July 2, 2002
THE TURKISH ECONOMY: ON THE ROAD TO RECOVERY?

On July 2, a CSIS conference focused on the troubled Turkish economy. The conference followed previous CSIS meetings in January and March on the state of the Japanese and Argentine economies. The speakers were Attila Karaosmanoglu, a former Turkish Deputy Prime Minister and World Bank Vice President and currently Chief Advisor to the Istanbul Chamber of Industry; IMF Turkey Desk Officer, Juha Kahkonen; and the Director of Emerging Markets, Merrill Lynch, Matthew Vogel. The Turkish Central Bank Vice Governor, Fatih Ozatay, was unable to attend, as his presence was required at an urgent Central Bank meeting in Ankara.

The conference was opened by Dr. John Hamre, President and CEO of CSIS, who emphasized Turkey's important role as an ally. Expressing confidence in Turkey's ability to overcome its current economic problems, Dr. Hamre said he believed "no country was more pivotal to the U.S. than Turkey." Following Dr. Hamre, the Turkish Ambassador to the U.S., Dr. Faruk Logoglu underlined the importance of continuing U.S. support as he also expressed hope about the future of the Turkish economy. While acknowledging the weaknesses and the political uncertainties in Turkey, Ambassador Logoglu pointed to the current coalition's ability to stick to the implementation of the IMF-backed economic program and reforms, especially in the banking sector.

Attila Karaosmanoglu began by saying that the recent release of the $1.1 billion tranche by the IMF, along with the positive assessment of the implementation of the economic program by IMF Director Horst Kohler, were "good news". However, the downgrading of Turkey by Standard and Poor's, the health problems of Prime Minister Bulent Ecevit, the disagreements between the coalition partners, particularly on the European Union issue, were "bad news." Karaosmanoglu also drew attention to reported disagreements among the economy bureaucrats, most notably between Economy Minister Kemal Dervis and the Governor of the Central Bank, Sureyya Serdengecti, on the economic impact of early elections, as well as on whether the growth rate had to be a target. Karaosmanoglu observed that "achieving the balance between exchange rates and the rate of inflation was proving to be very difficult" and that some people were worried by Ecevit's recent statement that attention should be focused on growth. Karaosmanoglu argued that sustainable growth required "changes to be implemented in a way that do not need review or adjustment, closer coordination between coalition partners and better communication between the economy minister and bureaucrats." Noting that Turkey was scheduled to receive only $4 billion or so more from the IMF and needed more direct foreign investment, Karaosmanoglu warned that Turkey would be "in a quagmire if the inflation rate continues to go up and there is no additional foreign investment or IMF money." Although "uncertainty was almost inevitable" in Turkey, Karaosmanoglu predicted the possibility of a "very difficult time in July and August."

Matthew Vogel also began by acknowledging that the performance of the Turkish economy was in line with the IMF program. While he was concerned over the debt ratio, Vogel said the program was "a good program and more robust than previous programs." In addition to the banking reforms, Vogel noted that the floating currency enhanced stability and the robustness of the economy to shocks.

Nevertheless, Vogel said that he had "quite a bearish outlook on Turkey." Arguing that the problem in Turkey was "now out of the control of the IMF, the Central Bank or the technocrats," Vogel said that he was "concerned about politics, along with the rest of the investment community in the U.S. and in Europe." He added, "The problem now I believe is that it is so difficult for one to see how political uncertainty in Turkey unwinds itself". According to Vogel, "in the last six years political uncertainty was the main driver feeding into interest rates and building the debt stock." Vogel confirmed that private foreign investors were negligibly involved in the Turkish lira and the Turkish debt.

Questioning the government's commitment to greater foreign direct investment, Vogel argued that in addition to the negative macroeconomic factors, the political instability was a factor in the lack of foreign investment in Turkey. He said that other countries in similar situations were able to attract more foreign direct investment partly because they were seriously attempting to provide a securer atmosphere for investments with foreign investment laws. While Turkey was hoping that the IMF credits would build a sustainable basis for foreign direct investments to take over the debt financing, the country was not taking the steps the Eastern European countries were taking.

Vogel commented that some investment circles in Europe would react negatively to the collapse of Turkey's attempts to gain accession to the European Union because of a failure to carry out the necessary reforms as well as the failure to solve the Cyprus dispute. While there were concerns about the effects of the current crisis in Brazil on the Turkish economy, Vogel argued that the negative impact would be negligible. Focusing finally on the political uncertainty again,

Vogel expressed skepticism on the growth potential in 2003 and concluded by saying, "It would be too easy for us to say what has been achieved so far is sufficient for Turkey to make it over the hump without another crisis."

Juha Kahkonen (Full transcript):
Thank you very much. I'd like to talk from the IMF perspective about Turkey - both from the long-term perspective and about the current situation. The way we see Turkey is that it is a country that clearly has been performing well below its potential for decades. What we have seen is inflation going up decade by decade since the 60's, whereas the growth performance has weakened. Average growth has come down every decade. This weakening performance has had to do not only with the high inflation but underlying structural problems - which have not been addressed for a long time - weak fiscal policy and also lack of policy credibility.

Over the past couple of years Turkey has been in the midst of a determined campaign to turn around this weakening performance. There have been three attempts at turning things around since the end of 1999. An ambitious three-year program was put in place by the government with IMF support. Despite good progress, there were two crises within 14 months that derailed the program. The next attempt started in May 2001 when the three-year program was strengthened and the exchange rate regime by that time had become a flexible exchange rate. That program, after some initial sputtering, was making good progress, and there were signs of a turnaround before 9/11. After 9/11 the economy suffered but market conditions improved when there were expectations of additional international financing. These expectations did materialize when a new three-year program started at the beginning of this year. Now this is the third attempt in getting the economy on a path to realize the potential that Turkey clearly has.

Coming to more recent developments, in our view, the first four months of the year have clearly demonstrated that the economics of the program are very sound. Economic growth, economic recovery did start in the first quarter of this year. Growth numbers that came out last week were very good and showed a very good start for the economy this year. Inflation has been coming down even more rapidly than expected and the Government's and the Central Bank's target of 35 percent for the full year seems well within reach and would be a remarkable achievement after long periods of high variable inflation. Also financial market indicators in the first four months of the year were much better than expected compared with the program expectations.

This good performance reflected the very strong efforts the government and all economic officials have made to implement the very ambitious program. There were very demanding prior actions to get the program started in January and all the conditions under the program have been broadly met. Even in the past couple of months when there has been political uncertainty the government has delivered on all key measures. Based on this good policy performance, there is now a track record for more than a year of very strong policy performance. There is more confidence on the authorities' ability to deliver on the needed measures.

The program's features should make it more robust to shocks than previous programs. There's the floating exchange rate that does absorb the shocks better than the earlier system. The banking system has been cleaned up significantly. Last year the focus was on state banks. The links between politics and the economics of state banks were severed and these banks were restructured, not only financially, but also operationally. This year the focus has been on private banks. There has been a very ambitious exercise of audits of private banks and then recapitalization of these banks. The audit results were announced a couple of weeks ago. We have followed the process very closely and in our view the exercise has been conducted so far in line with international best practice. The authorities have made some very courageous decisions in this context. The takeover of the medium-size and deeply insolvent Pamukbank was a very important step and an indication of the authorities' determination.

So the banking system once properly and fully capitalized should be in much better shape to handle any possible shocks. There have been also reforms in other important areas, like public sector reforms, that should help underpin a strong fiscal position. The adjustment in the fiscal balances in Turkey over the past two years has been one of the main achievements of the program and should help underpin debt sustainability for the medium term. The primary budget position has improved over the past three years by more than 8 percent of GNP at a time when the economy has undergone a deep recession. This adjustment is almost a world-record in its magnitude of significance and the efforts have helped create confidence that the program's sustainability is secured. To increase confidence that the fiscal position, strong fiscal position, can be maintained, there is a need to undertake reforms both on the expenditure and revenue sides of the budget. This has been done in some cases and is on the way in other cases. For example, indirect taxation has been reformed and for the fall the intention is to reform and revise direct taxation including the taxation of financial instruments.

For the program to deliver fully, it is also important to increase the role of the private sector and while reasonably good efforts in some areas have been made, privatization and foreign direct investment are the weakest areas of the program so far. In privatization, there are some understandable reasons for delays, such as market conditions for the sale of Telecom. But it is also clear that vested interests in this area are strong and there is a need for much faster progress in this important area. Foreign direct investment in Turkey has been very very low. In countries of Turkey's size and importance, one would expect to see foreign direct investment five or ten times that of Turkey now. And once reforms, including the enhancement of the private sector's role, get further along, one would expect and hope that foreign direct investment would also pick up.

So, that's briefly how we, the IMF, see Turkey. The Program has now had two reviews, which have been completed. The next one will start in a couple of weeks and the next IMF board meeting could be expected to take place in August. Thank you.

Umit Enginsoy (NTV): Mr. Kahkonen, given the high interest rates and the debt-rollover situation, under the current program Turkey is slated to receive $1 billion each next year and in 2004 from the IMF. Do you think additional international assistance would be necessary for Turkey for next year under the developing conditions? …

Juha Kahkonen: On IMF financing, under the program there's still something like $4.5 billion left to be dispersed. If the program remains on track, there will be about $1.1 billion in August and $1.5 billion later in the year - and $1 billion each, as you mentioned, in 2003 and 2004. The program is based on conservative assumptions and if things go according to plan, this is clearly sufficient. As developments early in the year showed, the program has potential to perform better than expected and it can then even be in a way over-financed. I mean Turkish net international reserves even now are more than $2 billion above the program's floor. So there are no plans for additional IMF financing and there has been no discussion of that.

Bulent Aliriza (CSIS): I know you're going back to Turkey next week for a review. I happened to be in Turkey when you came for your last review. What was striking to me was the extent to which you were optimistic about the country, even when other people, from TUSIAD and TOBB for example - whom you meet every time you go - were expressing concern, particularly about the political uncertainty. You talked about how the government has delivered on all matters in spite of all the uncertainty. When do you begin to get worried, as Juha Kahkonen or the IMF, about the Turkish economy and when do you begin to be more bearish on Turkey? Are there things that you are looking at that would be signposts for you to begin to get really worried about the way the government is behaving with respect to the politics and of course the political economy?

Kahkonen: Politics do of course matter for the success of the program. Overall what is needed is long-term credibility of the authorities' reform efforts and for that there is a need not only for economic stability and financial stability but also political stability. Of course, it is impossible to define precisely what is required for political stability. Markets will tell that - one can see from market signals to what extent there is this kind of credibility and stability.

Aliriza: If I may follow up briefly. Today the stock market fell again over 400 points and the Lira is back above 1.6 million to the dollar. When you talk about the market indicators, we know that you're looking at other factors, but you're also looking at these. Are you beginning to get worried or are you still as comfortable as you were before?

Kahkonen: We have seen over the past year good policy performance. This has been in conditions, which sometimes have seen political turmoil, the Turk Telecom episode and some other things. I mean there is a lot of confidence about one key element of the program - mainly whether the necessarily ambitious measures that are needed for the program to succeed can be done. There's more and more proof of that. As I mentioned, these efforts, which add to the credibility of the program and should help guarantee economic and financial stability, which also need to be accompanied by market confidence in political stability.

Deniz Enginsoy (Anatolian News Agency): IMF Managing Director, Mr. Kohler, said in a statement last Friday that Turkish authorities should work to convince financial markets. What specifically should the government do?

Kahkonen: On the economic front more of the same. As I mentioned earlier, there is a need to have economic, financial and political stability to help convince markets of the long-term credibility of the program. Clearly in the IMF we focus on the economic part, where the authorities have continued to deliver under difficult political circumstances.