MEETING ON THE TURKISH ECONOMIC CRISIS

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My presentation today will be mostly based on where I am coming from. The longest part of my professional career was spent as a central banker; so I will probably tend to look at things more from a central banker's point of view and less from a politician's point of view.

First of all, when you look at the Turkish economy, it's important to understand the fundamental dynamics. If you look at the past 10-15 years, we had a relatively robust growth averaging somewhere around 5 percent - but the growth had been rather volatile; we had sharp drops in Gross National Product (GNP) on various occasions and we also had fantastic years when GNP grew by about 9-9.5 percent. Another feature of the period is that we had high inflation, but inflation had been rather stable. Roughly speaking, in the 50-70 percent range which, given the size of the inflation, I would consider being rather stable.

What makes the Turkish economy run is really the capital flows. When you have foreign capital coming in - and this mostly took the form of short-term capital flows - the economy starts to perform well and there are two reasons for this. One is that it eases a fundamental foreign exchange bottleneck on the Turkish economy: when capital comes in, suddenly the foreign exchange reserves go up; with foreign exchange reserves increasing, it becomes easier to import goods; people tend to invest; the economy starts to grow; and with the growth accelerating initially, the international financial markets get "good news" from Turkey. Things are robust, people are investing, people are importing, and they are paying their bills. So, easing of the foreign exchange constraint on the economy tends to increase the growth of the economy. Simultaneously, capital flows also ease a second constraint on the performance of the economy, which is finance. The counterpart of the foreign exchange that is coming in through capital inflows goes as additional credit to the private sector, so that the private sector, the producers, the real economy, finds not only foreign exchange becoming more easily available, but they also get the necessary finance to purchase the foreign exchange, to make the investments more easily. So, with capital inflows coming in, the business sector's activity increases quite rapidly due to these two factors, both of which are the results of foreign exchange coming in.

As I said, initially the news is good. But bad news has a lag time and usually that lag time is about four-five months. With imports increasing in tandem with economic growth, the **current account starts to deteriorate. As the current account deteriorates, the numbers come** somewhat late, and suddenly the international financial markets start asking questions like: "well, things are going quite well in Turkey, but the current account deficit is widening. I wonder whether they will have a foreign exchange crisis some time down the road. " They also ask the kind of questions like: "are we excessively exposed in Turkey? Did we lend too much? Have we invested too much in Turkey? What if there's a crisis? Can we get out?" Suddenly, with bad news coming in and concerns like this in the minds of the people, capital flows start to decline. As they start to decline, suddenly the foreign exchange constraints become binding. It is no longer as readily available as it was six months ago. Suddenly the finance constraints become binding on the economy again. You cannot borrow as easily as you did eight months before.

With these constraints, suddenly businesses have difficulties; they cut down their import demands, they cut down their investment plans, they start having a relatively greater difficulty in servicing their debt and the bad news accumulates. They say: "Oh, things are not going well in Turkey. They have a huge current account deficit, they're cutting down investment, which means that growth will probably decline. So we'd better get out of the Turkish economy, when we still have the time." So capital flows reverse, capital starts to flow out. As capital flows out, of course the constraints become even more binding and the economy tends to slow down. But the slowing down has the impact of turning the current account the other way round, the deficit stops growing. Then over time, the deficit becomes smaller and smaller, turns into a current account surplus - not a major one, but a surplus nonetheless. These worries about the economy running into a foreign exchange crisis seem to have been exaggerated six months ago. So the sentiments change back again.

If you look at the numbers, the charts, the correlation is amazing. The co-movement of capital flows, the growth rate of the economy, the cycles in import growth and the reverse cycle of current account deficit. But, there is nothing wrong with this. This is a normal business cycle and if nobody interferes with it, the cycle continues. Maybe you don't want the cyclical

activity, but this is a fundamental dynamic. So, in that sense, I view short-term capital flows as the gasoline to the engine, if the Turkish economy is an engine. But over time, something else happens. We also have a large public sector and especially, large public sector deficits. In each cycle, these deficits being accumulated, the government takes a share of especially the credit availability. That, over time, reduces the efficiency of the capital flows in producing growth. It's like the octane of the gasoline. It's falling at every cycle. So, in order for the next cycle to produce the same amount of growth, you need even larger amounts of capital inflows coming in, because the fuel is not as good as it was in the previous cycle. But as to the driving force behind the Turkish economy, in my judgment, there's no question that it is the capital flows - and especially the short-term capital flows.

The second feature of the Turkish economy, which people often fail to realize, comes from its structure. If I were to characterize the salient features of the Turkish economy, I would say that in the Turkish economy we have high public sector deficits, we have the social and political culture that public sector deficits should be monetized by the Central Bank, and that they should be financed by monetary expansion. And all of this is taking place in a small financial system - a financial system, which is small with respect to the size of the Turkish economy. To give you an example - and this is one of the key issues with regard to any stabilization program - the financial system, the broad money supply, roughly speaking, is only about a third of our GNP. Shortly, I will run you through some numbers which will show you why a stabilization program is really very difficult to implement and that was one of the underlying causes of the failure of the previous program.

The Turkish financial system is not only small, but also weak. The financial system has a very significant amount of non-performing loans, whether these loans are actually recorded as such doesn't matter. The financial institutions are also financing a lot of losses in their balance sheets. They all have a relatively weak capital base. Although the financial system was weak, the economy - because of the monetization, because of the increase in the money supply over the years - had been going on with a relatively stable rate of inflation, without running into a major banking crisis. Surely that was not sustainable. It would have run into a crisis some time, some day. But at the end of 1999 when the stabilization program with the International Monetary Fund (IMF) was started, such a crisis was not really imminent. Because of years of high inflation rates, there was also an inflationary inertia coming from expectations of inflation: because people had experienced high rates of inflation over the years, people expected high rates to be continued, and all the contracts were made with the anticipation of a high rate of inflation continuing.

At the end of 1999, Turkey entered into a standby arrangement with the IMF. The standby arrangement - technically when you look at the whole program - was an internally consistent program. There were no internal contradictions within the set of policies described in the program. It was consistent; it tried to address some key issues of the Turkish economy; but in my judgment it was very difficult to implement in the medium term - for a number of reasons which I will come to in a minute.

To understand the philosophy behind the 2000 program, you also have to understand how the IMF, and especially the people involved in Turkey, look at the world and what their philosophy is. I read a number of articles published by Mr. Carlo Cotarelli, who was the mission chief to Turkey. He argues in those articles that, in order to break the inflationary inertia, the exchange rate should be used as a mechanism, as an anchor to lower the inflationary expectations - and this is not written particularly for Turkey, it is more of a philosophy in general. "This effort should be supported, made credible by a number of fiscal and monetary policies designed to guard the exchange rate as an anchor." But, then he adds, "because usually the governments who implement the stabilization program do not have sufficient credibility that they will implement and maintain these policies, the IMF, by endorsing these programs, should lend credibility to the program itself."

Philosophically that's exactly what happened in Turkey. If the government had announced the same program by themselves, if minister Recep Onal had made the statement in the parliament on what was contained in the letter of intent to the IMF, the markets - neither domestic nor international - would have believed him. This program would not have had any credibility without the support of the IMF and the World Bank. What was exercised in Turkey in the year 2000 was very much in line with the views expressed by Mr. Cotarelli in several of his earlier writings.

I will go over some key issues regarding the program. The program was essentially based on targeting an exchange rate, pre-announcing the exchange rate depreciation and ensuring that the Central Bank operated in a fashion that was compatible with the pegging of the exchange rate. The most novel aspect of the program is that they were basing it on an inflation target of 20 percent on wholesale prices and 25 percent on consumer prices, and that the exchange rate was targeted and announced to depreciate by only 20 percent over the year 2000, and that the Central Bank would essentially operate as a currency board. Namely that, there will be a floor on net international reserves of the Central Bank. Central Bank would expand liquidity only when it purchased foreign exchange; and to make sure that no money was printed to finance public sector deficits, so that no monetization of the deficits was done, there was a rather binding ceiling on the net domestic assets of the Central Bank.

Such an arrangement would work, but in any currency board arrangement or currency board-like arrangement, what you need is a strong banking system, because markets will test you - markets will test your resolve to adhere to the exchange rate rule that you declared. And when markets do that, usually what happens is you'll end up having difficulty in the banking system. The question is: "Is the government going to let banks fail, by adhering to the foreign exchange rule or will they ultimately be forced to change the foreign exchange regime and save the banks?" With a weak banking system, this was definitely a high-risk gamble because the banks already had problems standing on their own feet. Putting the banking

system under such stress - that one could easily expect under a currency board-like arrangement - in my judgment that was too big a risk to take.

There are other issues, which made this program somewhat incredible from the start. For example, in the letter of intent it says that the overall deficit of the consolidated government sector is not expected to exceed Turkish Lira (TL) 18.75 quadrillion or 15 percent of GNP for the year as a whole. Let's just keep that 15 percent in mind for a second. If the Turkish government had performed fantastically well, this is what the results would be, 15 percent of the GNP. Well, if that's the deficit, this deficit has to be financed. It has to be financed either by borrowing abroad or from the domestic financial system. There's no other way you can finance it. We look at the same letter of intent, there are performance criteria: on contracting or guaranteeing of new external debt by the consolidated public sector; and the amount allowed for financing of this deficit is only 7.5 percent of GNP - it is $15 billion. What that means is that the government can borrow no more than 7.5 percent of GNP - this is at the outset of the program.

The government is not allowed to borrow more than 7.5 percent of GNP to finance the deficit. That leaves us with a deficit of an additional 7.5 percent to be financed domestically. 7.5 percent of GNP, roughly TL 9.4 quadrillion, had to be financed, had to go to the assets of the banking system.

At the end of 1999, total monetary liabilities of the banking system were only TL 40 quadrillion. To provide the credit to the government means that the balance sheet of the banking system, the monetary liabilities would have to increase at least by 25 percent. This allows no credit to the private sector, which has to do the production to achieve the 5 percent growth as foreseen in the program. And I still haven't factored in the accumulation of net foreign assets by the banking system. Let's forget net foreign assets.

Until recently, the public sector was borrowing approximately an amount equal to half of the financial liabilities created by the banking system, and half goes to the private sector. This means that, roughly speaking, the private sector's needs would be at least equal to those of the government or the public sector. The public sector alone increases the money supply by 25 percent, which means that, together, the broad money supply had to increase by 50 percent - you need 25 percent to finance the government's deficit and you need 25 percent to give to the private sector.

In an economy, if you design a program where the minimum monetary expansion for 5 percent growth is 50 percent and try to convince people that you are going to have 5 percent growth and 20 percent inflation, then there is something wrong - unless you are a die-hard Keynesian and you think that money and prices have nothing to do with each other.

This was a major problem with the program. But more importantly, I will tell you a number of somewhat technical-looking difficulties. For example, under the monetary policy, before the program started, the Central Bank, with the endorsement of the IMF, reduced the reserve requirement on deposits from 8 percent to 6 percent and increased the liquidity requirement by two percentage points. You may say: "Well, there's nothing wrong with it: 2 percent down from one side, 2 percent up from the other," but there's a major difference because the liquidity requirement is satisfied through an averaging of the free deposits of the banking system. But on any single day, this change in the reserve requirement essentially gave banks an amount equal to 2 percent of the deposits - additional ammunition - to put to test the government's resolve on the exchange rate. On any given day, this increased the liquidity given to the banking system could be used to test the government's resolve by going to the Central Bank and demanding for an exchange. This was an aspect, which weakened the program.

Another issue - this is a performance criterion and again a technical issue - was that the Central Bank was prohibited from sterilizing capital movements and allowing the interest rates to be freely determined in the market. Well this is nice; we don't interfere with the market. But, again if you look at the chart of overnight interest rates, the volatility has increased tremendously. The Central Bank totally left the overnight money market; it had no operations whatsoever for the year as a whole, and because of that, not only the daily average interest rates started to fluctuate wildly, but also the spread between the minimum and maximum rates that prevailed on any given day has increased tremendously.

With the banking system holding almost the entire debt stock of the government, and interest rates going up from 50 percent to 100 percent from one day to the other, assuming an average maturity of 8 months for the debt stock, means that on any given day banks - when marked to market - were incurring losses equal to 4 percent of the GNP. That's comes out from the numbers. On any given day, if interest rates went up from 50 percent to 100 percent, the market value of the stock of government debt declined by an amount which was equal to 4 percent of the GNP. And clearly, banks are not capitalized sufficiently to absorb that. Of course, some days the reverse was also true, if the interest rates went down, they made huge profits.

Essentially because of this increased volatility in interest rates, the banking system increasingly became unable to operate in a sensible manner. I think it was a mistake to lower the reserve requirements and add it up to liquidity requirements; it was probably done with the objective of lowering the cost of borrowing. But also, taking the Central Bank completely out of the market, saying that it will not sterilize any capital movement, it will not interfere with the interest rates at all, essentially meant that suddenly the banks were unable to determine interest rates. With such a huge government debt, of course they didn't know when they would be hit. In November, when overnight interest rates went up and Demirbank had difficulty finding liquidity from the market, the Central Bank - because of the constraint on its domestic assets - was unable to extend liquidity to this bank. The bank was probably one of the largest holders of government securities in its portfolio, and to find liquidity, the bank decided to sell government securities at any price. This really pushed interest rates up - to 1,000 percent. At this rate, the losses you are incurring start to hurt.

The Central Bank initially adhered to the program. Demirbank lost all its capital in essentially 48 hours and the government took it over. Then, seeing that there was a major liquidity crisis, the Central Bank started to give liquidity. But by that time, the market psychology was such that all this additional liquidity was coming back to the Central Bank in the form of demand for foreign exchange. So the Central Bank lost - in a period of five days - roughly $6 billion in reserves.

Then we had the revised agreement with the IMF, where we were given the Supplemental Reserve Facility because of the crisis conditions, and the Central Bank was allowed to exceed the net domestic assets performance criteria. Then the market started to come back towards something of a normalcy starting with mid-December, going through January. But the banking system was hurt tremendously because of the events that took place at the end of November. So, the weak banking system was even weaker.

Then, there were also problems with the government implementing the reforms. The privatization process - they just couldn't do, the structural reforms were going too much slower than what was intended under the program. But from purely a market perspective, things were looking quite normal on the morning of February 19. I was visiting a friend, I left my home, drove about 30 minutes, got to my friend's, and my friend said: "You know, the prime minister left the National Security Council meeting, and he's holding a press conference." The prime minister described what had happened in the National Security Council meeting and how the president had insulted him and hurt his feelings. This was around 11 am, and in my immediate reaction I said: "This is a $5 billion day." Well, I was conservative. The total demand for foreign exchange on that day was $7.6 billion.

There is another technical problem, for which I think the Central Bank is to blame. On the 19th, the U.S. markets were closed. So dollar sales could not be done on the same day value. They were being transacted on the next day's value. The thing is, no one at the Central Bank, during the day, thought of asking the following question: "These banks are trying to purchase $7.6 billion and we are selling them on the next day's value. But the total Turkish liras that they have at the prevailing exchange rate is sufficient to buy only $1.2 billion." The total Turkish lira deposits of commercial banks with the Central Bank - the resources with which they could pay for this foreign exchange - was sufficient only to buy $1.2 billion. How in the world did the Central Bank contract to sell them $7.6 billion - I don't know. And, as things have materialized the next day, banks couldn't come up with the Turkish liras. So they sold back $6.1 billion to the Central Bank. So, there was no reserve loss from that. But of course, what happened was that, in the process, they contracted with the Central Bank to buy the foreign exchange and then they started shopping for Turkish liras. In the afternoon of the 19th, all Turkish banks were shopping for Turkish liras in an amount equivalent to $7.6 billion or $5 billion. But they did not have enough Turkish liras to buy that amount. It simply did not exist. So all this did was push up the interest rates. Banks didn't want to default to the Central Bank so they were willing to find Turkish liras at any price. The overnight rates hit 7,000 percent that night.

The Central Bank was not doing anything. It had to give credit to the banking system, but couldn't, because it would then have violated the performance criteria established by the IMF on its net domestic assets. It could have purchased government securities from the banking system, but that would have violated the net domestic assets condition as well.

Clearly, there were a number of mistakes made along the way by a number of parties. I am used to seeing policy mistakes or misguided policies being implemented by the Turkish government. I've probably participated in some of those myself. But what I don't really understand and what I think the international financial community - Wall Street, London, Tokyo and so on - should really question is the wisdom of the IMF before endorsing any program. My advice to the international financial community is: "Don't look at the program and trust it simply because it has the IMF's endorsement." The IMF is also known to make major mistakes. In this case, of course, the ultimate responsibility lies with the Turkish government, they were the ones who implemented and decided on the policies. But I think it was the comfort given to the international financial community by the IMF that made the failure so much more of a fantastic event.

Now of course, our good friend Mr. Dervis is in the process of preparing a new program. We all have to realize that a rapid disinflation, with the present state of the financial system in Turkey, is simply not possible.

The first priority has to be strengthening - very significantly - the Turkish financial system, especially the Turkish banks; and the approach for strengthening the banking system should be, in my judgment, not through shrinking the banking system, but through the capitalization and enlarging of the banking system. You can have a very small and very healthy financial system in Turkey, but you are not going to solve your problems with inflation because you won't be able to finance government expenditures.

A second issue is that a credible disinflation program will have to be based on a far more significant effort on part of the government to reduce its deficits. Reducing public sector deficits - not the primary surplus, but the overall deficit - to levels equivalent to about 15 percent of GNP, as under the last program, would simply be insufficient. Deficits should be reduced to below 5 percent if the program, in my judgment, is to be credible.

So the task before us in Turkey is a very difficult one. I wish Mr. Dervis and his colleagues the best. But I am not very optimistic about whether such a reduction in public expenditures can be done within the present social environment in Turkey.

QUESTION & ANSWER

B. ALIRIZA: One question that comes to my mind is with respect to the cycles that you described so well. The current account deficit kept on growing to the point where exports are about only half of the imports and clearly Turkey doesn't

have the money to finance these imports. People have argued that this was the legacy of the Ozal period opening to the outside world. Could it have been avoided?

Secondly, the last crisis that people are comparing this one is the one in 1994, which occurred soon after you left the Central Bank. At that time, you had warned that this was coming. Particularly with reference to your period as the governor of the Central Bank and addressing the opening to the outside world, could you talk a little bit about those?

R. SARACOGLU: First of all, let me brag a little bit. I was the governor of the Central Bank for six years. It was a very difficult environment, but almost crisis-free. We had no domestic crises. The maximum foreign exchange reserves that we held at the time never exceeded $5 billion. Now they had a crisis with $30 billion in reserves.

As for the opening up of the Turkish economy - and I am talking especially about the convertibility of the Turkish lira - I advocated for it from a citizen's perspective. I view convertibility as a freedom to the citizens of a country. At the end of 1970's in Turkey, even keeping $5 in your pocket was a crime. So you did not have the freedom to choose even the means of payment. Then in 1984, the foreign exchange regime was liberalized, people were allowed to hold foreign exchange and they were allowed to open foreign exchange deposit accounts with the banks. That gave people a choice, an additional freedom on how they wanted to keep their savings. But, they were restricted to the Turkish financial system. With the convertibility, Turkish people were given the freedom to choose the financial system they wanted. One cannot oppose giving Turkish citizens such a freedom. Of course, such a freedom does not come without a cost. The cost is that, under free capital mobility, the government finances have to be in a much better shape. The government has to be run in a radically different way from the way it was done before. This is what we couldn't accomplish in Turkey since 1989.

The crisis in 1994 was clearly nothing other than Mrs. Ciller's mismanagement. She wanted to lower the interest rates. She cancelled auctions; the Central Bank extended huge amounts of credit to the government because she was trying to lower the interest rates and eventually the exchange rate just blew up.

B. ALIRIZA: Following up on what you said; bad loans are part of the structural problems of the Turkish economy and clearly, they are political. We have a situation in the Turkish economy where in spite of the opening to the global economy, half of the economy is still controlled by the government. You have these public banks where these bad loans you have talked about have been made for political reasons and they are never going to be recovered; and financing those bad loans with external funds clearly is not going to occur this time. Do you think the Turkish political system is up to the task of preventing itself from doing what came naturally for so long?

R. SARACOGLU: No I don't think so; they have just announced that because of the small business owners' activities on the streets they have immediately turned around and lowered the interest rates on their loans, extended additional credit, and now the farmers' unions are demanding the same for agriculture. I realize that politically it is very difficult. The inclination of the Turkish politician, what I call "the natural instinct" of Turkish politicians is to be populist.

K. WEISSMAN: In terms of the scale of what happened, what would you compare this to as far as other financial crises that we have seen in the last couple of decades? The second question is: You're sitting here in front of a lot of representatives in Washington, what can we do, what can the U.S. government do?

R. SARACOGLU: First of all, let's not make a mistake. Turkey's problem today is not one of foreign exchange; it is one of domestic currency. This we have to understand. We don't need any additional foreign exchange. These losses, which have been accumulated from the past, are the stock problem. If we try to absorb the stock in the next three months, then the social fabric simply will not withstand it. Provided that the flow problem is corrected, what is needed as assistance to Turkey is to ease the absorption of the stock problem and to allow some time for the Turkish society to absorb it. But this is provided that we resolve ourselves the flow problem. So long as the flow problem is there, doing anything with the stock would be utterly useless. But if the flow problem is adjusted, I think it would be very important for Turkey to get assistance from her allies in easing the burden of the stock issue.

K. WEISSMAN: What about the international context part of that question? Is this like Mexico or Brazil or Asia? The losses we hear are staggering.

R. SARACOGLU: Clearly, the magnitude of the losses is larger than the previous crises. But that's because both the exchange rate and the interest rate have moved much more violently this time, compared to previous Turkish crises. The stock issue is I think somewhat exaggerated. All you need is reducing the stock to a sustainable level. There is a level of debt that you can maintain. You don't have to pay back all your debt that would be stupid. The numbers quoted are usually the entire stock of debt. But I think the actual need would be less than half of that, for the economy to sustain itself.

K. WEISSMAN: Do you mean some kind of a moratorium perhaps or a rescheduling?

R. SARACOGLU: I don't think Turkey will be asking for a moratorium. I hope they will not.

A. HEGBURG: Coming back to this payment problem. I have seen numbers of public and private debt repayment schedules that are quite large for 2001. Are you saying that there won't need to have a Paris or London Club rescheduling for some of this debt? Not just public debt, but certainly the private debt?

R. SARACOGLU: I don't think so. We don't have any problems with our external debt.

B. ALIRIZA: How about the domestic debt? I have seen projections that it is going to add up to 61 percent of the GNP. Isn't that a tremendous burden on the economy?

R. SARACOGLU: It is. With the domestic debt, the problem is also that it has a very short maturity. So, it is really your ability to roll over that debt. With the external debt, the maturities are much longer. Almost all of the domestic debt will be maturing this year, and if you cannot roll it over you are going to have a major problem. And that is the major risk. That is why that issue has to be resolved with an understanding with the international financial system.

In 1995, just before I was running for office, I got together in London with Stan Fischer for a conference. At that time it looked like my party was going to win and I was going to be the minister of the economy. I said that we would go into a currency board arrangement. My idea in 1995 was to peg the exchange rate, to fix it. But for that to be sustainable, I would need a package from the IMF and the World Bank, a standby facility, to be used only in case of a banking crisis, for $5 billion. I said: "On the basis of that, I also want the IMF to help me." In those good old days there were many Central Banks, now their number has declined substantially. I said: "I also want to have a swap arrangement with the Bundesbank, Bank of England, Banque de France, the National Bank of Belgium, Bank of Japan and so on. A swap facility, which will match what the IMF and the World Bank puts on a one-to-one basis, again to be used only in case of a banking crisis. And third, after we conclude the swap arrangement, I want to syndicate again a standby facility for $20 billion. Not to be used again. And as the Central Bank, I would be willing to pay the commitment fee for that. That's my cost of stabilizing my economy. But, we have to put together a $30 billion standby facility to be used only in the case of a banking crisis." Because I knew that when you go into a currency board arrangement your soft underbelly is the banking system. Now, such an arrangement, in my judgment, would require a standby facility of this type, of about $50 billion. Whether such a standby facility can be put together in today's world, given what we have gone through, is highly uncertain.

This does not mean that Turkey needs that money but Turkey needs that insurance. It's an insurance policy. That's why in 1995, I told Mr. Fischer himself that I wanted such an insurance policy before I implemented the program we were discussing privately between the two of us. And clearly, in 1999, when they entered into this program, what was fundamentally lacking was such insurance. At least the Supplemental Reserve Facility Agreement should have been made at the outset of the program. The Central Bank didn't need the reserves, it didn't have to use it, and it would have been a true standby facility. A standby facility is exactly this: it's a facility that you may need under certain circumstances, an insurance policy.

A. MAKOVSKY: Is your 1995 solution the right solution for now? Is that what you are recommending for the current situation?

R. SARACOGLU: I am not recommending that, but clearly whatever you do has to have an exchange rate component.

U. ENGINSOY: Especially after this second crisis in February, the IMF and the United States government have put all the blame on the Turkish government, and at this point - at least from the Bush Administration - I can see no signs of sympathy for the Turkish situation. And apparently no additional funds are coming, apart from the already allocated $6.25 billion that is supposed to come from the IMF. Also the Turkish government does not seem to be doing very well, especially on privatization. In your personal opinion, are we heading for a complete collapse?

R. SARACOGLU: No. We're going through some difficult times but there is no such thing as a "complete collapse" or "hitting the wall." Countries don't hit the wall. We are going to go through some difficult times, and as Mr. Dervis has said, maybe by going through these difficult times we can implement some political changes that are necessary and which underlie all the economic phenomena, then we may have a good outcome from that; but socially I think we are going to go through some difficult times.

U. ENGINSOY: What is the possibility of that political change?

R. SARACOGLU: I think the best idea to make the political change is for someone to form a party whose sole objective is to make political changes. In Turkey, if a party is formed today with the objective of making three or four - not too many - major constitutional changes: I'll vote for them.

B.ALIRIZA: It's interesting that after a briefing on the economy you end up calling for economic change in order to get out of the economic crisis.

M. PARRIS: You don't seem to have much optimism that the current political leadership is going to get right the necessary calculus of what's needed in time. You seem to suggest that the country will not hit the wall, but it will have to go through additional bracing in the markets before it reaches a point where you can achieve some kind of long term solution to the problem. For the short term, you're not as positive.

R. SARACOGLU: Let me put this into perspective; you see, as a citizen of Turkey, I'm sick and tired of realizing the downside risks, which are inherent in our political system. What I don't want is another Ozal who can maybe make big reforms, improve the economy, and convince the U.S. administration and the international financial community to put in $20 billion each because when Ozal goes the political system will not sustain those reforms. So what I want is a change in the political system where the downside losses are minimized or reduced.

M. PARRIS: But to get there, things probably have to get worse.

R. SARACOGLU: Probably, yes.

H. FINDAKLY: The IMF came into Turkey not because Turkey needed the IMF, but because it needed the IMF as a political cover for the kind of political and economic reform they needed to deal on the issues on deficit and privatization

and so on. They were running into big stumbling blocks in the parliament and within the social system. These problems remain and with the IMF out of the picture and with the current stock of problems rising, they have two options; one is to remove those constraints and allow inflation to run, with all the volatility and the problems that will go with it, but it will be less a political pain since politicians do the populist thing; and the second option is to follow a monetarist approach, which means you're going to run the risk of protracting the recession in the economy and that causes its own dynamics and problems. Between those two options, there is very little space that you can maneuver. Are we going into a situation where the economic pressures are now going to force social and political pressures?

R. SARACOGLU: I think economic pressures will get harder, leading to political pressures for change. However, for these pressures to be sustained, Turkey will have to go through a relatively high period of inflation. For the system to change we need more pressure.

N. TAN: As of today, if you were to deal with the existing situation, which comes first for you, economic reform or political reform?

R. SARACOGLU: It is the famous dilemma: if you are constantly fighting to put out fires, you don't have time to think about the prevention of fires. So, the more urgent task may be the economy, but the more important task is the political change.

U. ENGINSOY: You said that you expect Turkey to go through a period of relatively high inflation through this process. If we take the new economic program with the IMF to be another disinflation program, do you think that it's meaningless to pursue another program with the IMF?

Secondly, people are talking about reform, what exactly does this mean? Do you mean new politicians, a completely new constitution, or a "soft coup?"

R. SARACOGLU: Regarding your first question, it would be highly inappropriate for me to pre-judge a program that is not yet announced. I wouldn't pass judgment on that until I have seen the program. I have a limited ability to analyze things and maybe people who are much smarter than me can come up with a very good program and put the economy into an appropriate path without going through inflation.

With regard to the other issue, I think I told you what I had in mind. First of all, I think we need constitutional changes to constitutionally require, for instance, narrow district elections. In Istanbul, my district, I have 23 MPs, I don't know their names. In any event, I can't go and grab them by the neck and say: "I elected you," because the guy will say: "Are you kidding? My party leader put me in the number two spot and I got elected." So, definitely, we must have narrow district elections.

Secondly, members of parliament go there not with the intention of functioning as a legislature. They all go there hoping to become cabinet members. But you have only around 35 cabinet members in a parliament of 550. So what happens to the rest? They say: "Well at least in that case let me take care of the executive functions within my district. So let me decide who will be the police chief in my district, let me be a consultant about the head of the government hospital," and so on. So, we have to stop this expectation; namely that members of parliament should be prevented from becoming members of cabinet unless they resign from the parliament.