No. 723

February 28, 2001

Turkish Crisis Creates Opportunity for Needed Economic Reform

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The Turkish economic crisis is the first international economic challenge to confront the Bush Administration. Turkey plays a pivotal role in advancing U.S. policy goals in the Middle East, Europe, and Eurasia. America therefore cannot neglect Turkey and should help it to achieve economic stability. The Administration must not, however, perpetuate the Clinton Administration's disastrous policy of insuring developing countries and international investors against their own imprudent actions—a policy that resulted in eight major financial bailouts beginning with Mexico in 1995. The Bush Administration has stated its support for a new policy based on capitalism, not intervention. Turkey should be seen as the first opportunity to implement this policy, which would help set this important U.S. ally on the path toward long-term economic stability and growth.

Crisis in Turkey. Turkey and the International Monetary Fund (IMF) negotiated a three-year stabilization program in December 1999, the 17th agreement since 1961. The goal of the program was "to reduce inflation to single digits by 2002, ensure a sustainable fiscal position, remedy chronic structural inefficiencies in the economy, and raise the sustainable level of growth." Turkey complied with IMF loan conditions to reduce its fiscal deficit, begin privatizing state corporations and utilities, and establish a "crawling peg" to reduce inflation in which the value of its currency, the lira, was tied to a ratio of the U.S. dollar and the euro.

Considering that all the previous IMF agreements failed to lead Turkey to sustained economic growth, it is not surprising that Turkey is undergoing its second economic crisis in three months. What is surprising is how similar Turkey's crisis is to other exchange-rate crises of the 1990s and the IMF's determination to repeat past errors. The IMF required Turkey to reduce its fiscal deficit—the result of financing a bloated state sector through high-interest deficit spending—by increasing taxes. The higher taxation slowed the economy, leading the IMF to propose devaluing the lira to stimulate exports for economic growth.

Produced by the
Center for International Trade
and Economics (CITE)

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002–4999
(202) 546-4400
http://www.heritage.org

This paper, in its entirety, can be found at: *www.heritage.org/library/execmemo/em723.html*

The most recent crisis was triggered by a February 15 dispute between Turkish Prime Minister Bülent Ecevit and President Ahmet Necdet Sezer that further undermined investor confidence, leading investors to dump the lira and purchase dollars. The central bank lost an estimated $7 billion defending the peg before Turkey was forced to allow the value of the lira to be determined by markets, or to "float," on February 21. The lira promptly dropped 36 percent against the dollar.

Assured of a predictable exchange rate under the peg, the banking sector had taken advantage of easy profit opportunities by borrowing foreign currency at low interest rates in order to buy government debt at much higher interest rates. (This typical reaction to the peg was also a factor in the Mexican and Asian financial crises.) Then, when the peg collapsed, the already weak banking system was left with a drastically increased foreign currency debt.

A New Crisis Policy. Turkey is the latest victim of the IMF's dedication to currency pegs, high taxation, and bailouts that reward imprudent financial policies; other casualties of this faulty approach include Mexico (1995), Asia (1997–1998), Russia (1998), and Brazil (1999). In each case, the IMF supported a peg as way to create currency stability, failed to predict the ultimate collapse, and blithely went on recommending the policy.

A strong and stable international economy is in America's interests. To force the IMF to halt its faulty policies, the Administration must refuse to bail out countries that fall victim to crises through their own short-sighted policies and investors that expect IMF bailouts when crisis strikes. Under this strategy, as outlined in the March 2000 Meltzer Commission report to Congress, countries need to be held responsible for their actions. If they take steps to reduce their vulnerability to crises, they will be eligible for emergency loans in specific circumstances; otherwise, they will not.

President Bush informed Prime Minister Ecevit that the U.S. would not oppose the IMF's disbursement of the $11.4 billion in loans already scheduled. This would not compromise the Administration's principled position on loans. Refusing to release the IMF money at this time would only aggravate the crisis. The Bush Administration should insist, however, that IMF loan conditions be adjusted in light of past failures. Current conditions should be waived in favor of three priorities:

- The lira is now floating, and Turkey should be encouraged to accept the market-determined rate. Trying to reestablish the peg will only invite another currency crisis.
- Turkey should encourage highly regarded foreign banks to enter the economy or purchase domestic banks, which immediately would increase the credibility and creditability of the Turkish banking system because of their financial stability and reputation for prudence.
- The foreign debt, effectively increased by 36 percent as the lira devalues, must be restructured once the economy has stabilized. Current reserves and IMF funds should meet short-term needs, but Turkey's $104 billion in high-interest sovereign debt hinders recovery prospects.

Turkey has taken positive economic steps in recent years, including pursuing privatization and reducing the size of the bureaucracy. Nonetheless, the economy remains over-regulated, overtaxed, and riddled with corruption, and privatization needs to be accelerated. These problems should be addressed in a detailed plan to restore investor confidence.

Conclusion. In an interview with the *Financial Times*, Treasury Secretary Paul O'Neill demonstrated his grasp of the key issue: that financial crises do not "have anything to [do] with the failure of capitalism. It's to do with an absence of capitalism." Countries with low levels of economic freedom are vulnerable to external or internal crises. The Clinton Administration floundered in responding to financial crises without ever grasping this critical truth. The challenge for the Bush Administration will be to refrain from reflexively bailing out countries and investors during crises and to compel them to act under the assumption that a bailout will not be forthcoming.

As a key U.S. ally, Turkey should be the first country in crisis the United States encourages to adopt economic policies that complement the international financial system—in a word, capitalism. A country repeatedly hobbled by economic crisis cannot be a reliable ally.

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