkey signed a three-year Stand-by with the Fund for SDR 1.25 billion - six times Turkey's quota and the largest credit extended by the IMF to that date - on June 18,1980. The terms of the Letter of Intent are not public, but are known to have included the usual ceilings on net domestic assets of the central bank and on net borrowing by the public sector, along with provisions to liberalize the import regime as circumstances permitted, to refrain from adopting multiple exchange rate practices, and to prevent the accumulation of any new payments arrears.

These steps, in turn, permitted a rescheduling of outstanding debt, and the commitment of new money by the International Monetary Fund and the World Bank. In the Stand-by agreement, the Turkish Government agreed to undertake some degree of financial liberalization within two years. In fact, on July 1, the borrowing and lending rates of the commercial banks were entirely liberalized (apparently totally unexpected by the Fund), and left to be determined by market forces.[26]

A military government assumed power in September 1980, but signalled its commitment to the policy reforms by retaining Turgut Ozal as the top economics official. Among its early actions, the Military Council banned strikes,

---

[26] However, representatives of the main commercial banks apparently met quickly and agreed upon rates to be charged among themselves. The result was that lending rates for commercial credit rose from 25 percent to over 60 percent a year, while sight deposit rates rose only slightly from 3-5 percent a year. Okyar, op. cit., P.549.

outlawed DISK, the radical trade union, and suspended collective bargaining wage negotiations. Instead, a High Arbitration Council was established to decide on wage increases, based on such criteria as "prevailing economic conditions" and "cost of living". It is estimated that wage increases in 1981 averaged around 25 per cent, contrasted with a 60-70 percent increase in 1980.[27] Simultaneously, in a move intended to guard against unemployment, the Military Council issued a decree preventing the discharge of workers.

Over the following year and a half, the government adhered fairly strictly to the ceilings agreed upon with the IMF, and simultaneously further liberalized the import regime. After the maxi-devaluation of January 1980, there were ten further devaluations of the TL over the subsequent fifteen months. Then, starting in May 1981, the Central Bank was given the authority to set exchange rates daily, which inaugurated a period which still continues in which exchange rates are changed almost daily. Although there have been changes in the real exchange rate (see Table 3 below), the system can most aptly be described as being a crawling peg.

After the reforms were announced in the winter of 1980, the downward slide in economic activity was halted. The first several years of the program were ones of positive, but relatively slow growth of real GNP (see Table 7 below). However, exports began accelerating rapidly, thereby permitting the authorities further to ease restrictions upon foreign exchange.

Before analyzing the effects of the reforms, however, it is worthwhile to examine the measures taken after 1983. For, drastic as the reforms of 1980 were relative to the policies that had earlier been undertaken, there followed

[27]Okyar, P. 550.

measures liberalizing Turkish markets further still.

4. The Second Phase of Policy Reform: 1983 to ?

During the 1980s, there was only one real pause in the momentum of reform. By early 1983, nominal interest rates were high, while inflation was decelerating. Whether as a consequence of the credit squeeze, or for other reasons, a prominent Turkish financier was unable to meet his obligations, and the ensuing panic resulted in sharp increases in interest rates and a scramble for liquidity. The military government reacted by firing Turgut Ozal, and replacing him with an economics team much less strongly committed to carrying out the reform program.[28] Moreover, the new team relaxed the monetary and fiscal restraints on economic activity and inflation began accelerating.

Shortly thereafter, the military governnment announced that elections would be held in the fall of 1983. Mr. Ozal organized a new (Anap) political party, which won a plurality among the three parties (including the one supported by the military) which contested the election. Thus, by late 1983, a new - democratically elected[29] - government was in power under a Prime Minister committed to economic liberalization and with a mandate to carry out further reforms.

The new Ozal government moved quickly to regain the momentum of policy reforms. Changes proceeded rapidly over the next three years. However, the

[28]It was believed by many that the financial crisis was anticipated but that the authorities did not believe they could not act until the liquidity problem became apparent.

[29]There is no question but that the election was fairly conducted. However, the government's control over the parties which could contest the election, and the fact that there remained many politicians who had been forbidden to participate in politics after the 1980 military takeover, led many to question the legitimacy of the election.

reform package and objectives after 1983 focussed almost entirely on achieving structural changes within the economy, especially with regard to the role of import-competing and export industries on one hand, and the role of the private and public sectors, on the other. The goal of stabilization was largely forgotten as government expenditures began rising sharply, and inflation once again accelerated. Unlike earlier fiscal expansions, however, this one was geared largely toward increased expenditures on infrastructure, while State Economic Enterprises remained subject to fairly strict controls.

In the second phase, a number of major policy changes were effected. These included major reforms in the financial sector (including banking deregulaton, freeing of interest rates, opening the Istanbul stock exchange, creating a foreign exchange market, and reduction of taxes on financial transactions), tax reform (including especially the introduction of a value added tax in 1985 and a reduction in the highest marginal rate of income taxation from 45 to 25 percent) and increased incentives for efficiency in the State Economic Enterprises. There was also the beginning of a privatization program which, to date, has been able to effect only small sales of SEEs to the private sector.

Turning to the trade and payments regime, many restrictive aspects of the Turkish trade regime of the 1960s and 1970s were still intact in mid-1983, despite the much greater stability of the real exchange rate. Much of the increased incentive for exporting that had been accomplished in the first phase of the reform program had been effected by special export incentives, rather than dismantling the protection accorded to import-competing goods.[30]

[30]See Krueger and Aktan, (forthcoming), Ch. 4 for an account of the various export incentives and their value during the 1980-89 period.

In the second phase, it was announced that there would be moves toward a unified exchange rate and elimination of special rates, and that the trade regime would be further liberalized. To that end, the Import Lists were changed from negative lists (under which no item may be imported unless listed) to positive lists (all items not listed could be imported). About 200 items were ineligible for importation under the 1984 program, and further commodities were made eligible for importation in later programs. Simultaneously, tariff reclassifications were announced, and the average tariff rate was reduced by about twenty percentage points. Import procedures were also greatly simplified.

However, there were some conflicting currents. As import duties were reduced and items removed from the Negative Lists, several special "funds" were created. These funds, which were offbudget items, were for particular purposes, such as a "Housing Fund", a "Support and Price Stabilization Fund" (SPSF) and so on. While the rates of levy for these funds were far below earlier tariff levels (reaching a maximum of 10 per cent for the SPSF in 1989) and applied uniformly to a large number of imported commodities, they were increased several times and their scope was generally extended.[31]

Potentially more damaging was the establishment of a Foreign Exchange Risk Insurance scheme (FERIS) in April 1984, which guaranteed borrowers of foreign exchange that they would not take foreign exchange losses on repayment. FERIS was introduced with the stated purpose of covering that risk. In practice, FERIS increased the fiscal difficulties of the government in raising resources

[31]See Appendix 1 of Krueger and Aktan (forthcoming) for a chronology of the dates and amounts by which the levies were increased. They were initially imposed at a rate of 2 percent in 1981. See also the discussion in Chapter 4 of the use of SPSF funds for export incentives.

for debt-service as the exchange rate was depreciated to keep pace with inflation: since the private sector earned and earns most foreign exchange, the government must raise revenue to purchase foreign exchange from the private sector.

Although there was no announced policy, the real exchange rate was further depreciated in 1985 and 1986. Baysan and Blitzer estimate that, on average, the real exchange rate depreciated by about 3.6 percent annually from May 1981 to May 1986.[32] As inflationary pressures intensified in the late 1980s, however, policy toward the exchange rate became more ambivalent: in 1987 and again starting in 1989, the nominal exchange rate depreciated by considerably less than the rate of inflation: in 1990 alone, the real exchange rate appreciated 20 percent. There were thus indications that failure to control inflation might undermine the outer-oriented stance of the government.

The government also reduced restrictions surrounding convertibility of the TL and announced that steps would be taken to make the TL convertible. Foreign banks were encouraged to open branches in Turkey. Other immediate moves included the liberalization of restrictions on the amount tourists could take abroad, and widening the band within which commercial banks could deal in the foreign exchange market in Turkey. Subsequently, Turkish residents were permitted to open foreign bank accounts and make payments, withdrawals, and transfers abroad. After July 1988, foreign investors were permitted to enter the Turkish capital market, and by June 1989, foreign investment funds were allowed to operate in Turkey. Also in 1989, Turkish residents were given the

---

[32]Baysan and Blitzer (1988b), p. 11. Estimates from the Central Bank suggest even greater real effective exchange rate depreciation. See also Saracoglu (1987), P.126. See also Table 3.

right to purchase foreign securities freely, and could purchase up to $3,000 in foreign currency without restriction.

Finally, steps were taken to increase the attractiveness of Turkey for private foreign investors. These included easing conditions governing the transfer of profits and repatriation of capital, as well as the general relaxation of capital and exchange market controls.

5. Results of the Altered Trade and Payments Regime

The Magnitude of Changes in Incentives

Table 3 gave estimates of the real exchange rate over the 1975 to 1990 period. As can be seen, the real exchange rate - whether measured against the U.S. dollar or against a 7-country basket - appreciated considerably in the late 1970s. In real terms, the devaluation fo 1980 was substantial, amounting to more than 30 percent on either basis. During the first half of the 1980s, real depreciation continued, so that by 1985, the real cost of foreign exchange in terms of domestic purchasing power was more than twice what it had been in 1979. This in itself constituted a major change in the incentive for exporting.

For imports, quantitative restrictions were removed, while simultaneously tariffs were reduced. This offset, of course, a considerable portion of the increased real price of foreign exchange importers had to pay. Estimates of the combined impact of removal of quantitative restrictions and tariff reductions suggest that imports, on average, cost 129 percent of the c.i.f. price (at the nominal exchange rate) in 1980, fell gradually to 99 percent in 1984, and then to 68 percent in 1985 and 55 percent by 1987. Thus, the protection accorded to import-competing industries was greatly reduced.[33]

At the same time, export subsidies were employed to increase the attractiveness of exporting. Nontraditional exports were eligible for export subsidies averaging 11 percent of f.o.b. value in 1980; subsidies reached a peak at 20.3 percent of f.o.b. price in 1983, and thereafter declined to 9.1 percent in 1988.[34] Simultaneously, the paperwork and delays associated with exporting were greatly reduced, including the ability of exporters to import needed inputs duty-free and to retain foreign exchange for that purpose or for travel abroad.

If account is taken of the value of all export incentives (that were not simply offsets to additional costs imposed on exporters by the import regime) and the protection to imports, it would appear that the trade and payments regime was strongly biassed in favor of import-substitution industries in 1980: a one dollar saving of foreign exchange through import substitution earned about as much for a Turkish producer as earning $1.95 earned. By 1986, this bias had fallen so that exporters had to earn $1.21 in foreign exchange to receive the same return as importers who saved $1.00, and by 1989, the differential was down to $1.12.

Response to Altered Incentives: Exports

Thus, removal of quantitative restrictions, tariff reductions, export incentives, and a more realistic real exchange rate all served to increase the relative and absolute attractiveness of exporting. It is difficult to convey the extent of the transformation of the economy, and of attitudes toward

---

[33]See Krueger and Aktan (forthcoming), Table 4.5 for details and rates applicable to individual commodity groups.

[34]See Krueger and Aktan (forthcoming), Table 4.6.

exporting. Historically, Turks held a deep-seated distrust of foreign trade and were highly pessimistic as to the capabilities of Turkish businessmen. In the late 1970s, exports constituted only about 7 percent of GNP. This was an amazingly small number for a country such as Turkey.

By 1987, the share of exports in GNP had risen to 21 percent. This represented a tripling of export share in GNP in less than eight years. That increase was accomplished with an average annual rate of growth of export earnings (in U.S. dollars) of 18.9 percent over the 1980-88 period. By the standards of any decade, that export growth rate was impressive. Because there was a severe slowdown in the growth of world trade in the first half of the 1980s, Turkish performance is even more outstanding.

Accompanying the increase in export earnings was an increase in the share of imports in GNP. Imports increased from a range of 15-17 percent of GNP in the late 1970s to over 22 percent in every year after 1984. Thus, the increase in exports represented a structural shift as <u>both</u> exports and imports increased in relative and absolute importance.

Table 4 gives summary data on the growth of exports by major commodity group. As can be seen, all major categories of exports grew, although exports of industrial goods grew much more rapidly than did exports of agricultural commodities, and mineral products exports grew very little after a short-lived burst in the mid-1980s. Thus, whereas agricultural commodities constituted 57 percent of exports in 1975 and 1980, their share of total exports had fallen to around 20 percent by 1989. Conversely, the share of industrial goods in total exports rose rapidly, reaching more than three quarters of total exports by the latter 1980s.

Export earnings from agricultural commodities rose only at an average annual rate of 2.7 percent over the 1980-89 period. Nonetheless, the growth rate pf earnings exceeded that of earlier years. Moreover, exports of processed agricultural commodities rose from $209 million in 1980 to $919 million in 1989; to the extent that these commodities might otherwise have been exported in crude, or unprocessed, form, the growth of agricultural exports is understated by examining only exports of unprocessed commodities.

Table 4. Export Earnings by Major Commodity Categories, 1980 to 1988
(millions of U.S. dollars)

	1976	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
<u>Commodity Group</u>:											
Agriculture and livestock	1254	1672	2219	2141	1881	1749	1719	1886	1853	2341	2125
	(64)	(57)	(47)	(37)	(33)	(25)	(22)	(25)	(18)	(20)	(18)
Mineral products	106	191	193	175	189	240	244	247	272	377	413
	(8)	(7)	(4)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(4)
Industrial goods	596	1047	2290	3429	3658	5145	5995	5324	8065	8943	9088
	(30)	(36)	(49)	(60)	(64)	(72)	(75)	(71)	(79)	(77)	(78)
of which:											
Processed ag.	87	209	412	568	670	809	647	667	954	885	919
Manufactures	509	857	1879	2861	2989	4336	5348	4658	7111	8059	7250
Total	1960	2910	4703	5746	5728	7134	7958	7457	10190	11662	11627

Source: See Krueger and Aktan (1990), Appendix Table 10a.
Note: Numbers in parentheses indicate percentages of total exports.

Table 5. Commodity Composition of Manufactured Exports, 1975, and 1980 to 1989
(millions of U.S. dollars)

	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Textiles and clothing	128	424	803	1056	1299	1875	1790	1851	2707	3201	3508
Hides and Leather Products	65	50	62	111	192	401	484	345	722	514	605
Chemical Products	5	76	94	148	120	173	266	350	527	734	774
Rubber, Plastic Products	33	16	72	60	77	97	108	141	258	352	313
Glass, Ceramics	18	36	102	104	108	146	190	158	205	233	258
Nonferrous Metal Products*	37	58	228	251	160	142	159	138	141	233	300
Iron and Steel Products	20	34	100	362	407	576	969	804	852	1458	1349
Metal Products	4	8	20	27	19	16	73	60	107	52	23
Others**	29	98	270	397	373	501	939	633	1362	951	828
Tota	338	800	1771	2516	2755	3927	4978	4480	6881	7495	7939

* Includes cement.
** Includes forestry products, electrical and nonelectrical machinery, motor vehicles, instruments, and miscellaneous manufactures not classified elsewhere.

Note: The total of manufactured exports here does not correspond to the number given in Table 4 because of differences in classification between manufactured and nonmanufactured exports.

Table 5 provides a breakdown of the commodity composition of manufactured exports. As can be seen, earnings from virtually all categories of manufactured exports grew at rates in excess of 10 percent. In the late 1970s and early 1980s Turkish manufactured exports of individual manufacturing sectors had been relatively small and scattered except for processed food and textiles and clothing. By 1989, export production was significant in a much larger number of two-digit industries.

Manufacturing production was somewhat lower in 1980 than it had been in 1975. By 1985, however, it had increased substantially with rapid increases in most two-digit industries. Since domestic demand grew only slowly over the first several years after 1980, it is a reasonable inference that the growth of manufacturing output was in large part the consequence of the expansion of exports.

By the late 1980s, it was evident that the reorientation of incentives toward a more outer-oriented economy had indeed changed the structure of the Turkish economy. In the first years of the export drive, there had been some skepticism. Skeptics had questioned whether exporting out of excess capacity would continue once domestic demand recovered. That question was decisively answered in the latter half of the decade when economic growth accelerated and exports continued to grow. A second source of concern was the very large fraction of increased exports, especially in the early 1980s, that were destined for Iran and Iraq. That concern, too, was put to rest when those countries reduced their imports from Turkey but overall Turkish exports continued growing.

Yet a third source of concern focussed on claims of faked invoicing. The magnitude of export incentives clearly provided an inducement for exporters to overstate the value of their foreign exchange earnings, and the Turkish newspapers were able to expose several instances of that practice. Analysis of the trading returns of partner countries suggests that this may have accounted for an average overstatement 5 or 6 percent for most years in the early 1980s, but for 21 percent of the stated value of exports in 1984. The actual rate of growth of export earnings may therefore have been somewhat lower than recorded in the early 1980s; if that is true, the rate of growth of exports in the latter 1980s (when special export incentives were greatly reduced because of faked invoicing) is commensurately understated.[35]

Overall, Turkish export growth during the 1980s was impressive. Against a background of worldwide recession, Turkey was able to transform her economy from a highly inefficient, inner-oriented one to one more closely integrated with the international economy.

The Balance of Payments and Foreign Debt.

Whereas the "balance of payments" constituted a major policy problem in the 1970s, it was hardly noticed during the 1980s. Not only did the current account deficit diminish, and actually turn to surplus in 1988, but almost all categories of transactions had been liberalized. There were even occasions when the Turkish Lira sold at a slight premium to foreign currencies, especially the U.S. dollar, but black market activity in foreign exchange all but ceased.[36]

The most striking feature ofd the Turkish balance of payments during the

[35]See Rodrik (1988), P. 31 and Krueger and Aktan (forthcoming), Table 5.5 for further details.

[36]See Krueger and Aktan (forthcoming), Data Appendix Table 13, for estimates of the magnitude of the differential between the official and the free market rate. Since the latter was legal, there was, strictly speaking, no black market.

1980s is the simultaneous increase in both exports and imports. The hallmark of Turkish reforms in the 1980s was an opening up of the economy, and both exports and imports constituted a larger share of economic activity. The trade balance was a negative $4.6 billion in 1980, fell to minus $2.7 billion by 1982, and thereafter was in the range of minus $2.8 to $3.1 billion in every subsequent year. During that interval, exports increased more than four-fold.

For present purposes, what is important is to note that the 1980 devaluation and liberalization package resulted in fairly immediate and sharp drop in the current account deficit, but that thereafter, Turkey maintained a fairly constant current account balance for the next several years. After 1984, the non-interest current account was positive, as other receipts were sufficient to cover current account non-interest payments and a portion of the interest on the debt. By 1988, of course, the non-interest current account surplus was large enough to cover all interest charges and reduce debt.

Although the current account deficit diminished after 1981, financing for the external deficit was still required from 1980 to 1987. That financing necessarily originated primarily from new borrowing. Indeed, accumulation of foreign exchange reserves in 1986 and 1987 implied that borrowing in those years exceeded the amount that would have financed the current account deficit.

Some observers have suggested that Turkey's very successful macroeconomic growth performance of the 1980s was attributable to the increased imports that were financed in part by accumulation of additional debt.[37] It is important, therefore, to consider two issues. On one hand, there is a question as to how

---

[37]See for example Collins (1989), P. 14.

Table 6. Turkish Debt and Debt-Service, 1980 to 1988

	1980	1981	1982	1983	1984	1985	1986	1987	1988
a. Magnitude of Debt (billions of U.S. dollars)									
Total Debt	19.0	19.2	19.7	20.3	21.6	26.0	32.8	40.8	38.7
Long-term	15.5	15.7	16.5	16.4	16.9	19.9	24.8	31.3	30.7
Short-term	2.5	2.3	1.8	2.3	3.2	4.8	6.9	8.7	7.7
IMF	1.1	1.3	1.5	1.6	1.4	1.3	1.1	.8	.3
b. Debt-Service Indicators (ratios)									
Debt/Export ratio	6.54	4.08	3.34	3.44	2.92	3.15	4.32	3.95	3.27
Debt Service/Exports	.38	.38	.40	.40	.32	.45	.46	.48	.56

Source: Krueger and Aktan, (forthcoming), Data Appendix Table 12a.

much borrowing (or equivalent means of financing a current account deficit) there was. On the other hand, there is a question as to the importance of the current account deficit in permitting a resumption of economic growth during the 1980s.[38]

The evolution of Turkish debt may be seen in Table 6. From a level of $19.0 billion in 1980, Turkish debt rose by less than $1.0 billion by the end of 1983. Even in 1984, it grew only by $1.3 billion. Thereafter, however, it rose $7.8 billion in 1986, $8.0 billion in 1987, and then declined by $2 billion in 1988 (reflecting the current account surplus of that year).[39]

Although Turkey received new monies during the 1980's, their magnitude appears to be no larger, relative to the size of the Turkish economy, than monies involuntarily lent to other heavily indebted countries during the same period. It is difficult, therefore, to account for the difference between Turkish performance and that of other creditors by noting that Turkey restored creditworthiness and received new money.

It should be noted, in any event, that the fact that lending to Turkey was voluntary was in large part because of her export performance. Had exports grown only slowly during the 1980s, it seems clear that Turkey would have faced the same borrowing constraint that afflicted most heavily indebted countries: private creditors would have refused additional credit.

Overall Economic Growth

Just as one can divide the Turkish reforms into an initial period from

---

[38] Turkish debt was rescheduled as a part of the 1980 reform package, and there is no question that rescheduling at that time was essential.

[39] Turkish outstanding debt is estimated to have declined another $2 billion in 1989. Financial Times, March 6, 1990, P. 2

1980 to 1983, and then a longer period during which there was a continuing drive toward liberalization, so, too can the 1980s be divided in terms of Turkish economic growth. The period from 1980 to 1983 was one of relatively slow growth, whereas the period from 1984 to 1990 witnessed much better economic performance.

The initial results of the January 1980 program were highly visible to all in Turkey. Shortages disappeared as import flow resumed and as power outages, petroleum shortages, and other bottlenecks disappeared while destocking of inventories also took place.[40]

In its initial phase, the major success of the program was to bring about a reduction in the rate of inflation. By early 1981, it was estimated that the rate of inflation had dropped to 35 percent, contrasted with its high in February 1980 of 133 percent; it remained at about that rate through 1982.[41] Although inflation accelerated in 1983 as government expenditures increased prior to the election and the new economics team reversed earlier restrictive policies, the first two years of the program must nonetheless be deemed to have been successful in achieving their objective of reducing the rate of inflation.[42]

Likewise, the balance of payments situation rapidly improved. Exports

---

[40]The military outlawed strikes upon assuming power in September 1980. The elimination of strikes was also a factor in the upturn in capacity utilization in Turkish industries.

[41]Economist, September 21, 1981, Turkey Survey, P. 8.

[42]The rate of inflation has not again reached 100 percent, although there have been sizeable swings in the inflationary effects of the government budget and its financing.

rose sharply, and were more than 50 percent over their corresponding 1980 level for the first half of 1981.[43] Industrial exports rose even more rapidly, and were more than double their 1979 level by 1981. By 1983, Turkish export earnings were $5.7 billion, compared with $2.9 billion in 1980.

However, investment was sluggish during the 1980-83 period, and exports apparently were produced with existing capacity. Thus, despite export growth, the overall level of economic activity rose only modestly. Real GNP grew at rates significantly above those of the late 1970s and per capita income was again rising, but the rate of growth was still well below the rates of growth realized in earlier years. Likewise, unemployment appeared to be rising, and real wages, which had risen sharply in the late 1970s, declined as the nominal wage increases permitted by the military government fell far short of inflation.

Although Turkish economic growth in the early 1980s was better than it had been in the late 1970s and much superior to that of most developing countries in the midst of the worldwide recession, it was not until 1984 that

[43] Economist, Turkey Survey, September 21, 1981, P. 9. There is some dispute as to how much of the recorded increase in exports reflected a real increase in export volume and how much reflected a shift from under- to over-invoicing of exports on the part of exporters. See Chapter 5 for an analysis of the importance of this possibility.

Table. 7. INDICATORS OF MACROECONOMIC PERFORMANCE, 1980 TO 1988

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Real GNP Growth (%):	-0.5	3.6	4.5	3.9	6.0	4.2	7.3	6.5	4.7	0.4
Growth of Real Investment (%):	-10.4	-0.7	-0.3	2.4	0.2	16.7	12.1	3.6	8.0	-3.4
Growth of Exports (%):	28.7	61.6	22.2	-0.3	24.5	11.6	-6.3	36.7	14.4	-0.3
Increase in Consumer Price Index (%):	116	36	27	31	48	50	37	40	72	70
Increase in GDP Deflator (%):	104	42	27	28	50	44	31	38	66	67

Sources: Krueger and Aktan (forthcoming), Data Appendix Tables 1 and 9a.

growth accelerated. Thereafter, growth rates were highly respectable by any standard. Table 7 gives data on macroeconomic performance during the 1980s. As can be seen, real GDP growth averaged more than 5 percent after 1984.[44] In the early 1980s, observers had been concerned that investment was stagnant and not increasing, even when output growth accelerated. That this was the case is confirmed by the data in Table 7. Real investment was quite sluggish until 1985, but accelerated thereafter. Thus, in the early years of the reform program, growth came mainly from better utilization of existing capacity; it would appear that it was not until the mid-1980s that the reoriented trade regime was consistent with an increase in real investment.

Other aspects of the reforms met with mixed results. Manufacturing employment was generally thought to have grown very slowly, despite the drop in real wages.[45] In part, this may be because the Military government decreed that employers could not lay off or fire workers after 1980; there may have been enough redundant workers to permit considerable expansion of output with little or no increase in employment.

Even in the early 1980s, there was rapid growth of investment and output of utilities and transport, partly as a result of the government's emphasis on developing infrastructure to support private industry. As a result, industrial employment grew considerably faster than manufacturing employment, rising from 1,996,000 persons employed in industry in 1981 to 2,271,000 employed in 1985, and to 2,561,000 in 1989. Given the rapid growth of the Turkish labor force, even this growth of employment opportunities was disappointing. This

[44]Preliminary estimates suggest that real GNP grew 9 percent in 1990.

[45]See Celasun (1989) for an analysis.

led to concerns, which still continue, about the impact of the policy reform on income distribution in Turkey.

The least satisfactory results have been the persistent rapid rate of inflation. In large part, this was because of persistently large government expenditures which, as already mentioned, were directed largely toward the development of infrastructure. Government expenditures were 25 percent of GNP in 1980. They fell to a low of 18.9 percent in 1985, and rose thereafter to the 21-22 per cent range for the following three years. Moreover, the fiscal deficit rose from its low of 1.7 percent of GNP in 1981 to 3.0 percent in 1983 and 5.3 percent of GNP in 1984. Thereafter, it was once again sharply reduced to 2.8 percent of GNP in 1985, but rose to 3.6 and 4.5 percent of GNP in the following two years. In 1988, it stood at 3.4 percent of GNP. The reasons for this were numerous: interest payments on domestic and foreign debt were a factor, but so, too, were increased government expenditures prior to each election.

To the extent that the large gains achieved by the reorientation of Turkish economic activity toward the international economy are threatened, it is the failure to achieve a lower rate of inflation that constitutes the most visible threat. Each inflationary round since 1980 has reached a higher rate of inflation than the preceeding one before restrictive monetary and fiscal policies were adopted, and the low, before the next acceleration of inflation, has been successively higher.

Until 1989, however, the exchange rate was managed in such a way that the real value of the TL was not permitted to appreciate in response to changes in the domestic price level. In 1989, however, the nominal exchange rate changed by approximately half the rate of inflation. There was already a marked slowdown in the rate of growth of exports, although special factors - including reduced exports to Iraq attendant upon the end of the Iran-Iraq war and the phasing out of some special export incentives - undoubtedly contributed to the outcome.

Nonetheless, it can hardly be questioned that a real appreciation of over 30 per cent in 1989 must have made exporting considerably less attractive than it had previously been. Moreover, the real appreciation of the TL continued in 1990. Although part of this real appreciation may have been the result of market forces[46], it is also possible that depreciation of the TL was deliberately slowed down as an anti-inflationary device.

Resolution of the inflation problem for Turkey is therefore not only a political necessity, but it is also essential for achieving a more stable real exchange rate. Should real appreciation, even if at a lower rate than in 1989, continue, it is difficult to imagine that exporting will remain profitable, and of course, importing will become increasingly attractive.[47] At some point, another major policy reform package would be required, and many of the economic gains realized in the 1980s would be - temporarily at least - lost.

6. Evaluation

There is little question that, on economic grounds, the Turkish policy reforms of the 1980s succeeded in significantly altering the trade regime and reducing the role of the government in the economy. Especially when viewed in light of the worldwide recession of the early 1980s, the Turkish reforms and

[46]Estimates indicate that Turkey had a surplus on current account of $966 million in 1989, compared to $1,596 in 1988.

[47]Along with other measures, the authorities also further liberalized imports significantly at the end of February, 1990.

the switch toward a less inner-oriented economy are truly remarkable. Equally, however, they did not accomplish the desired objectives with regard to inflation.

As of the early 1990s, the important question is whether the momentum of success regarding the trade and payments regime and liberalization of the economy will provide time and support for a renewed effort to reduce or eliminate inflation or whether, instead, the effort to contain inflation will erode the real exchange rate and undermine the altered incentive structure of the economy.

Failure to control inflation through monetary and fiscal policy seems to have led inevitably to an effort to use the nominal exchange rate as an instrument of inflation control, despite the lessons of experience in any number of countries that such an effort cannot succeed in the longer run. Should Turkish inflation and exchange rate adjustments continue at present rates, it seems inevitable that, eventually, the export boom of the 1980s will come to a halt. However, the structure of the Turkish economy is radically changed from what it was a decade ago. Moreover, the performance of the private sector has altered political attitudes toward private business irreversibly. In that regard, even if one is pessimistic about the short run, there is considerable basis for believing that most of the export boom of the 1980s has laid the foundations for renewed economic growth, based on integration with the world economy, once the current macroeconomic difficulties are resolved.

References

Balassa, Bela, 1985. "Outward Orientation and Exchange Rate policy in Developing Countries: The Turkish Experience", Essay No. 10 in Bela Balassa, Change and Challenge in the World Economy, MacMillan Press, Ltd., London

Barkey, Henri, 1984. "Crises of the Turkish Political Economy: 1960-1980", Pp. 47-63 in Ahmet Evin, ed., Modern Turkey: Continuity and Change, Leske and Budrich, Germany.

Baysan, Tercan and Blitzer, Charles, 1988a. The Timing and Sequencing of a Trade Liberalization Policy: The Case of Turkey, World Bank, mimeo. Forthcoming in Vol. xx of Choksi, Armeane, Michaely, Michael, and Papageorgiou, Dimitrius, editors, The Timing and Sequencing of Liberalization Efforts. Basil Blackwell, 1991.

Baysan, Tercan and Blitzer, Charles, 1988b. "Turkey's Trade Liberalization in the 1980s and Prospects for its Sustainability", paper presented at conference on Turkeys Economic Development in the 1980s: Changing Strategies and Prospects for the Next Decade. Harvard University.

Celasun, Merih and Rodrik, Dani, 1987. "Debt, Adjustment and Growth", in Jeffrey D. Sachs, ed., Developing Country Debt and Economic Performance, National Bureau of Economic Research, University of Chicago Press, 1989.

Dervis, Kemal and Robinson, Sherman, 1980. "Structure of Income Inequality in Turkey", Ch. 4 of Ergun Ozbundun and Aydin Ulusan, The Political Economy of Income Distribution in Turkey, 1980, Holmes and Meier Publishers, New York. pp. 83-122.

Krueger, Anne O., 1974. Foreign Trade Regimes and Economic Development: Turkey, Columbia University Press for the National Bureau of Economic Research, New York.

Krueger, Anne O., 1987. "The Importance of Economic Policy in Development: Contrasts between Korea and Turkey", in Henryk Kierzkowski, editor, Protection and Competition in International Trade, Basil Blackwell, Oxford.

Krueger, Anne O., and Aktan, Okan, forthcoming Swimming Against the Tide: Trade and Economic Policy in Turkey in the 1980s, International Center for Economic Growth, San Francisco.

Okyar, Osman, 1983. "Turkey and the IMF: A Review of Relations, 1978-82". in John Williamson, ed., IMF Conditionality, Institute for International Economics, Washington, Pp. 533-561.

Okyar, Osman, 1965, "The Concept of Etatism", Economic Journal, March.

Organization for Economic Cooperation and Developmenet, Economic Survey, Turkey, 1981

Rodrik, Dani, 1988. "Some Policy Dilemmas in Turkish Macroeconomic Management", Kennedy School of Government Discussion Paper Series No. 173D.

Saracoglu, Rusdu, 1987. "Economic Stabilization and Structural Adjustment: The Case of Turkey", Pp. 119-143 in V. Corbo, M. Goldstein and M. khan, ed.s, Growth-Oriented Adjustment Programs, International Monetary Fund and World Bank, Washington.