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<th>Abbreviation</th>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BRSA</td>
<td>Banking Regulation and Supervision Agency</td>
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<td>CBRT</td>
<td>Central Bank of the Republic of Turkey</td>
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<td>CMB</td>
<td>Capital Markets Board</td>
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<td>EFTA</td>
<td>European Free Trade Agreement</td>
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<td>EU</td>
<td>European Union</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ISE</td>
<td>Istanbul Stock Exchange</td>
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<td>MHF</td>
<td>Mass Housing Fund</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>SDIF</td>
<td>Savings Deposit Insurance Fund</td>
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<td>SEE</td>
<td>State Economic Enterprise</td>
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<td>SIS</td>
<td>State Institute of Statistics</td>
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<tr>
<td>SPO</td>
<td>State Planning Organization</td>
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<td>SSK</td>
<td>Institution of Social Security</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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THE IMPACT OF GLOBALIZATION ON THE TURKISH ECONOMY

1. INTRODUCTION

The aim of this study is to provide a detailed overview of the economic reform process in Turkey since the beginning of 1980 and an account of whether these reforms were successful in terms of attaining their final objectives. As was the case in most developing and underdeveloped countries during the late 1970s, Turkey also witnessed the weaknesses of import-substitution strategy and attempted to overcome these weaknesses by gearing towards a more outward-oriented economic development strategy. Especially during the 1980s, there was an accelerated reform and adjustment process in almost all sectors of the economic system. The reform process started with liberalization of the foreign trade regime and the financial sector and culminated in the liberalization of capital accounts during late 1989, the latter changing the whole pattern of policy-making environment radically.

The trade liberalization process is overviewed in the second section of this report. The third section overviews the liberalization of the financial sector and capital accounts. The fourth section consists of a brief evaluation concerning the overall macroeconomic developments, comparing the pre-reform performance of the Turkish economy with the post-reform period. We divide the post-reform period into two phases, that is 1980-1989 and 1990-1999 to see the full impact of the capital account liberalization on the Turkish economy. In the fifth section, a review of the developments during the 2000-2001 period including a special emphasis on the 1999 program, the following financial crisis in November 2000 and February 2001, and the policy measures taken after the crisis to restore the economy are explained. Finally, the conclusion section includes an evaluation of the pros and cons of the integration of the Turkish economy into the international markets and points at some lessons to be drawn from this process.
2. TRADE LIBERALIZATION PROCESS

As was the case in many developing economies in the world, the main economic development strategy of Turkey centered on import-substitution policies during the 1960s and 1970s. This period was characterized by immense public investment programs, which aimed at expanding the domestic production capacity in heavy manufacturing and capital goods. Foreign trade was under heavy protection via quantitative restrictions along with a fixed exchange rate regime that, on the average, was overvalued given purchasing power parity.

The import substitution strategy heavily relied on imported raw materials. Hence, Turkey’s terms of trade have deteriorated following the first oil shock in the 1973-1974 period. This deterioration caused a huge burden on the balance of payments, while the additional burden was compensated by short-term borrowing. From 1977 onwards, since the required amount of imports could not be realized in due time, there appeared problems in the labor market, and important difficulties emerged on the supply side. On the demand side, expansionary fiscal policy was maintained. Imbalances in the aggregate supply and demand accelerated the already increasing inflation. Inadequate measures taken to overcome the crisis, as well as the negative effects of the second oil shock in 1979, deepened the crisis. Turkey’s trade liberalization process was initiated to overcome the unresolved 1977-1979 balance of payments crisis in an environment of low domestic savings and sluggish investment.

The 24th January 1980 Decisions were announced in order to curb inflation, to fill in the foreign financing gap, and to attain a more outward-oriented and market-based economic system. Within the framework of these decisions, export subsidies were granted and exchange rates were allowed to depreciate in real terms to make Turkish exports more competitive, which would lead to the promotion of export-led growth.

The economic program launched in 1980 included export subsidies, a high devaluation and price increases for goods and services produced by the State Economic Enterprises. The initial “big push” in the exchange rate, interest rates and administrated public product prices were coupled with quickly implemented heterodox export incentive schemes. These initial
moves also proved to be helpful in regaining the confidence of international creditors. The IMF Stand-by and World Bank adjustment loans were rapidly arranged and disbursed in conjunction with additional debt relief operations.

The trade reform process was facilitated by three characteristics of the policy environment. Firstly, net foreign lending allowed the resumption of intermediate goods' imports and eased pressures on public finance. Because of the low rates of capacity utilization (at around 45-50 percent), industrial firms showed a strong export response to the rapidly altered incentive structure. Secondly, the exchange rate depreciation was high but sustainable. Thirdly, domestic absorption was significantly lowered in the first half of the 1980s to provide room for the initial push in export expansion. In this period, real wages and agricultural incomes were decreased substantially.

2.1. Expansion of Export Incentives and Subsidies

In the 1970s, a number of export incentive schemes, such as tax rebates, concessional credits, and FX allocation, were already in operation. Nevertheless, in the absence of realistic exchange rate and supportive macroeconomic policies the impact of these schemes was limited. During the 1970s, the composition of exports changed in favor of manufacturing, while agriculture maintained its dominance with a share of over 60 percent on the average.

The 1980 Adjustment Policy Package expanded and consolidated export incentive schemes, improved administrative efficiency, and promoted foreign trade companies. The post-1980 export incentive schemes may be grouped into the following five major categories:

1. The exchange rate was maintained on a depreciating path. The government’s policy to support exporters was to achieve a real depreciation trend, which amounted to a PPP- plus rule until 1988. After 1988, the Central Bank slowed down the rate of depreciation of the Lira. (Rodrik, 1991)
2. Direct payments were made to the exporters. The initial costs of exporters were covered by the government’s budget and extra budgetary funds. In other words, direct payments were made through tax rebates and cash premia from extra budgetary funds (Celasun, 1990). During 1980-1984, tax rebates made up the main part of direct payments. It is estimated that direct payments as subsidies reached 17 percent of the value of manufactured exports in 1984. However, pressure on the government budget caused a shift in emphasis from export subsidies to a more active exchange rate policy. In addition, after 1984, cash premia from extra budgetary funds became significant due to the approval of GATT code in 1985, which gave rise to phasing out tax rebates. Moreover, increased import liberalization would serve as a stimulus to exports. Consequently, direct subsidies for exports were cut gradually, and decreased to 4.4 percent in 1990 and thereafter totally abolished.

3. Preferential and subsidized export credits were provided. The Export Promotion Fund, Central Bank, Turkish Development Bank and Turk Eximbank provided subsidized export credits. Rediscount rates for exporters were kept below the commercial interest rates. At the beginning of the 1980s, the CBRT resources were used effectively to promote exports, but after 1984 CBRT credits decreased to very low levels. In line with this development, the share of the commercial bank loans in export credits increased and commercial banks became the dominant lenders in the export credit market.

4. Tax exemptions were provided on imported inputs. Imported goods, which are used as input in the production of export goods, were exempted from import taxes. Therefore, tax exemptions increased gradually, while the export sector was growing.

5. Corporate tax allowances were provided. Although there is no precise estimation for corporate tax allowances, it is estimated that tax allowances increased over time as the volume of exports increased.

Consequently, total export subsidies as a percentage of the value of total manufactured exports increased between 1980 and 1984, and then decreased gradually as the export sector became more self-sufficient over
time. In addition, the subsidies were differentiated by sectors. In particular, the tax rebates were the highest for skill-sensitive investment goods, and below the average for labor and resource intensive consumer goods in manufacturing. However, the share of consumer goods was the highest in direct payments, because the latter product group (including textile and food processing) comprised the largest portion of total manufactured exports.

2.2. Import Liberalization and Structure of Protection

By the end of the 1970s, import commodities were mainly classified into three lists, namely the Quota List (imports subject to quantitative limits), the Liberalized List 1 (including all goods that could be freely imported) and the Liberalized List 2 (including all items whose importation required a license). The imports of any other goods that did not appear in any of the above-mentioned lists were prohibited. According to the pre-1980 import regime, importers were required to place an advance deposit guarantee to the Central Bank for import activities. In 1979, deposit requirement rates were set at 20 percent on the value of imports for industrial uses and 40 percent for commercial purposes. Moreover, tariffs and non-tariff charges consisting of municipal tax, stamp duty, wharf charge and production tax were also imposed on imports (Tiktik, 1997). During the 1970s, the composition of imports witnessed important changes because of the import substitution strategy. As the five-year development plans of the period encouraged the production of investment goods domestically, the share of these goods in the total import bill decreased substantially, from 47 percent in 1970 to 20 percent in 1980. On the other hand, two oil shocks in the 1970s contributed to the increase in the share of intermediate goods in total imports, from 48 percent to 78 percent.

1 In addition to export incentives and subsidies, the Free Trade Zones Law was issued in 1985 with the objective of increasing export-oriented investment and production. Mersin and Antalya free zones became operational in 1988; the Aegean and Istanbul Atatürk Airport free zones in 1990; the Trabzon free zone in 1992 and commercial activities have been conducted in the Mardin and East Anatolian free zones since October 1995. In addition, Turkey has been a member of World Export Processing Zones Association since 1991.
In 1980, as a first step, the stamp duty on imports was reduced from 25 percent to 1 percent and import regulations were simplified. In 1981, the Quota List was abolished and a large number of items were transferred from the Liberalized List 2 to the less restrictive Liberalized List 1.

The January 1984 reform of the import regime represented a major break with the past. Two principle lists were abolished and three new lists were introduced, namely The Prohibited List, the List of Imports Subject to License, and the Fund List (covering luxury goods.) Under the new regime, all commodities that were not explicitly prohibited could be imported. The reductions in quantitative restrictions were accompanied by cuts in the rates of customs duties. The goods included in the Fund List were subject to a specific dollar denominated surcharge, in addition to the trade taxes. The levy proceeds were channeled to the so-called extra budgetary funds, to serve two purposes, namely financing of social projects such as mass housing and providing temporary protection to domestic industries.

In 1985, the Prohibited List was phased out; banned commodities were reduced from 500 to 3 items, which were weapons, ammunition, and narcotics. In 1988, 33 different items were subject to import license. In July 1989, the Government introduced an “anti-dumping law” aiming to protect domestic production from unfair competition. In 1989, import liberalization gained further momentum. The number of goods subject to licenses was reduced from 33 to 16, while tariffs and levies on imports were reduced substantially.

The import regime changed again in 1990, the import guarantee deposit scheme and licensing were phased out entirely, a new list called “The List of Investment Goods” was created, and custom duties and Mass Housing Fund (MHF) levies were consolidated in a single list. After the minor tariff adjustments in 1991 and 1992, a new set of measures was introduced in January 1993. All tariffs and tariff-equivalent charges other than customs duty and MHF charges were eliminated in line with commitments given to the EU and remaining reductions in tariffs and MHF were completed until the beginning of 1996.
Turkey has been a member of the GATT since 1950 and signed the Uruguay Round Treaties in 1994. GATT regulations on textile, services, and agricultural trade as well as trade related individual property rights were accepted. As a result, the Turkish Patent Institute was established in 1994. Turkey also has been a member of the WTO since 1995.

In conclusion, during the 1980s Turkey managed both to remove quantity rationing and reduce import tariff levels. In this respect, the World Bank classified Turkey as an intensive adjuster in 1991.

2.3. Establishment of the Customs Union with the EU

According to the Ankara Treaty, signed in 1963, Turkey established a Customs Union with the EU on January 1st, 1996. Turkey agreed to eliminate all the duties and MHF charges imposed on EU and EFTA products, as well as all the quantitative restrictions and impose common customs duties for the third countries. As a result, after January 1st, 1996, weighted protection rate on EU and EFTA products decreased from 5.9 percent to zero percent. In addition, the import protection rate imposed on third countries' products decreased from 10.8 percent to 6 percent. However, import duties on some specific goods (car, truck, leather, shoes, ceramics, etc.) were decreased gradually. Turkey lowered import duties on these goods in 1997 by 10 percent, in 1998 by 10 percent, in 1999 and 2000 by 15 percent and in 2001 by 50 percent. After January 1st, 2001, import duties on these goods for the third countries decreased to the common customs duties level imposed by the EU.

3. FINANCIAL LIBERALIZATION PROCESS

Since the 1980s, the globalization process has seen individual domestic markets take striking steps towards strengthening connections with each other and integrating with the international financial system. Hence, all major industrialized countries commenced economic policy initiatives in order to liberalize their domestic financial markets. Most developing countries followed industrialized countries within this process.

As stated earlier, prior to 1980 Turkey had pursued a highly regulated inward-looking economic strategy and had an inefficient financial system. With the structural reform program of 1980, overall
development strategy moved away from a highly regulated inward-looking economy with direct monetary controls toward an outward-oriented, open economy operating with a market-based approach. Accordingly, Turkey launched a series of economic, legal and institutional reforms at the beginning of 1980s.

3.1. Transformation of the Exchange Rate Regime

In the financial liberalization process, the first step for transition to more market-oriented policies was the change of the exchange rate regime. Before the 1980s, a fixed exchange rate regime was implemented in which the value of Turkish lira was determined and adjusted by the government according to the changing economic conditions. However, lags between the adjustments occasionally resulted in significant overvaluations of the Turkish lira. Therefore, a more realistic and flexible exchange rate policy was initiated with the stabilization program in January 1980. Thus, Turkish lira was largely devalued against other currencies and a uniform rate was established which also eliminated the black market. From May 1981 onwards, the Central Bank of the Republic of Turkey commenced daily adjustment of exchange rates.

At the end of 1982, commercial banks were permitted to hold foreign exchange positions. This measure mainly aimed at facilitating the foreign exchange transfers from abroad and parallel markets to the banking system and preventing capital flight. The foreign exchange rate regime was broadly liberalized on July 7th, 1984 with Decree No: 30. The measures taken with Decree No: 30 in order to set necessary preconditions for freely determined exchange rates can be summarized as follows:

- Restrictions on importing Turkish lira banknotes, coins and other means of payments were removed although exporting of Turkish lira items was subject to the Government’s permission.

- Residents were permitted to hold foreign currency, foreign exchange deposits and to make payments via foreign exchange.

- The Central Bank was authorized to import and export gold bullion. Banks were also authorized to sell gold bullion in the domestic market.
• Banks were allowed to accept foreign currency deposits from residents, to keep foreign currency abroad and to engage in foreign exchange transactions.

• Importing and exporting all kinds of securities were allowed. The sale of securities denominated in foreign currency issued in Turkey to non-residents was allowed.

• Non-residents were allowed to purchase real estate and real rights in Turkey, by converting foreign exchange and transferring all proceeds through a bank.

• Non-residents were allowed to invest, engage in commercial activities, purchase shares, and engage in partnerships, open branch offices, representative offices and agencies by bringing required capital in foreign exchange.

• Banks gained freedom to fix their own exchange rates within a narrow band around the exchange rate declared by the Central Bank.

• Consequently, banks were allowed to fix their exchange rates for their commercial, non-commercial and interbank transactions freely by June 29th, 1985.

3.2. Deregulation of Interest Rates

Throughout the 1970s, the government primarily controlled deposit and lending interest rates. However, real interest rates became negative due to rapid increase in inflation towards the end of the decade. In January 1980, ceilings on deposit and lending interest rates were abolished since financial funds were rapidly withdrawn from the banking system and channeled into parallel financial markets and foreign exchange. The interest rate deregulation mainly aimed at attracting savings into the financial system and encouraging competition among financial institutions in order to deepen the financial sector. However, major commercial banks made a consensus on setting interest rates collectively through “gentleman’s agreement” in order to prevent further increases in interest rates.
Self-imposed ceiling on deposit interest rates gradually increased due to the excessive demand for credits as well as competitive pressures coming from the brokerage houses and small banks. Consequently, many brokerage houses and small banks that could not compensate their committed payments failed in the middle of 1982.

Failure of these institutions led the government to make new regulations by taking into account the future trend of interest rates. Thus, the government authorized the nine largest banks to set interest rates and allowed the smaller banks to pay a premium. However, large banks were also willing to raise deposit interest rates. In December 1983, the Central Bank was reauthorized to determine deposit interest rates and review them regularly. In June 1987, with a communiqué of the Central Bank, banks were authorized to determine their deposit interest rates up to a certain extent. Consequently, all kinds of deposit interest rates were freed on October 12th, 1988.

3.3. Capital Markets Law and the Establishment of the Capital Markets Board

Enactment of The Capital Markets Law in 1981 was an important step to promote the development of the securities markets in Turkey which aimed at regulating, promoting and supervising the capital markets and protecting the rights and benefits of investors through the secure, transparent and stable functioning of the capital markets.

Subsequently, the Capital Markets Board, subject to the provisions of the Capital Markets Law, was founded in 1982 as a regulatory and supervisory authority on the conditions and functioning mechanism of the capital markets. Since then, the banks and other financial institutions have been subject to the Capital Market Law provisions and to the Capital Markets Board supervision in terms of their capital market intermediary activities.


Before the 1980s, fiscal deficits were frequently financed by direct monetization through the Central Bank. The short-term advance granted by
the Central Bank to the Treasury was limited to 15 percent of the current year’s budget appropriations, until the financial crisis of April 1994.

Until 1985, governments preferred not to issue securities in order to finance fiscal deficits and the Treasury tended to use intensively the short-term advance facility granted by the Central Bank. Therefore, monetary policy was mostly dependent on fiscal policy. In May 1985, the government began to issue treasury bills and bonds to finance the budget deficit. The negative impact of fiscal deficits on the Central Bank balance sheet was reduced to a certain extent with the introduction of the treasury auctions.

The government securities auctions provided the essential pre-conditions for the initiation of open market operations at the Central Bank and setting up of a secondary bills and bonds market at Istanbul Stock Exchange (ISE). Thus, the government securities auctions provided an attractive alternative investment area for financial and non-financial institutions since interest rates of these instruments were determined under market conditions and had zero-credit risk. Moreover, yields of these auctions have been accepted as major rates for the economy since they have been determined as a result of competitive bidding and the volume of the Treasury auctions have been high. The yields of these auctions signaled to the markets the future trend of the interest rates.

After the financial crisis in 1994, the short-term advance facility of the Central Bank to the Treasury was limited to 12 percent of the excess amount of the current year’s total general budget appropriations over the previous fiscal year’s total general budget appropriations. This ratio was gradually lowered to 10 percent in 1996, 6 percent in 1997 and 3 percent for the subsequent years. With the new Central Bank Law of 2001, short-term advance facility was forbidden.

3.5. Market Opening Reforms at the Central Bank

At the beginning of 1986 Istanbul Stock Exchange as a secondary market platform for the government securities began to operate. In the same year, the implementation of monetary policy was modified. Under the new monetary policy regime, the Central Bank mainly aimed at controlling money supply by controlling total reserves of the banking system. In this context, the rediscount facility, which had automatically
supplied credits to high priority sectors, was limited to medium term credits. This limitation on the automatic acquisition of reserves by individual banks through the rediscount facility required the introduction of a market-oriented distribution system to mobilize the liquidity in the banking system.

**Interbank Money Market**

The Interbank Money Market at the Central Bank was activated on April 2nd, 1986. The banks were required to keep collateral at the Central Bank in order to be able to do transactions in Interbank Money Market. The Interbank Money Market has provided efficient functioning of the banking sector and developed cash management understanding.

**Open Market Operations**

The Central Bank commenced open market operations as a main tool in implementing monetary policy as of February 1987. The open market operations primarily aimed to adjust liquidity level of the banking system and thereby control the money supply.

**Foreign Exchange and Banknotes Markets**

In August 1988, Foreign Exchange and Banknotes Markets were established at the Central Bank and started the daily fixing sessions of exchange rates. Foreign Exchange and Banknotes Markets are accepted as another monetary policy instrument in using foreign exchange reserves more effectively. The Central Bank announced on January 2nd, 2002 that it would gradually end its intermediary function in Interbank Money Market and Foreign Exchange and Banknotes Markets by December 2nd, 2002.

3.6. Capital Account Liberalization

Capital account liberalization in Turkey was initiated in conjunction with the process of economic and financial reforms that started in 1980, and was fully completed in 1989. Before 1980, capital flows were controlled through foreign exchange regulations. After 1980, capital account liberalization started with the Decrees No: 28 and 30, which were put into force in December 1983 and July 1984, respectively. These decrees partly

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2 See Appendix I for the details in the legislations concerning capital accounts.
liberalized the capital accounts and full capital account liberalization was accomplished in 1989. Decree No. 32 was issued on the Official Gazette on August 11, 1989. With this Decree and amendments on it, capital movements were fully liberalized and the major steps for convertibility were taken. The main points of Decree No: 32 were as follows:

- The residents can buy foreign exchange without any limitation from the banks and special finance institutions and they are not subject to any restrictions for keeping foreign exchange.
- Foreign exchange corresponding to any services rendered by residents for non-residents could be brought into the country.
- It is free for non-residents to buy and sell all the securities listed at the Stock Exchange and the securities issued upon the permission of the Capital Markets Board.
- It is free for residents to purchase and sell through banks and special finance institutions, the securities quoted at the foreign stock exchange, and treasury and government bonds which are denominated in the currencies bought and sold by the Central Bank and to transfer abroad their purchase value.
- Turkish residents are free to issue, to introduce and to sell securities abroad. Residents are free to bring securities to Turkey and to take them out with them.
- The proceeds of sales and liquidation of foreign capital may be transferred freely out of the country by the banks and special finance institutions.
- Obtaining foreign credits is liberalized.
- Non-residents are allowed to open Turkish lira accounts and to transfer principal and interests accruing to these accounts in Turkish lira or foreign exchange.
- Blockage on real estate sales is removed and transfer of sales income is liberalized.
- Non-residents are allowed to buy and transfer foreign exchange and send Turkish lira abroad without any limitation.
The banks and private financial institutions are obliged to give information about the transfers exceeding 500,000 US dollars or its equivalent of foreign exchange, except import, export and invisible transfers.

Turkish residents are free to establish liaison offices, representations etc. abroad.

3.7. Reforms and Regulations Concerning the Banking Sector

Turkish banking sector has traditionally played a prominent role in Turkish financial system. As a reflection of the liberalization policy of 1980s, a series of institutional and legal reforms were carried out concerning the Turkish banking sector. The main purpose of these reforms was to enhance the soundness and effectiveness of the financial system by encouraging competition among banks.

Although competition and insurance are accepted as opposite concepts, Savings Deposit Insurance Fund (SDIF) was established at the Central Bank by means of an amendment to the Banks Act in 1983. The main aim behind the establishment of the SDIF was to reestablish public confidence that has deteriorated because of the repeated failures in the banking system and to protect depositors against the negative effects of the banking crisis. Initially, a nominal upper limit was approved for each savings account. Banks were required to participate in the SDIF.

From the 1980s, to the present time, two Banks Acts have been ratified and implemented. The first one is the Banks Act enacted on May 2nd, 1985. The Banks Act of 1985 mostly consisted of subjects related to the structural problems of the banking system. It mainly aimed at providing a legal basis for prudential regulation and supervision of the banking system. Within the framework of Banks Act of 1985, banks were required to have a standard accounting system and the Sworn Bank Auditors were authorized to monitor legal performance and financial structure of the banks. Furthermore, banks were required to be audited by independent external auditors every year in accordance with the globally accepted principals of accounting. The government was authorized to change the management of risky banks and credits extended to a single customer were strictly limited.
The Council of Ministers was primarily authorized to specify the main rules in provisioning for non-performing loans with an amendment of the previous Banks Act in 1983. Then, a decree issued on December 11th, 1985 required banks to keep specific loan loss provisions regarding their past unpaid loans as well as general provisions for their whole loan portfolios.

By January 1987, banks were required to present to the Central Bank their financial reports, which were also audited by independent external auditors.

In October 1989, banks were required to adopt capital adequacy ratios in line with the BIS guidelines in order to ensure that banks keep enough capital with respect to the risk of their assets. The application of the capital adequacy ratio has facilitated to compare Turkish Banks with the banks abroad.

After the stabilization program of April 5th, 1994, the already established SDIF was reorganized to prevent potential turbulence in the banking sector. In this respect, the government announced a full guarantee to all savings deposits. Moreover, with the amendment made to the Central Bank law and the short-term advance facility to the Treasury was limited in order to increase public confidence.

The second Banks Act was enacted on June 18th, 1999. The Banks Act of 1999 mainly consisted of more broadened measures to strengthen the financial structures of the banks and the supervision mechanism. Accordingly, weak banks that could not be rehabilitated despite all measures taken were required to be transferred to the SDIF. The Banks Act of 1999 also aimed at providing accordance with the international standards and the European Union implementations in terms of supervision mechanism. Hence, the Banking Regulation and Supervision Agency (BRSA) as an organizationally and financially autonomous body was established in order to enhance the efficiency, the competitiveness and the soundness of the banking sector, to maintain public confidence and to minimize the potential risks to the economy coming from the banking sector. The Banks Act of 1999 brought more demanding conditions in terms
of the establishment and operation procedures for banks. Banks were also required to establish internal control and risk management systems.

Despite all mentioned institutional and legal regulations, the weakness of the financial structure of the public banks led to the ongoing vulnerability in the banking system. As of 2000, among 80 banks only 7 (4 commercial, 3 investment and development banks) were owned by the state and state-owned commercial banks had a 34 percent share of the banking sector’s total assets. The financial structure of the public banks further deteriorated since they financed public expenditures for a long time. Due to the high share of non-performing assets, which mainly consists of so called “duty-losses”, these banks’ short-term liquidity needs raised sharply. The sharp increases in interest rates during financial crisis also contributed to rapid accumulation of duty losses. Since the state-owned banks usually offered higher interest rates than market average in order to meet daily liquidity needs, the competition in the banking sector was distorted.


4.1. Balance of Payments

With the January 24th, 1980 Decisions the government accepted export-led growth strategy and sustained the external competitiveness of the Turkish economy through exchange rate policy and export subsidies. On the other hand, the 1980s witnessed a deliberate contraction in real wages, which aimed at producing an exportable surplus and enhancing export competitiveness through lower labor costs. These export-oriented policies succeeded in raising exports considerably.

As a result, exports raised from 2.9 billion US dollars in 1980 to 11.8 billion US dollars in 1989 in annual terms (Figure 1). The composition of exports has changed considerably within the same period: the share of industrial products in total exports rose from 36 percent to 78 percent. With the gradual liberalization of the import regime during the 1980s, imports

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3 See Table 1 for the evaluations in this section.
started to increase, albeit with a slower pace than exports, from 7.9 billion dollars in 1980 to 15.8 billion dollars in 1989.

**Figure 1: Exports and Imports (percent of GNP)**

As an indicator of international openness of the economy, a significant improvement in the share of foreign trade in GNP has been observed in the last decade. The average share of exports in GNP in the 1980s exhibited an almost threefold increase, while the share of imports doubled in the same period.

The sustained policy to let Turkish lira appreciate for financing purposes in the 1990s resulted in surged imports and stagnant exports. Export growth in the 1990s dropped almost by half on the average when compared with nearly 20 percent of the 1980s, as labor costs increased in real terms and the exchange rate policy was no more in favor of exports during this decade. Imports maintained this pace after import liberalization during the 1990s, hence the portion of imports financed by exports dropped to around 60 percent from its average of 70 percent in the 1980s. The current account deficit, one of the main reasons behind the 1994 crisis, reached a record high level of 6.4 billion US dollars in 1993, mostly due to the foreign trade deficit of 14.2 billion dollars (Figure 2). For the rest of the decade, the trade balance was the main determinant of the current account.
balance, while tourism revenues and unrequited transfers kept their weights.

Aside from the foreign trade deficit, which averaged 4 percent of GNP in the 1980s, the invisible accounts played an all-important role in relaxing the current account balance. As an outcome of the policies favoring the tourism sector, steadily improving tourism revenues became a major source of foreign exchange earnings, despite high foreign debt interest payments (Box 1). Along with the favorable developments in tourism, unrequited transfers were another income for Turkey, with an average slightly above 2 billion dollars each year during the 1980s. Therefore, current account deficit as a percentage of GNP showed a slight contraction compared to the 1970s and stood at 0.8 percent of GNP in the 1990s, while the trade deficit increased from 4 to 6.1 as percent of GNP, respectively.

*Figure 2: Current Account and Trade Balances (percent of GNP)*

![Figure 2: Current Account and Trade Balances (percent of GNP)](image)

*Source: Central Bank.*

Despite the fact that the legal framework for attracting foreign direct investment was amended to set in a liberalized framework in 1954, the legal efforts were insufficient to attract the desired level of FDI given Turkey’s inward-looking economic structure. Although net foreign direct investment in the 1980s was positively affected by the further amendments
to the foreign investment legislation and positive economic environment, Turkey has never been a foreign direct investment destination for investors. In other words, throughout the last three decades, the share of FDI in GNP remained insignificant, rising only from 0.1 percent during the 1970s to 0.4 percent during the 1990s. Between 1971 and 1980, the total amount of foreign direct investments to Turkey was around USD 100 million, compared to foreign direct capital amounting to USD 40.5 billion invested in Britain, USD 7 billion in Spain and USD 5.7 billion invested in Italy during the same period. Total amount of authorized foreign investments in Turkey between 1980-2001 amounted to USD 31.3 billion, while only USD 17.2 billion inflow was realized during the same period. Hence, Turkey could not capture the benefits of liberalized policies set in 1980s in terms of attracting more FDI to promote growth and facilitate more employment opportunities.

Box 1: Investment Incentives in the Tourism Sector

The basic policy of the Government designed for raising the number of tourists and tourism revenues has been to provide the private sector with incentives to carry out superstructure investments. Infrastructure investments have been the responsibility of the Government itself, as proposed in the Five Year Development Plans since 1963. However, the public-owned and managed hotel chains across Turkey dominated the sector until 1980s. The government regarded the tourism as an essential sector for development and decided on a Framework Decree on Tourism Incentives in June 1980 and the Tourism Incentives Law was passed by the Parliament in March 1982. These incentives included, inter alia, assignment of public land to tourism investments, discounts in the prices of utilities, and some tax-related incentives. The number of investment incentive certificates granted to the tourism sector rose sharply after 1985, bringing a parallel rise in the share of certificates granted to the tourism sector. Besides, the Tourism Bank extended credits to those enterprises having Tourism Investment Certificate amounting up to 80 percent of total investments, with very low interest rates and 20-year maturity (of which four years were redemption free), during the 1983-93 period.

A policy shift in the 1990s against incentives in favor of tourism was observed; as credit allocations were constrained substantially, assignments of land owned by the public were restricted, and incentive implementations were narrowed. The maturity of the investment credits was shortened and the interest rates were increased in early 1990s. The main rationale behind the policy switch after 1995 was to support the use of existing capital more efficiently, rather than supporting new investments. This was accomplished through efforts
eliminating seasonality in the tourism activity, lengthening the tourism season, improving product variety, and enhancing the infrastructure according to the Tourism Sector Master Plan. In line with this policy orientation, travel agencies and tour operators were picked up in the first line to receive incentives.

Total investments in the tourism sector rose rapidly after financial incentives had become available in the second half of the 1980s. With new hotels and facilities being built up, total bed capacity improved remarkably in the 1980s. An important consequence of the incentive schemes for the tourism sector, aside from the four-fold increase in physical capacity, was that the quality of tourism services improved significantly. As a result, the growth rate of tourism revenues surpassed the growth rate of number of tourists.

**Investments and Incentives in the Tourism Sector**

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<tr>
<td>Share in Total Number of Investment Incentive Certificates (percent)</td>
<td>2.1</td>
<td>10.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Total Amount of Investment Incentive Certificates (billion US dollars)</td>
<td>1.3</td>
<td>26.7</td>
<td>6.1</td>
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<tr>
<td>Credits Extended by the Tourism Bank and Turkish Development Bank (billion US dollars)</td>
<td>...</td>
<td>0.7</td>
<td>†0.1</td>
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<td>Share in Gross Fixed Investments (annual, percent)</td>
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<tr>
<td>Private</td>
<td>0.7</td>
<td>3.4</td>
<td>3.0</td>
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<tr>
<td>Public</td>
<td>0.6</td>
<td>1.4</td>
<td>1.2</td>
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*Source: Treasury, SPO.*


**Tourism Sector**

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<tr>
<td>Bed Capacity (end-period, thousand)</td>
<td>79.7</td>
<td>435.0</td>
<td>564.9</td>
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<tr>
<td>Number of Tourists (annual average, million)</td>
<td>1.3</td>
<td>2.4</td>
<td>7.4</td>
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<tr>
<td>Tourism Revenues / GNP (percent)</td>
<td>0.4</td>
<td>2.0</td>
<td>3.2</td>
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<tr>
<td>Tourism Revenues / Exports (percent)</td>
<td>11.5</td>
<td>13.7</td>
<td>21.4</td>
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*Source: Central Bank, SIS, Association of Turkish Travel Agencies.*

After the capital account liberalization in 1989, except during the Gulf crisis in 1991, the financial crisis in 1994 and the Russian crisis in 1998,
Turkey was able to provide more than enough foreign capital inflow to finance the current account during the 1990s. While the goal of capital account liberalization was put forward as further integration with the international capital markets, the evidence suggests that easing of the financial constraint on increasing public expenditures was an important determinant underlying this decision. Following the liberalization, the composition of capital flows changed considerably, as medium- and long-term credits were replaced by short-term credits to finance the balance of payments (Figure 3).

*Figure 3: Capital Inflows by Maturity (billion US dollars)*

The volume and volatility of short-term capital flows rose considerably, in line with the expectations, increasing the overall uncertainty in the Turkish economy (Table 2). Domestic banks have been the main means in providing short-term credits especially up until the financial crisis in 1994, which are mostly used to buy government debt securities. In the long-term capital flows, the deposit facility for the Turkish workers abroad with the CBRT, which was initiated in 1983, has been successful in providing foreign exchange. Another striking development after the liberalization of the capital account is that the portfolio investments from abroad have been allowed and then raised considerably within this period, though highly volatile after 1994. Within the portfolio investments category, investments in equities have been less significant than investments in government debt securities. The government generated
a considerable volume of capital inflow by issuing bonds especially after 1989, while remaining a consistent re-payer in medium- and long-term credits. In general, portfolio investments have not been as important as deposits, loans and trade credits. During the 1990s, the private sector, excluding banks, has been the main generator of net capital inflows, the composition of which has been dominated by medium- and long-term credits. Hence, though the public sector held the bulk of the external debt stock during the last decade, the share of the government in net capital inflows was relatively small compared to the share of the private sector.

Another indicator concerning whether the economic reform process in Turkey has succeeded or not is the foreign debt stock. Foreign debt stock as a share of GNP, which was around 10 percent during the 1970s, increased almost fourfold and reached to 43 percent during the 1990s (Table 1). While the share of public foreign debt in GNP declined from 24.2 percent during the 1980s to 21.8 percent during the 1990s, the share of private foreign debt almost tripled, rising from 5.8 percent to 14.3 percent, respectively. Besides, the share of short-term foreign debt also increased (Figure 4). Widening fiscal gaps also contributed to the deterioration of the efficient usage of the external borrowing. One can see that the incremental capital/output ratio, which was estimated as 3 in 1960 and 5.4 between 1980-1991, increased to 7.6 between 1992-1995\(^4\). This is an indication to validate the worsening allocation of the external resources in Turkey (Karluk, 1999).

\(^4\) A small incremental capital/output ratio indicates that the capital inflows have been directed into higher return production fields. Likewise, smaller ratios indicate a lower level of capital requirement to attain a given level of output. Thus, smaller incremental capital-output ratios are favorable with a view to attain efficient resource allocation.
Box 2: Impact of External Shocks on the Turkish Economy

External shocks played an important role in the economic crises that Turkey experienced from the beginning of 1970s, yet the weak structure of the Turkish economy amplified the impact of these shocks.

In the early 1960s a newly formed State Planning Organization was given responsibility for designing development policy. The SPO designed the policy of encouraging industrialization through import substitution. Thus, import-substitution policies remained the main policy objective during 1960s and 1970s. As the import-substitution strategy was dependent on imported raw materials, the first oil shock in 1973 has deteriorated Turkey’s terms of trade. The government failed to take significant action in response to the oil price increases, causing the current account to worsen rapidly, paying for the excess of expenditures over receipts by running down foreign exchange reserves and borrowing from abroad. During the second half of the 1970s, the government continued to subsidize the petroleum products and this caused the fiscal deficit to rise sharply. 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 an abrupt drop in rates of increase of export earnings and a steep rise in rates of increase in demand for imports. The current account had turned sharply into deficit following the oil price increase in 1973, reaching a USD 1.6 billion by 1975 and making a dip of USD 3.1 billion by 1977. Consequently, the failure of economic policies to adjust to the oil price increase of 1973 deteriorated the overall balance.
of the economy, and with the emergence of second oil shock in 1979, effects of the crisis deepened. Turkey’s trade liberalization process was initiated to overcome 1977-1979 balance of payments crisis.

Turkey accumulated sizable debts to official and private creditors in the 1970s and faced a debt crisis in January 1980 as severe as the crises that were to confront Mexico, Brazil, Argentina and other heavily indebted countries in 1982-1983. While other developing countries struggled and failed to resume growth and restore credit worthiness, Turkish economic growth accelerated, and Turkey was worthy throughout the worldwide recession of 1980-1983 and beyond (Krueger and Aktan, 1992).

Southeast Asian Crisis: The most important and direct effect of Southeast Asian crisis on global economy was through changes in prices of traded goods. After a series of devaluation of the currencies of Southeast Asian economies, export prices of these countries decreased dramatically. Consequently, primary commodity prices also went down, economies dependent highly on the exports of primary goods found themselves in trouble with declining revenues. Upon Asian crisis, demand contraction in Turkish economy resulted in the decrease in prices of exports and imports. However, the decrease in international raw material prices and oil prices on one hand, and slowdown in domestic demand in line with the implemented economic program on the other hand prevented deterioration in the current account balance in the first half of 1998. However, the turmoil of October 1997 had only a short-lived impact on Turkey’s market access. Although there was no bond or equity issuance in November-December 1997, net capital flows in the fourth quarter of 1997 remained positive and in the first half of 1998 attained a record quarterly average of USD 3.8 billion, partly due to high domestic interest rates. To sum up, “the loss of confidence in the emerging markets due to the Asian crisis resulted in an increasing demand for foreign exchange where the reserves of Central Bank fell by USD 2.8 billion in the last quarter of 1997, but since the Central Bank was aiming at achieving financial market stability and not at stressing the exchange rate, the effect of the crisis was not as significant as the Russian crisis in August 1998” (Binay and Salman, 1998).

Russian Crisis: Russian crisis had serious impact on Turkish economy. After the crisis, capital outflows from Turkey amounted to USD 11 billion. In accordance with the developments, the Central Bank’s reserves decreased from USD 26.7 billion to USD 21.5 billion. Some part of the foreign exchange purchases stemmed from the banks’ desire to close their open positions; however a significant part was due to capital outflows. In August 1998, in light of these developments, capital outflows resulted in a liquidity squeeze and a rise in the interest rates. Financial markets registered severe losses in the third quarter of 1998: external debt spreads rose sharply from about 450 basis points to over 700 basis points and domestic interest rates shot up from about 70 percent to over 100 percent. The policy response focused on allowing interest rates to rise sharply to defend the exchange rate. Definitely, the crisis affected the fiscal deficit through high real interest rates, Treasury’s debt program, and cost of debt financing and maturity of the debt.
Bond and equity issuance ceased in the period of August-October 1998. The loss of confidence with the Russian default was the most effective crisis in the market where a significant amount of capital outflow did occur in the ISE. The composite index of ISE dropped more than 57 percent during the July-October period.

There was no adverse change in terms of trade of Turkey, yet due to an approaching world recession, the volume of trade began to decline. The decline in trade volume was particularly due to the decline in the domestic demand and pessimist behavior of the domestic industry on production. In addition, the crisis in Russia, being one of the largest trading partners of Turkey, contributed to the poor performance of Turkish exports mostly through shuttle trade. While the volume of exports did not register a decrease, total exports declined in nominal terms. Despite the slowdown in exports in 1998, the trade deficit shrunk as the decline in imports exceeded the decline in exports. The decline in imports was then mainly due to the domestic recession. Another reason of the contraction in trade deficit was the decline in oil and raw material prices. Trade deficit shrunk to USD 19.7 billion in 1998 from its USD 22.3 billion level in 1997.

Uncertain external demand conditions and rising real interest rates due to credit shortages led to a fall in production, especially in the industrial sector. During the period May-October 1998, the growth rate of industrial production declined. The downturn was especially observed in the manufacturing industry. Since Russia had become one of Turkey's main export markets for textiles, clothing and leather goods, the fall in the Russian demand had a direct impact on the demand for Turkish textile products.

4.2. Fiscal Balance

The tax reform, adjustment in the State Economic Enterprises’ (SEEs) pricing, and rationalization of agricultural support as well as taming public expenditures in the early 1980s led to a decline in public deficits. As a result of the tax reform, which included, among other measures, the adoption of Value Added Tax (VAT), the efficiency of tax collection increased, hence raising ratio of tax revenues to GDP especially after 1985. However, public deficits and their financing were still important during 1980s, since public expenditures exceeded revenues. The shares of net foreign borrowing and Central Bank financing of the public sector deficit decreased, while that of domestic borrowing increased in the 1980s. Nevertheless, the burden of export subsidies and the effect of depreciating exchange rate on foreign debt valued in terms of domestic currency put a further pressure on public spending.
In the aftermath of capital account and financial liberalization, the main features of the Turkish economy were still low domestic savings and structural problems in the supply side. In 1989, the wage suppression policy was abandoned and more populist policies were initiated. For instance, real wages in manufacturing sector increased by 90 percent from 1988 to 1991 (Boratav et al., 2000).

The relaxed income policies pursued by the governments especially after 1989, the persistent problems in the taxation system, the SEEs’ financial structure due to government policies to control inflation through SEEs pricing, the transfers to the social security institutions and to the agricultural sector through subsidies, all resulted in huge public sector deficits. There was no significant improvement in terms of the government’s ability to collect direct taxes, while indirect taxes had become the main source of revenue during the 1990s (Table 3). As can be seen from Figure 5, the government’s failure to broaden the tax base and to introduce a more efficient tax administration in the 1990s resulted in a substantial increase in the share of indirect taxes mostly levied on consumption.

Because of the relaxed income policies during the 1990, the share of personnel expenditures of the consolidated budget in GNP almost doubled and rose from 4.6 percent during the 1980s to 7.8 percent during the 1990s (Table 4). During the same periods, the total share of transfers to social security institutions plus other transfers, mainly consisting of agricultural subsidies, in GNP rose from 2.2 percent to 3.6 percent, respectively. Throughout the 1980s, deficits of state economic enterprises were the most important source of the overall fiscal deficits. However, after 1994, this has been reduced as the financing of social security transfers and interest payments have become relatively more important. The share of the social security transfers (before transfer from the budget) increased from 0.4 percent of the public sector borrowing requirement in 1990, to 10 percent in 1993 and 33 percent in 1997.

In line with the general tendency encountered in many countries in 1990s, Turkey has also employed extra-budgetary funds to support certain sectors, which could not be then easily and quickly facilitated through the budget. Extra-budgetary funds were created to extend subsidies to the
agricultural sector through public banks, and seemed to work very well to provide flexibility in that period. However afterwards, the expenditures of those funds started to increase in a nontransparent manner, and caused a deterioration in the financial condition of the public banks, resulting in “public banks’ duty losses.” Because of the prevailing dominance of the public banks in the sector, these fiscal policies in turn increased the vulnerability of the banking system as a whole. The unmonitored expenditures of the extra-budgetary funds, revolving funds and local administration, undermined the fiscal discipline and integrity of the budget, meanwhile generated extensive financing problems given the insufficient tax collection. Nevertheless, since 1994, a serious number of extra-budgetary funds have been transferred to the consolidated budget and thereby have become subject to more stringent budgetary vetting process.

In 1990s, financing of increasing public deficits heavily depended on borrowing from domestic financial markets and the share of short-term borrowing from the Central Bank declined, mainly owing to the attempts of the monetary authority to facilitate the fiscal discipline. Between 1981 and 1986, 0.57 percent of the public sector borrowing requirement, which was
4.2 percent on the average, was financed by short-term Central Bank resources, while the Central Bank’s share declined to only 0.08 percent in 1990 (Karlik, 1999). Consequently, reliance on borrowing both from the domestic and foreign markets submerged. This resulted in two interrelated dilemmas regarding the domestic debt and open capital account in the 1990s. Increased domestic borrowing requirement implied high interest rates, which in turn led to higher interest payment costs and a further widening of the public sector deficits. Interest payments on domestic debt to GNP ratio rose significantly from 1.1 percent during the 1980s to 6.3 percent during the 1990s (Table 4). In addition, the maturity structure of domestic debt was mostly short-term. The budget deficit, as a share of GNP increased considerably from 1.6 percent during the 1970s to 6.2 percent during the 1990s (Table 1). PSBR as a share of GNP almost doubled, rising from 6 percent to 9.4 percent during the same period. In addition, the total stock of duty losses of the public banks as share of GNP, which were not recorded in the budget, rose from 0.7 percent in 1993 to 16.7 percent in 1999, more than half of the share of the Treasury domestic debt stock in GNP (29.3 percent) in 1999.

Concurrently, high interest rates attracted short-term capital inflows and this paved the way to real appreciation. Besides, the Central Bank played a supportive role to attract short-term capital inflows with its monetary and exchange rate policies. High interest rates, which were the result of increasing domestic debt stock and the main characteristics of the monetary policy implemented in this period also meant high credit costs for real sector and therefore high volatility in investments. Unfortunately, the governments’ failure to ensure the fiscal discipline before and after liberalizing the capital account led to an unsustainable economic structure, which shaded the benefits of financial integration. As mentioned above, the Turkish experience after full liberalization can be well summarized by a very familiar transmission mechanism; large public deficits, putting pressure on shallow financial sector, raise the real interest rates ending up with an increasing dependency on more short-term capital inflows. Eventually, less and less resources were available to production and investment.
The Impact of Globalization on the Turkish Economy

Box 3: The April 1994 Financial Crisis

After full liberalization of the capital account in 1989 and with the exception of the periods during the Gulf war in 1991, the financial crisis of 1994 and the Russian crisis of 1998, Turkey has recorded capital account surpluses, excluding central bank reserves, during the 1990’s. Thus, the availability of foreign capital eased the financing constraint of the governments and delayed the required fiscal discipline necessary for a sustainable macroeconomic environment.

After a sustained rise in the PSBR during 1991-1992, the government modified its domestic borrowing strategy in the last quarter of 1993 with the aim of reducing interest rates on T-Bills and curtailing the interest expenditures in the budget. This policy in turn enhanced the uncertainty perceived in the markets, leading to a decrease in the demand for T-Bills and a monetization of debt. As this strategy prevailed in the first quarter of 1994, the Treasury was left with the Central Bank short-term advances as its only domestic source to finance the budget deficit. The excess liquidity in the market immediately transformed into a speculative attack on foreign currency. As noted in Ersel and Sak (1995), the Central Bank, while trying to keep the interest rates at their artificially low levels, attempted to defend the exchange rate by selling foreign currency. As a result, both the international reserves and the foreign exchange reserves of the Central Bank declined to their historical low levels. Although the authorities hoped that an increase in the Central Bank’s exchange rate might stop this process, the turmoil in the markets continued as exchange rates started to rise at an unprecedented rate (Ersel and Sak, 1995). Thereafter, the rumors that the Government was to introduce a legislation to convert foreign exchange (FX) deposits into Turkish lira (TL) deposits at a specified exchange rate, led to a bank run in the form of FX deposit withdrawals from the banking system. This turned into a general bank run also inducing the withdrawal of TL deposits and led to an overall liquidity crisis in the system.

The banking crisis led to the introduction of the April 5 measures. With a jump in the exchange rate and in the prices of public goods and services, followed by a response from the private sector, the working capital available for non-financial firms decreased dramatically in real terms. Further, the decline in real income reduced the domestic demand. Both factors contributed to the sharp decline in industrial production in the last three-quarters of 1994. In the spring of 1994, the government signed a stand-by agreement with the IMF in order to regain credibility. Two further measures were also introduced. First, deposits within the banking system were put under “full insurance” coverage. Second, the government passed a bill aiming at the gradual elimination of public sector borrowing from the Central Bank. With the implementation of the stabilization program, the ratio of the PSBR to GNP decreased from 11 percent in 1993 to 8 percent at the end of 1994.

At the beginning of 1995, another stand-by agreement was signed with the IMF. This agreement however came to an end with the announcement of early parliamentary elections.
in September 1995. The period after the announcement of the early elections was marked by political instability in Turkey. Nevertheless, the revision of the Central Bank Act in October 1995, which had set limits for the short-term advances to the Treasury in advance, was particularly important in avoiding a liquidity crisis similar to the one experienced in the first quarter of 1994.

There were frequent increases in political uncertainty and reversals in interest rate policy during the last months of 1995 and this continued through most of 1996. Despite these unfavorable conditions, it can be argued that two other factors were also important in preventing a financial crisis. First, the current account deficits after 1995 were well below the level reached in 1993. Related to this, international reserves reached their historical peak at the end of 1995. The Central Bank had been accumulating foreign exchange reserves since the beginning of 1995. Excluding the temporary attempts to reduce interest rates on T-Bills, the accumulation of foreign exchange reserves and the flexibility of the interest rates on T-Bills for the most part of the period enabled the Central Bank to prevent speculative attacks on foreign currency without substantial foreign currency reserve losses up until the Russian Crisis in 1998.

4.3. Monetary Policy

The environment of monetary policy implementation has changed substantially since 1986. Before 1986, the monetary policy of the Central Bank was characterized by direct interventions aimed at controlling the expenditure and portfolio structures of both the private and public sectors. More importantly, the public sector’s borrowing requirement was mainly met through the Central Bank resources, which in effect fully subordinated monetary policy to fiscal policy. Starting from 1986, the Central Bank has modified its monetary policy environment substantially, the critical changes being a shift from direct to indirect monetary policy instruments. The new policy centered on the control of the Turkish lira reserves of the banking system with the aim of increasing the effectiveness of interest rate policy and hence achieving an indirect control over broad money supply.

The Central Bank designed a monetary program for the first time in 1986 for internal purposes, targeting the broad money supply M2. Similar programs were prepared in 1987 and 1998, but were also not announced to the public. The program in 1989 aimed at increasing the control of the Central Bank over its own balance sheet. In the same year, the use of short-term advance facility by the Treasury was limited and the credits extended
to the banks through the rediscount window of the Central Bank were brought under control. Furthermore, the growth in the Central Bank balance sheet began to be driven more through the increases in net foreign assets rather than expansion in domestic currency components. In 1990, the Central Bank prepared a medium term monetary program and announced it to the public, again setting the target at the level of its own balance sheet. The program was broadly successful in terms of achieving the desired restructuring in the balance sheet.

Nevertheless, the capital account liberalization in late 1989 has changed the monetary policy making environment substantially, exposing the economy to strong and mainly short-term capital flows. Thus, the main development on the monetary front has been the gradual but steady decline of the effectiveness of monetary policy and the loss of control of the Central Bank over the monetary aggregates (Figure 6).

Figure 6: Reserve Money (percent of GNP)

![Graph showing Reserve Money (percent of GNP)](image)

Source: Central Bank.

The aim of the Central Bank through the 1990s was mainly to provide financial stability in the financial markets rather than control inflation. This was due to the high level of dollarization that was indicated by the increase of the share of foreign currency denominated bank deposits in total deposits from 24 percent in 1989 to 46 percent in 1999 (Figure 7), the acceleration of public sector deficits during the 1990s and increased
political instability especially after 1995. Thus, while between the 1989 and the 1994 currency crisis the Central Bank was committed to a certain ceiling on exchange rate depreciation, between late 1995 and early 1998 the Central Bank’s main focus was the stability of the real exchange rate (Figure 8).

*Figure 7: F/X Denominated Deposits (percent of total deposits)*

*Source: Central Bank.*
Figure 8: Real Effective Exchange Rate (1995=100) and Interbank Overnight Lending Rate of the Central Bank

Source: OECD, Central Bank.

Note: An increase in REER index implies appreciation of the Turkish lira.

4.4. Financial Sector

Theoretically, financial liberalization is expected to result in higher savings. When the Turkish case is examined, it is observed that total savings have not shown striking increases in the aftermath of the financial liberalization (Figure 9). The sub-periods show that total savings did not exhibit a significant rise until 1986 and then increased considerably during the 1986-1989 period. Nevertheless, when the 1980-1989 period is evaluated, savings seem to slightly increase in this period compared to the 1970-1979 period. The share of total savings in GDP declined considerably in 1989, fluctuated and increased only slightly in the 1990s. It is interesting to note that during these periods, while there has been a significant rise in the GNP per capita, the increase in the GDP per capita was not directed to savings proportionally.
Another expected result of the liberalization efforts was that the savings would concentrate in the financial system. When the Turkish case is examined, it is observed that following financial liberalization a noteworthy increase was realized in the financial assets holdings of the economic agents (Table 5). The time deposits and M2 to GNP increased considerably until 1985 and then started to decline. As mentioned above, residents and non-residents were allowed to open foreign exchange deposit account from 1984 on and this caused the shift of time deposits to foreign exchange deposits. In the aftermath of the capital account liberalization in 1989, M2Y, which includes foreign exchange deposits, displayed an upward trend. The increase in the financial assets holdings makes apparent that there was a significant rise in financial deepening in the 1980s as a result of the liberalization efforts. The main characteristic of the financial system was the dominance of the bank deposits among financial assets and the deepening in the financial system was going on simultaneously with the increasing borrowing requirement of the public sector.

Lastly, the market discipline imposed over the corporate sector by the financial liberalization efforts is expected to result in a more efficient allocation of resources, and thereby increase economic growth. But the
credit-financing behavior of the banking system in Turkey did not change accordingly in spite of the successfully implemented financial reforms.

As the data reveals, although the commercial bank’s balance sheet total considerably enlarged as a ratio of GNP from 42 percent in the 1970s to 59 percent in the 1990s, the banking sector credits as a share of GNP remained at around 23 percent for both periods (Table 6). Moreover, the total credit to total deposits and the total credits to total assets ratios were both declining throughout the period. Although there are arguments in favor of crowding-out of the private sector by the public sector because of the latter’s increased need for domestic borrowing, the evidence is inconclusive as there are also studies documenting crowding-in. As to the reasons behind this adverse development in the credit market, Ozatay and Sak (2001) argue that all three major risk factors in managing bank balance sheets, namely credit risk, interest rate risk and foreign exchange risk, increased during the post-reform period, especially after the capital account liberalization in 1989, limiting the room for maneuver for the banking sector as a whole. Moreover, the increased volatility of the growth rate during the 1990-1999 period as a proxy for the default risk of the borrowers made it difficult for the banking sector to identify credit worthiness of prospective borrowers, thus increasing the reluctance of the banks to extend loans to corporate firms. Thus, in an environment of increased risk, the banking sector as a whole preferred to remain liquid as it is revealed in the growing share of government debt instruments in bank balance sheets. Similarly, increased price and growth rate volatility could also have influenced the loan demand of the corporate sector negatively. On the demand side, studies on the corporate firms’ financing behavior reveal that almost one third of financing was based on inter-firm trade-credits during the 1990s and bank loans remained a secondary source of finance. Moreover, with the capital account liberalization, especially the large-sized corporate firms were able to gain access to direct foreign borrowing. Indeed, the increased short-term nature of the Turkish economy can easily be observed from the maturity structure of both the commercial bank deposits and loans. For the last decade the average maturity of time deposits hardly ever increased over 3-4 months whereas almost three–fourths of the loans to the private sector were short-term.
As to the dominance of public banks in the sector, it is observed that the share of public banks’ total assets in the whole sector, which remained at the level of 44 percent in the 1970s and in the 1980s, declined to 39 percent during the last decade. Its share in the loans market, which increased from 40 percent in the 1970s to 45 percent in the first decade of the reform period, also declined to 37 percent during the 1990s. Nevertheless, the share of the public banks in the deposit market increased throughout the whole period, rising from 37 percent in the 1970s to 44 percent in the 1990s.

Despite all the changes in laws and regulations concerning the banking sector, all in all Turkey failed to undertake the necessary framework to regulate effectively the financial sector with a view to ensure the soundness and stability of the sector right after full capital liberalization. The establishment of an independent regulatory authority regarding the banking sector was delayed until 2000 and the necessary measures for the integrity of the system were lacking before then. Coupled with the insufficient financial regulatory framework, the banks found it more profitable and less risky to borrow from abroad- opening their FX positions- at relatively lower costs and to channel those resources into high-return government securities. Besides, government guarantee over the savings deposits hindered the improvement of competition in the banking sector, and encouraged banks’ tendencies towards adverse selections. The credit rationing in the Turkish banking sector broadly relied on sister-company lending as one can argue that many large corporations- benefiting from the deregulation- bought or established new banks to seize cheap credit opportunities. However, the lack of fair competition catalyzing bad governance and moral hazard problems in the banking sector, which had been tolerated until the end of 1990s were the major impediments for banking institutionalization and subsequently imposed a huge burden on Turkey, in terms of less output and higher public debt burden arising from rehabilitation of the sector.

4.5. Growth

As a response to the measures described in the previous sections, the economy, which contracted in 1979 and in 1980, entered the growth path from 1981 on. However, the average growth rates in the 1980s and the
1990s were below that of the 1970s and were more volatile. The average growth rate of GNP, which was 4.8 percent during the 1970s, declined to 4 percent during the last two decades (Figure 10). Since the beginning of the 1980s, the share of agriculture in GDP continued its downward trend steadily, while the share of industry, mainly manufacturing, displayed an upward trend.

*Figure 10: Growth Rates (annual percentage change)*

After having displayed high increase in the 1970s, total investments were stagnant in the 1980s (Figure 12). The share of total, private and public investments in GNP decreased between 1988-1993, after having their peak values in the year 1988. Public investments declined following the 1994 financial crisis in accordance with the saving precautions taken as a result of the April 5, 1994 stabilization program. While there was a slight increase in the private investments in this period, the increase was not proportionate with the decline in the public investments.

*Source: SIS, SPO.*
Public investments started to recover in 1996. However, the increase was limited. When the 1990-1999 period is compared with the 1980s, it is clear that the total investments increased slightly in this period. On the other hand, because of the reasons cited above, the volatility of the total investments increased in this period. One of the reasons behind the limited increase in the private investments in this period, might be the high real return of financial assets as a result of increasing public deficits. The liberalization process that began with the January 24 Decisions aimed at increasing the role of manufacturing industry in the production. In accordance with this strategy, a significant increase in investments of the manufacturing sector was expected. Nevertheless, the increase in the manufacturing industry investments during the last two decades has been quite reluctant to achieve this objective.

Source: SIS, SPO.
Despite all efforts to increase the share of industrial production in GDP, its share still remains around 27 percent and the sector employs only around 17 percent of the labor force. The share of agricultural sector in GDP remains around 15 percent and it employs around 42 percent of the labor force. Indeed, the value added per capita of the agricultural sector, which averaged at 0.54 throughout 1970s, declined to 0.34 in the 1990s (Karluk, 1999). This indicator underlines the ongoing agricultural inefficiencies and “distortions in resource allocation” in Turkey, mainly originating from the government subsidy policies in the sector. Coupled with the macroeconomic instabilities, the major impediments to industrialization stayed intact and Turkey could not gather enough pace to catch up with “industrialized countries.”

Moreover, various studies investigating the structural consequences of the post-1980 outward-orientation on the market concentration, pricing behavior and accumulation patterns in the Turkish manufacturing industries reveal very little structural change in these areas (Metin-Ozcan, Voyvoda, Yeldan 2000, Yalcin 2000). The speed of adjustment of concentration has been very slow in spite of the import discipline or export penetration and both the technological and institutional barriers to entry seem to persist over the last two decades. Concerning profit margins, the openness to foreign trade has had very little impact and evidence suggests
that the manufacturing sectors have responded to shocks of trade policy and real wage costs by increasing their profit margins. The profit margins, in turn, were found to be positively and significantly affected from concentration power and real wage cost increases.

4.6. Inflation

As mentioned previously, Turkey’s liberalization efforts coincided with the stabilization program aimed at halting the balance of payments crisis in the late 1970s and reducing the rate of inflation, which was above 100 percent in 1980. The stabilization program succeeded in reducing inflation rate in 1981 to around 34 percent. For the decade on the average, both the CPI and WPI increased by around 50 percent, twice as much as the preceding decade. The rate of inflation measured by the changes in the CPI jumped to a higher plateau above 65 percent in the 1990s (Figure 13). In 1994, the inflation rate rose to 106 percent due to the huge depreciation rate of the lira. After the crisis was overcome, the inflation rate fell to 89 percent, but moving on a higher plateau. To sum up, the reform attempts since 1980 in terms of reducing inflation in Turkey were not successful. The CPI, which was around 24 percent during the pre-reform period almost tripled and reached around 77 percent during the 1990s.

Box 4: Trade Liberalization and Competition

A study on the concentration ratios regarding the manufacturing industry, between 1985-1992 by the State Institute of Statistics shows that out of the 82 sub-sectors, 17 of them were classified as competitive (21 percent of total sectors), 19 as semi-competitive (23 percent), 18 as highly concentrated (22 percent) and 28 sectors (34 percent) were classified as highly monopolized sectors. The study reveals that 56 percent of the manufacturing industry is estimated to be monopolized. The sectors, which exhibit high concentration ratios, are the tobacco, petroleum refinery, electronics and tire industries. The sectors, which show signs of strong competition with the lowest concentration ratios, are the clothing manufacturing, textile and clothing intermediary sectors. The same study which elaborates the concentration ratios in manufacturing industry in 1998 yields similar results, and shows that out of the 124 sub-sectors, 20 sectors are classified as competitive (16 percent of total sectors), 35 as semi-competitive (28 percent), 25 highly concentrated (20 percent) and 44 sectors (35 percent) are classified as highly monopolized. In line with the previous study, the most competitive manufacturing sectors are recorded as the sub-sectors of clothing and textile sectors and the sectors that exhibited high concentration ratios are the relatively high
tech industries such as electronics, petroleum refinery and tire industries. Similarly, the share of monopolized sectors in total manufacture industry is estimated to be still around 56 percent in 1998.

The conclusions drawn from the two studies reveal that the structure of manufacturing industry is more or less retained, even though significant sectoral growth has been achieved. In a broader historical perspective, one can argue that the trade liberalization and export led policies have positive contributions to the main export sectors, such as clothing and textiles, in terms of enhancing the competition.

Theoretically, monopolization is not always detrimental if there are natural monopolies, or if it can introduce better marketing and financing opportunities, or bring about technological know-how, incentives to innovation etc. However, the Turkish case does not demonstrate any significant movement towards monopolization or competition within the manufacturing industry. A survey conducted by SIS in two major industrialized cities of Turkey (Istanbul and Kocaeli) shows that most of the private enterprises reported no major improvement in the sector in terms of higher market shares or increasing competitiveness. Also the survey showed that more than 80 percent of the private manufacturers did not compel to modify their production technologies with the intention of maintaining their market shares or increasing their competitiveness. In addition, about 91 percent of the enterprises reported that there was no change in the number of workers employed and 79 percent stated that their requirement of qualified labor did not change. Although the scope of the survey remains limited to draw general conclusions, it suggests that the integration with EU on average has not been as effective as expected in terms of a move towards a more efficient resource allocation to encourage the exporting sectors and enhancing the competition within the manufacturing industry.

High budget deficits and the associated fast growth in monetary aggregates, as mentioned above, represented the main underlying cause of high inflation. To hedge against the costs and income deteriorating effects of high and persistent inflation, backward indexation was extensively used in the wages, salaries and rent contracts in Turkey during the 1990s and this adversely contributed to the inflationary expectations. Keeping the administrative prices low, which affects a significant component of the WPI, has been useful in disinflation efforts in some periods. Nevertheless, as the fiscal deficits widened, the medium and long-term adverse effects of this policy have become evident. With the reversal of this policy, the substantial increases in public sector product prices have stimulated the increase the prices of private sector.
Another side effect of high and persistent inflation has been on the growth performance of Turkey by increasing the uncertainty and discouraging investment decisions. A study by the IMF at the beginning of 2000 argues that, had inflation been in single digits, annual per capita growth could have been 1-1.5 percentage points higher in Turkey than the 1.7 percent per capita growth realized in the 1990s.

4.7. Income Distribution

One of the successes of the reforms was to increase the GNP per capita, which was 1073 US dollars during the pre-reform period to 2810 dollars during the 1990s. Nevertheless, according to some studies, the distribution of income is worsened by poor performance thus impairing equitable development efforts of Turkey. Empirical studies on poverty are generally scarce in Turkey because the most recent data concerning size distribution of income are available only for 1987 and 1994. However studies about poverty and income distribution in Turkey generally indicate that there is a worsening of income distribution and increase in poverty during the 1977-1988 and the post-1994 periods. There are four main characteristics of this process.
(i) Adverse changes in real wages/salaries, in pensions and in agricultural terms of trade;

(ii) further widening of the gap between the wages of high and low paid segments of the urban working class;

(iii) the dual character of labor markets consisting of formal and informal segments,

(iv) high interest rates generated trade-offs with other income categories. A rising share of interest payments from the value added, crowds out the share of either net profits and wages or both. In addition to this, welfare-oriented public expenditures have also been crowded out because of continuing expansion of the public debt burden.

4.8. Developments in Labor Market and Social Sectors

In this section, the developments of labor markets during the last two decades as compared to the pre-1980 period will be investigated in the context of employment, wages and productivity. The main focus will be on the manufacturing sector because of the reliability and availability of data for this sector. In the last part of this section, developments in health and education systems will be taken into consideration briefly.

Unemployment rates decreased after 1980 (Table 7) as a result of the increase in employment rates surpassing the increase in labor force. While the unemployment rate was 11.6 percent in 1980, it declined to 8.6 percent in 1989 and then to 6.6 percent in 2000 as the increase in labor force lost some momentum during the 1990s. The average growth rate of labor force between 1981 and 1989 was 2.6 percent it dropped to 1 percent during the period of 1990-2000. This provided an important contribution to the decline in unemployment rates in the 1990s.

As to the sectoral breakdown of employment, the agriculture sector still leads all the other sectors in total employment throughout the last two decades. Although the share of the agriculture sector in total employment decreased sharply and steadily after the reforms in 1980, it still remained high. While industry failed to provide sufficient employment
opportunities, employment in the services sector increased significantly mainly due to the higher growth in tourism, trade and financial sectors.

The real wages in the Turkish manufacturing sector fluctuated in general and the magnitude of these fluctuations increased during the last two decades (Figure 14). To show the magnitude of fluctuations, we calculated standard deviations of the growth rates of real wages in the pre-1980 and the post-1980 periods (Table 8). While the standard deviation of real wage growth is 10.5 for the 1970s, it rose to 16.6 in the 1980s and to 17.4 in the 1990-1997 period. Especially the volatility of growth rates of real wages increased sharply during the 1980s- a period in which the real wages in the manufacturing sector decreased 1.7 percent on average per year.

On the other hand, the growth rate of labor productivity was slow before the reforms in 1980 when compared to the last two decades. In other words, the growth rates of labor productivity in the manufacturing sector accelerated during the 1980s and the 1990s. While the growth rate of employment slowed down after 1980, the idle capacity in the manufacturing industry, which had been created largely in the 1970s, was utilized in high rates. This raised labor productivity in the 1980s and 1990s, especially for medium and large scale manufacturing firms.

When the relationship between real wages and labor productivity is investigated, it is observed that labor productivity in the manufacturing sector increased constantly from 1980 to 1993 and the average labor productivity in 1997 realized twice as much as the level of average labor productivity in 1980. However, during the 1980s real wages decreased continuously and despite the relative improvement between 1990-1993, by 1997 they were at the same level they had been in 1980. In other words, during the last two decades real wages did not associate with real labor productivity.
One of the most important characteristics of labor market developments during the 1990s has been an overall intensification of marginalized labor employment in the Turkish economy. Marginal labor employment in manufacturing industry increased considerably after 1980, in particular after 1990—the era of the liberalization of the capital movements.

Concerning social sectors, some health indicators like population per bed and population per physician, improved significantly indicating to the better health services after 1980. While life expectancy increased by more than 6 years, infant mortality declined by more than 40 percent due to the intensive vaccination campaigns as well as better health conditions during the last two decades (Table 9).

Even though in the 1981-1988 period the average ratio of total health expenditures to GNP lowered as compared to that of 1980, the health expenditure per capita, which is calculated according to PPP in dollar terms, increased gradually (Table 10). Through the 1990-1998 period health expenditure per capita increased considerably. During the same
period, the share of public sector in total health expenditures exceeded the share of the private sector as in the beginning of 1980s.

After 1980, schooling rates, in particular for primary and higher education, have increased steadily and sharply, while no significant improvement was observed in schooling rates in the 1970s. Whereas the schooling rate for primary education realized as 76.3 percent in the 1970-1971 school year, this rate rose to 96.1 percent in the 1999-2000 school year. One of the most important developments concerning the education system in Turkey was realized in 1997: the structure of the primary education was rearranged and the duration of compulsory primary education increased from 5 years to 8 years. This played an important role in the sharp increase of the schooling rate of primary education in the late 1990s (Table 11).

The share of education expenditures in the consolidated budget increased throughout the 1980s. Nevertheless, it began to decline after 1992, and gradually went down as low as 10.1 percent in 2000 (Figure 15). This was mainly due to the increase in private education expenditures as well as the deterioration in public finances during the 1990s. The 1990s witnessed a considerable increase in the number of private schools in primary and intermediate education in addition to private universities.

*Figure 15: Education Services in Consolidated Budget (percent of expenditures)*

![Figure 15: Education Services in Consolidated Budget (percent of expenditures)](image)

*Source: SPO.*
5. RECENT MACROECONOMIC DEVELOPMENTS AND REFORMS

5.1. The Developments in 2000 and 2001

After unsuccessful stabilization attempts in the past, Turkish authorities launched a comprehensive disinflation program in 1998, known as Staff Monitored Program (SMP), with the aim of reducing inflation and improving the fiscal performance of the country. However, the political uncertainties and the earthquakes in August and November 1999 impeded the program to obtain the expected results. Moreover, the Asian and the Russian crisis undermined the performance of the program severely.

Turkish government announced a new comprehensive program with the guidance of the International Monetary Fund (IMF) at the end of 1999. The 1999 program aimed at decreasing inflation to single digits until the end of 2002, decreasing the real interest rates and thus providing a stable macroeconomic environment in order to improve the long-term growth potential of the country. It was basically an exchange rate based stabilization program, which announced the value of the exchange rate basket for the first one and a half year period. Afterwards the exchange rates were allowed to fluctuate within a gradually widening band. Moreover, the program set up limits on some fiscal and monetary aggregates, introduced some important structural measures in the agricultural sector, the social security system and fiscal management as well as a privatization program to help achieve the fiscal targets. This went hand-in-hand with appropriate incomes policy.

With the implementation of the program, a sharp decline in interest rates was realized as a result of the removal of the exchange rate uncertainty and the decline in the risk premium. Important progress was then attained in curbing inflation. This in turn contributed to the decrease in the interest expenditure and therefore led to a relief in the budget. However, the inertia in the inflation rate led to the real appreciation of the foreign exchange rates. The real appreciation, together with the recovery of domestic demand, increase in international oil prices and weakening of the euro, affected the current account balance negatively. The current account

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Footnote:

5 Even if the realized inflation figures were above the program targets, they were well below the last fourteen year’s averages.
The Impact of Globalization on the Turkish Economy

deficit much exceeded the levels projected at the beginning of the program. The worsening of the current account deficit coupled with the delays in the privatization efforts and the structural reforms during the second half of the year had an adverse impact on capital flows thus leading to increases in

the short-term interest rates in August 2000. Although the regulatory framework existed in principle with the newly formed BRSA, the key supervision and restructuring measures were delayed due to the retardation of appointments to the BRSA board and other staffing problems. Besides, the reluctance of the government to bring in additional measures in the face of worsening current account deficit resulted in the IMF’s postponing the release of the 3rd tranche of the loan in October. This, in turn affected the expectations of international investors negatively. The rise in interest rates had an adverse effect on the financial structures of some banks that had a high share of government securities in their portfolios and financed those securities with rather short maturity resources. The deterioration in banks’ balance sheets gave rise to deterioration of overall confidence in the financial markets in regards to the sustainability of the program in November. Foreign investors began to reduce the size of their portfolios in Turkey. The rapid exit of capital created serious liquidity problems for the banks, which were highly dependent on foreign funds. The turmoil in the financial markets and the outflow of foreign capital, which was estimated to have exceeded 5.2 billion US dollars, resulted in a decline in the foreign exchange reserves of the Central Bank. A hike in interest rates was observed with the decline in the reserves. The sharp increase in the interest rates adversely affected banks, which had large government paper portfolios and funded this portfolio from the overnight markets. The lack of confidence towards those banks that suffered from a maturity mismatch combined with a sudden rise in the liquidity needs of these banks’ led to a sharp increase in short-term interest rates in the second half of November. Following the hike in short-term interest rates, the prices of both public securities and stock prices went

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6 The main reasons behind the rapid exit of capital in November can be summarized as follows: Disappointing inflation results for October, unexpectedly high monthly trade deficits, political difficulties encountered in privatization, worsening relations with the EU, the economic situation in Argentina, and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the SDIF (Akyuz and Boratav, 2002).
down. The CBRT provided liquidity to the markets by breaching NDA corridors limits on the 22nd of November. An enhanced policy package put into effect in December 2000 and the IMF’s support in the form of Supplementary Reserve Facility helped to restore the confidence in the program and the fluctuations in the markets were removed partially. The Central Bank reserves were restored in a short time and interest rates declined significantly, although still higher than the pre-crisis levels. Imports slowed down and the decline in inflation continued however the inflation rate was still higher than the rate of depreciation.

Although capital inflows revived to a certain extent after the measures taken, the November crisis increased the overall vulnerability of the banking system. The maturity of both domestic and foreign funds shortened after the November crisis and the still-high level of interest rates compared to the rise in foreign exchange rates led to suspicions concerning the sustainability of the prevailing foreign exchange regime. Since there still appeared serious problems in the fundamentals of the economy, the stability did not last long. The decline in the maturity and a rise in the interest rates in the government securities auction cast doubts about the public debt sustainability. The increase in the public debt, high inflation rates and appreciation of Turkish lira against the basket generated suspicions about the peg sustainability. Shortly after the rearrangement of the targets of the program with the IMF officials, a political dispute in the coalition government eroded the market confidence totally and caused an immense foreign exchange demand on the 19th of February, amounting to a total of 7.6 billion US dollars. The Central Bank attempted to defend the foreign exchange rate with a squeeze in liquidity that was followed by another hike in short-term interest rates. The sharp increase in the interest rates did not hinder the capital outflows. Nevertheless the excessive liquidity needs of public banks locked up the whole payments system. Thus, the unsustainability of the foreign exchange regime became rapidly apparent and the crawling peg regime was abandoned on 22nd February, which was the basic pillar of the 1999 disinflation program. The US dollar rate instantly moved from 680 thousand Turkish liras to 960 thousand Turkish liras on the 23rd of February.

\[ \text{Overnight rates reached 5000 percent} \]
In the aftermath of the financial crisis, a new agreement was made with the IMF in May 2001 and a new program, “Turkey’s Program for Transition to a Strong Economy” which has been more decisive about the implementation of the structural reforms, was announced. The overall strategy of this program can be summarized in three steps: Firstly, vital measures were taken in order to reduce uncertainty in the financial markets; Secondly, measures were taken to stabilize the money and the foreign exchange markets and lastly, measures to establish macroeconomic balances were taken.

One of the aims of the program was to ensure long-term sustainability of the fiscal adjustment, and to improve the efficiency of the public sector governance. In this regard, the regulations to strengthen the budget discipline and to enhance the revenue resources were adopted. Acquired sources planned to be utilized to support social justice and to reduce the debt stock. In this context, to combat tax evasion and distribute the tax burden evenly, the tax regulations were enacted to extend the use of tax identification numbers. Precautions were taken in order to expand the coverage of the budget and improve fiscal control. In accordance with it, the budgetary, extra-budgetary and revolving funds were closed. A new Law on Public Finance and Debt Management was submitted to the Parliament.

Income policy in line with the targeted inflation rates was one of the basics of the program. The dialogue with business circles and the employee representatives was enhanced in order to attain moderate wage and price increases. The Economic and Social Council Law, which brings together employers and employees of the public and private sectors and other civil society organizations, was already enacted in the year 2000. This law aimed at developing consensus and collaboration among social groups in formulating economic and social policies.

Although some important measures were taken concerning the banking sector, such as the establishment of the Banking Regulation and Supervision Board, problems related to the fragility of the banking sector deepened during the November 2000 and the February 2001 crisis. Therefore, the new program gave the top priority to banking reform. In the new term, the overnight position of the state and SDIF banks were reduced
in order to decrease their pressure on the interest rates. The governance structure of the state-owned banks was reformed in order to minimize the political influence on the banking sector. The duty losses of the state banks were eliminated. A plan to resolve the banks taken over by SDIF was implemented and amendments to Banking Law were approved by the Parliament.

5.2. Some Important Regulatory and Institutional Reforms

The early reforms of 1980s comprised important steps with the aim of developing market economy in Turkey. Nevertheless, these attempts have not prevented the Turkish economy from having deep-rooted problems like macroeconomic instability and chronic inflation in the last twenty years. As time passed, it became more evident that the reform efforts should be much more comprehensive. For this reason, Turkey carried out new reforms in the late 1999. Nevertheless, early success of these reforms caused reluctance among the policy makers. This, in turn, resulted in the November 2000 and the February 2001 crisis. The current crises revealed the fact that the current situation would only worsen without more stringent reforms, especially in the public sector and banking sector. Additionally, the EU accession process, which helps to shape reform agenda and provides a benchmark for the reforms, also plays an important role for Turkey’s reform efforts.  

5.2.1. Financial Sector Reforms:

The Establishment of Banking Regulation and Supervision Agency (BRSA)

Although important steps were taken in the liberalization of the financial system in the aftermath of the 1980s, there still existed some severe problems in the banking sector. In order to contribute to the efficiency, competitiveness and soundness of the banking sector the “Banking Regulation and Supervision Agency” was established with the Banks Act of 1999. The main goals of the BRSA were: to safeguard the rights and benefits of depositors and create the proper environment, thus contributing directly to the achievement of long-run economic growth of

8 See Appendix II for a detailed list of structural reforms and legislation
the country; to enhance banking sector efficiency and competitiveness; to maintain confidence in the banking sector; to minimize the potential risks to the economy from the banking sector; to enhance the soundness of the banking sector.

Transition to an Independent Central Bank

The changes that were provided with the new law enacted in April 2001 emphasized that the primary objective of the Central Bank of the Republic of Turkey was to achieve and maintain price stability. The Central Bank of the Republic of Turkey was prohibited to grant advance and extend credit to the Treasury and public institutions. The Central Bank was also prohibited to purchase debt instruments issued by the Treasury and public institutions in the primary market. Terms of office of vice governors were extended from 3 years to 5 years. According to the former Central Bank Law of 1970, Governors could not be excused from office before the expiration of their terms. With the new law, this rule also became applicable to Vice Governors. Thus, accordance was attained with the second paragraph of the Article 14 of European Central Banks’ System Status. Transparency and accountability in determination and implementation of monetary policies were also enhanced.

5.2.2. Public Sector Reforms:

The main aim of the public sector reforms was to ensure transparency and accountability in resource allocation in the public sector.

Reforms about the Public Sector Transparency

In Turkey, the 1980s and the 1990s witnessed the violation of the principle of budget unity as a consequence of the increase in extra-budgetary funds and duty losses. The flexibility of the budget was lost to a great extent and the preparation process and the application of the budget became inefficient. With the weakening of correlation between resources and expenditures, the budget system has gradually become inadequate to provide information to decision-makers. In the 1990s the importance of the public sector on the whole economy continued to increase. Therefore, urgent precautions were required in order to increase the transparency in the public accounts and the efficiency of the budget process. Hence, fiscal
adjustment measures started to be implemented in 2000. With the new Program, significant progress has been attained in eliminating obstacles and delays in the management of public expenditures, and rapid progress has been made in providing budgetary discipline.

**Reforms in Strengthening the Public Finance and Administration**

Turkish authorities were aware of the urgency of the effective regulatory management system and took important steps in order to reform the public administration. These attempts aimed at building an effective, accountable, and merit-based public administration. The first requirement for this aim was to build a system in which the recruitment of civil servants was based on the merit of the worker. This required changes to the system of recruitment. The old system was dependent on exams that were held by the recruiting agency and based on flexible criteria. This procedure was open to abuse and sometimes led to favoritism in recruitments. To prevent these a new examination system was adopted. Additionally, the reform attempts included a scheme to fight corruption in the public sector. A committee whose aim is to prepare a plan to prevent corruption was established.

The structural measures included the rationalization of public expenditures and revenues. The earlier structure, which did not allow efficient and productive use of public resources, has been subject to reform. The budget system, which did not depend on prioritization was basically in the form of incremental budgeting. The priorities of the current term were not taken into account in the budgeting, whereas the items were increased incrementally. The control mechanism of the budget was old-fashioned. While there were strict controls in the appointment of the budgetary funds to the institutions, the control in the evaluation of the projects was not very strong. The reforms aiming at resolving fundamental problems in this area includes strengthening public finance and improving operational performance. For this purpose, reforms aiming at enlarging the scope of the budget, and increasing the role of the priorities of the budget were planned. More flexibility in the budget implementation was among the main concerns of this new program.
Reforms in the Agricultural Sector

While, there has been a decline in the share of the agricultural sector in GNP in recent years, the share of population employed in this sector has been still extensive in Turkey. In addition to the low income of these groups, there has been income inequality in the sector. Therefore, supporting the agricultural sector was inevitable.

Earlier support schemes had adverse effects in the resource allocation by distorting market price signals, such as providing support to the rich farmers more than the poor ones, and lacking coherence given the fragmentation of the policy making process in this sector which was dispersed across several ministries and public institutions. Reform programs that were initiated in 2000 aimed at phasing out the existing support policies and replacing them with a direct income support system targeting poor farmers directly. In accordance with the new program, Direct Income Support to the Farmers was introduced and in order to ensure the farmers are adequately recorded, necessary steps were taken.

Reforms in the Social Security System

Turkey’s pension scheme had serious problems in the past. The primary objective of the system was distorted over time and it became a major source of fiscal burden. The growing fiscal burden of the social security institutions on the budget by the late 1990s speeded up debate and efforts to reform the system. A reform proposal was prepared and enacted in September 1999.

Firstly, the reform introduced a minimum retirement age of 58 (female) and 60 (male) for contributors entering the system while current contributors are allowed a gradual transition period. Secondly, the reform has changed the benefit formula for new entrants to SSK and BK. Thirdly, the reform provided for gradual expansion of the reference wage period of the full contribution career, aiming at improving the linkages between contributions and benefits. Lastly, with this reform, discretionary pension indexation generally based on civil service wage increases, was replaced with pensions being indexed to the consumer price index. Besides, the ceiling on the SSK contributions was raised. Another important development was the introduction of unemployment insurance.
Traditionally, the severance payments program has been the primary form of protection against involuntary employment in Turkey. With the new unemployment insurance scheme, which was put into effect as of June 2000, there would be no payments before February 2002.

The second phase of the reform consisted of institutional improvements in the system. In order to provide the unity of norms and standards, to establish and share a common and reliable database between the three different institutions and monitor the actuarial and financial developments, a Social Security Institution was established under the Ministry of Labor and Social Security. Additionally, health insurance and pension insurance departments within SSK and social security were separated. With a change in the legislation, the Turkish Employment Institution was established in order to monitor the needs and provide the requirements of the active labor markets with new programs and be responsible from the management of the newly founded unemployment insurance system. Another important area of the reform process was the establishment of voluntary-funded private pension schemes, with a view to support the already existing public insurance system.

6. CONCLUSION

Broadly defined, globalization is the process of the complete integration of the constituent parts of the world economy with each other and with the international system. As the overview of the Turkey’s adjustment process since the beginning of 1980 reveals, much has been done for the last two decades in terms of integrating into the world economy on various fronts. Nevertheless, as some of the main macroeconomic indicators exhibit, the Turkish economy could not adequately benefit from this integration. The main underlying factors for this failure are the short-term orientation of economic policies by frequently changing coalition governments and postponed structural reforms, mainly in the areas of banking sector, public finance and public management during the 1990s. High public sector deficits created a chronic and high-inflationary environment, impeding medium-term planning of economic agents. Another factor is related to the state of the international economy. After the worldwide spread of capital account liberalization measures adopted especially in the 1990s, the overall vulnerability of the
developing economies to external shocks increased considerably. In that sense, the Turkish economy was not an exception and it also suffered from the adverse effects of the economic crisis elsewhere, such as the Gulf War in 1990-91 and the Russian Crisis in 1998. These shocks took the form of sudden and huge reversals in short-term capital flows throughout the 1990s.

To sum up the overall effect of this integration, Figure 16 provides a fair summary. According to Figure 16, the balance of payments problems of the Turkish economy seem to have slightly improved during the last two decades compared to the pre-reform period. Nevertheless, this improvement has coupled with the declining long-term growth rates and with high and persistent inflation. Especially after the liberalization of the capital account at the end of 1989, the growth rate has become more volatile and the overall level of uncertainty in the economy has increased. Besides, the reform process resulted in a higher foreign indebtedness. Although in terms of per capita income there has been an improvement, this was coupled with a worsening of income distribution.

Every country has its own story to tell on globalization. Turkey’s experience was full of ups and downs, as the basics were not properly in place before the economy was opened up. Since this analysis is ex-post, it is difficult to judge whether the policy makers could have known the necessary macroeconomic framework at the beginning of the 1980s. This has mainly been a “learning by doing” process as people and countries learn from their own mistakes.

As the previous sections presented, volatile growth rates, high public sector deficits, a chronically high and persistent inflation, a deteriorating income distribution, a poorly regulated financial system, and high expectations and confidence in the immediate and positive impacts of the direct implementation of free market policies, were the prevalent features of the economic policy environment in the 1980s.

In overall assessment of the recent decades, one of the benchmarks should be the growth rate. Turkey reached high growth rates of 6 percent per annum in the 1960s and 1970s, yet these rates slowed down significantly and became more volatile in the 1980s and 1990s. Even so, the
growth rates of the 1980s and the first half of the 1990s seem successful (around 4.5 percent per annum) when compared with the poor growth performance of other middle-income developing countries during the same period.

**Figure 16**

![Graph showing GNP Growth (annual percentage change) vs. Budget Deficit (percent of GNP) vs. Inflation (annual percentage change) vs. Current Account Deficit (percent of GNP) with data points for 1970-79, 1980-89, and 1990-99]

Source: SIS, Central Bank, SPO.

**Note:** The larger the area of the quadrilateral the better is the performance of the economy.

Sluggish performance of the 1980s and 1990s can be attributed to the fall in gross fixed capital formation as a percentage of GNP in the early 1980s. Scarce public resources led to a decline in public investment. While there was an expansion in the private sector investment, the main driving force of private investment was the rapid increase in construction spending for housing. If housing is excluded from private investment, the ratio of private investment to GNP did not move upwards and stayed at the level of 10-12 percent of GNP in the said period. The export led growth strategy...
was employed during this period and substantial subsidies were provided to exporters. However, booming exports did not raise private manufacturing industry’s gross fixed capital formation. Private manufacturing industry’s gross fixed capital formation was less than 4 percent of GNP during the 1980s and increased only slightly in the 1990s. Celasun (1994) explains this fact as the product of unsustainably high public sector borrowing requirements that led to high inflation and interest rates, therefore crowding out private investment by public borrowing. Indeed average growth of 3.9 percent for the 1980-99 period can be decomposed as 1.6 percent for capital productivity, 1.7 percent for labor productivity and remaining 0.6 percent accounts for total factor productivity. These figures are apparently low for a high-potential developing economy. Furthermore, a study carried out by the World Bank (2000) points out that “the main source of productivity growth in Turkey between 1975 and 1990 were changes in the sectoral composition, that is “the flow of labor from agriculture to other sectors.” Analysis can be extended to developments in labor market and job creation capacity of the economy. Turkey faces a labor absorption problem as manifested by the unemployment rates. During 1981-97 total employment grew only by 1.5 percent per annum while working age population (the pool of all potential workers) grew by over 3 percent (World Bank, 2000). There are two possible explanations to this question; namely, either the economy is not growing enough to generate employment for rising population or it is growing but this growth is not sufficiently labor intensive. No clear-cut answers are available on these issues. Basic trade theory suggests that specialization will follow and labor abundant economies will produce more labor intensive goods, therefore create more employment after undertaking substantial efforts to liberalize trade and integrate with the world economy. However, after trade liberalization, employment creation did not take place in Turkey. Neither did the trade reforms help to improve general productivity in the economy.

Looking at the series of banking panics and collapses in Southern Cone, McKinnon (1993) retrospectively argues that these economies have not been able to put sufficient internal fiscal and monetary controls in place to support a dismantling of their interventionist policies. He asserts that
countries that stabilized their price levels and real exchange rates while keeping moderately positive real interest rates on deposits in an open capital market show a much higher productivity growth of physical capital than those with repressed financial systems. As to the order of economic liberalization, McKinnon’s prescription and sequencing is as follows: First, fiscal discipline should precede financial liberalization. Second, domestic capital markets should be opened up and positive real rates should prevail. The pace of deregulation of banks and other financial institutions in liberalizing economies must be carefully geared to the government’s success in achieving overall macroeconomic stability. Without price level stability, unpredictable volatility in real interest rates or exchange rates makes unrestricted domestic activity far too risky. Third step is setting the appropriate pace for the liberalization of the financial transactions. Even the rationalization of foreign trade policy need not call for full foreign exchange convertibility. McKinnon warns against the destabilizing impact of allowing hard foreign currencies to circulate in parallel with still soft domestic currency. The final stage is allowing free international capital mobility. Before introducing full capital mobility, domestic capital markets should function properly at the equilibrium interest rate and domestic inflation should be under control so that the depreciation of the exchange rate is unnecessary.

Looking at the Turkish experience retrospectively and comparing it with McKinnon’s recipe, the most striking fact is that Turkey has never satisfied the very basic precondition of price stability and fiscal discipline to start with. Deregulation of interest rates in the 1980s was not preceded by the stabilization of the price level. The basic preconditions of price and exchange rate stability were not there even when subsequent steps on financial liberalization were taken. Fiscal deficits were high and the stability in price level and exchange rate were not achieved. It was not surprising that the 1982 financial failure took immediately after the interest rate liberalization. Even when the interest rates were set free again in late 1988, the fiscal restraint and price stability conditions were not achieved. In Turkey, after the trade regime was substantially liberalized, the capital account liberalization was in place in 1989. McKinnon tells us that liberalization in current account transactions should be preceded by the
The Impact of Globalization on the Turkish Economy

liberalization of domestic trade and finance. In sum, though Turkey followed the right course of action in terms of sequencing, the preconditions for the start of successful sequencing were not totally satisfied. As argued by Gokce (1993), in Turkey “financial sector reform was used as a tool for disinflation rather than as an end target by itself.”

As McKinnon cautioned, when preconditions are not met, some destabilizing consequences may emerge. Indeed, in Turkey, the 1984 foreign exchange regime liberalization led to pressures for currency substitution. Already high fiscal deficits together with the pressures on currency substitution led to very high real interest rates during the reform period as policy makers tried to defend the Turkish lira with the hope of curbing inflation. Increasing real interest rates also served to improve the capital account. Banks were the primary beneficiaries of the short-term capital and their borrowing of merely 1 billion US dollars in 1990 reached to 3.5 billion US dollars in 1993. Both the public sector and the non-financial private sector were faced with a new operating environment. It was the availability of finance that allowed the government to have a loose fiscal policy and the governments immediately seized this opportunity. It is also true that the government benefited a lot in financing of its increasing expenditures from the domestic market and the stock of domestic debt reached 20 percent of GNP in 1997 up from 6 percent of GNP in 1989. It was the short-term capital flows that helped banks to extend credit to the government. Therefore, the short-term flows became “the long arm of fiscal policy overcoming credit restraints and money constraints of the monetary authority” (Cizre-Sakallıoğlu and Yeldan, 1999). Furthermore, high interest rates attracting short-term capital deterred private investment and made financial assets more attractive to real sector firms rather than the yield offered by physical investment. As a result, productive capacity of the economy remained quite stagnant.

After the capital account liberalization, economic activity became more vulnerable and volatile. Unstable exchange and interest rates and the heavy presence of government in financial markets led to ever shortening maturities and planning horizons. All in all, capital account liberalization made the life of policy makers more difficult and resulted in boom and bust cycles in the economy where economic activity remained heavily
dependent on the availability of foreign financing mainly in the form of short term capital.

The boom and bust cycles have also contributed to the political instability that intensified during the 1990s. Unlike the 1980's, after the parliamentary elections in 1991, the duration of the governments’ stay in office was very short, that is 15 months on the average. Moreover, as recent evidence suggests, coalition governments perform worse than majority governments in terms of budget discipline. Hence, the fact that Turkey has been governed by coalitions or minority governments since the elections in 1991 probably has played an important role in the increase in public deficits (Atiyas et al, 1999). The dominance of a distributive political culture, which has become the predominant means of political competition in Turkey, also put public finances under pressure. Another factor has been the fragmented nature of the central control agencies in the economy. In Turkey, there are three different agencies that play a critical role in the conduct of budget policy. The budget coverage both in terms of commitment and control has also been limited in Turkey, especially with the introduction of an increasing number of extra-budgetary funds during the 1990s as well as the increase in the state banks’ quasi-fiscal operations to conduct the agricultural subsidies. In addition, the high and persistent inflation during the last two decades has also resulted in “supplementary budgets” being a norm whenever expenditures do exceed appropriations. Thus the fact that governments can spend public resources outside the budget has increased their discretion and reduced the transparency of the budget. Consequently, budgets have been prepared virtually with no information on the allocative and cost efficiency of existing programs. This, in turn, has made strategic prioritization at the budget preparation stage extremely difficult. As a result, whenever budget cuts have been necessary, they have been carried out across the board, without a strategic focus (Atiyas et al., 1999). Fortunately, as it has become clear after a decade of ad hoc and across-the-board cuts in public expenditures (to move from a state controlled to a more market-oriented economy), not only the size of the state in the overall economy but the existence and the capability of the state institutions to change the rules of the game in a well-timed and effective manner also mattered. The current crises in November 2000 and February
2001 once more revealed the fact that the current situation would worsen in the long run without more stringent and high-quality reforms especially addressing the public sector and the banking sector.

The Turkish financial sector did not perform the traditional role of intermediation between the firms and households. Rather, it functioned as a finance house to accommodate the ever-increasing government borrowing needs especially during the 1990s. Lucrative real interest rates made entry into the banking business very attractive and the number of banks has increased during the reform period. Despite the numerous changes in bank laws and regulations since 1980, the supervision and enforcement could not keep up with these developments hence culminating into the recent bank takeovers. The stock of Treasury securities issued for bank restructuring was estimated to have reached 33 percent of GNP by the end of 2001. The public sector failed to identify and cure the problem before it became a large destabilizing factor for the economy. The public sector, in need of financing for its deficits, wanted to have as many banks as possible in the system to ease its financing needs. The increasing number of banks and good real interest margins paid on the government securities made the banking business ever lucrative for businessmen and governments easily granted the banking licenses. It became a self-sustaining cycle in the economy until it broke out with the failed disinflation program of 1999. The recent government, once paying very high real interest rates and as a consequence facing a snowballing debt stock, was strongly hit this time by bank failures and subsequent takeovers, necessitating public funds for recapitalization, which translated into a substantial increase in the domestic debt stock. The new economic program of 2002-2004 therefore put a high priority in restructuring and reforming the banking sector.

Along with the rise in domestic debt, there was also an upward trend in the external debt stock after the liberalization efforts. Related theory tells us that “when undertaking reform and stabilization programs, some countries are prone to excessive foreign borrowing that ultimately proves unsustainable. A sharp withdrawal of foreign funds, declines in asset values and painful economic downturn may follow” (McKinnon and Pill, 1997). Chile in 1982-83, Mexico in 1994 and Britain in early 1990s are
examples of over-borrowing and boost cycles after the liberalization programs. Turkey was no exception and the liberalization effort of the 1980s was followed by the 1994 crisis. The foreign debt stock of the country reached 43 percent of GNP in the 1990s quadrupling the stock of foreign debt in the 1970s of 10 percent. Turkey was faced with both increasing domestic and foreign debt stock in the 1990s. At this point, it should be noted that Turkey did not have a debt problem in the 1980s when Latin American economies were suffering from debt overhang. The late 1990s were the period that Turkish debt sustainability was questioned.

The 1980-89 period was characterized by the liberalization efforts of government on many fronts. The 1990s was a lax post-reform period in the Turkish economy. The so-called “first generation reforms” were in place and the impact of these reforms was surfacing. The 1990s was also a decade of external and domestic shocks and crises for the Turkish economy. Economic fundamentals and rules of the game were totally changed during the last decade. The 1994 financial crisis reminded the policy makers of “inconsistent trinity/open economy trilemma” of Obstfeld and Taylor (2002). A country cannot simultaneously maintain a fixed exchange rate and open capital accounts while pushing ahead a monetary policy oriented towards domestic goals. “Governments may choose only two of the above...if fixed exchange rates and integration into the global capital market are the primary desiderata, monetary policy must be subjugated to those ends” (Obstfeld, 1998). Turkey experienced the inconsistent trinity paying a very high price of 60 percent nominal depreciation of the currency within four months and a 6.1 percent contraction of the GNP in 1994. The 1994 crisis proved that the first wave of reforms were alone not enough and there was a need to go ahead with reforms to put public finances in order and run the economy with a proper set of rules aimed to achieve a competitive free market economy.

Having seen the ailing national economies after the first wave of reforms, policy makers both in national and international quarters became highly aware of the importance of proper rules, institutions and governance in achieving stable growth. Only then, the so-called “second generation reforms” were pushed forward by the international agencies. Hence, second generation reforms and the issue of good governance were
the main agenda items during the late 1990s. Therefore it could not be too fair to charge policy makers in the 1980s of being ignorant of the process or need for further reforms as nobody at that time could have known about the absolute need of the second generation reforms.

The original intentions of policy makers when introducing the financial liberalization policies in Turkey were financial deepening, higher savings, investment and growth, increased competition and efficiency in resource allocation. “Policy makers believed that structural adjustment policies could not be implemented successfully unless financial markets were deep and mature enough to meet the financing needs of an outward oriented economy” (Saracoglu, 1996). It would be unfair to claim that none of these targets were realized, but the progress was far less than satisfactory as explained. It is true that Turkish bureaucracy and politicians have believed that the deregulation of financial system would be enough to create a competitive, sound financial structure functioning efficiently (Ersel, 1991). This naive approach that liberalization in the form of “deregulation” would bring the economy to the much-desired equilibrium where resources are allocated efficiently was prevalent on all fronts. Besides, neither the consecutive governments nor the economic management teams were able to assess the impact of new measures beforehand properly and to foresee the possible adverse developments in the midst of a fast-changing domestic economy, operating in the context of an overall unstable international economic order especially during the last decade.

It is true that availability of foreign capital eased the financing constraint of the governments and delayed the required fiscal discipline necessary for a sustainable macroeconomic environment. Given the flow of external financing to the country, policy makers have seen no harm and indeed encouraged capital flows to the country. Central Bank’s policy of keeping exchange rate competitive implicitly signaled an unannounced crawling-peg regime and made the calculation of real gains fairly easy given the inflation expectations. With no real foreign exchange risk on the horizon, Turkish banks borrowed from abroad and invested in high yield government securities. In an ideal world, foreign capital flows if invested in productive investment would increase the productive capacity of the
economy, and as marginal rate of return on the capital is higher, capital scarce developing countries would pay a handsome yield to foreign investors. Yet, in Turkey, foreign flows were mainly used to finance budget deficits stemming from substantial rises in transfer and current expenditures of the budget. Gross fixed investment of the public sector came down to 6 percent of GNP in the 1990s from 7.6 percent of GNP in the 1970s. Foreign direct investment also remained at very low levels and did not contribute to the capital formation process either. In sum, foreign financing and integration with the international capital markets did not raise the productive capacity of the economy but helped the policy makers to postpone necessary reforms that were, in fact, unavoidable in the face of pressing problems into an uncertain future through a rising debt stock.
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### Table 1: Main Macroeconomic Indicators of Turkey: 1970-1999

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Source: CBRT, Treasury, SPO, SIS.

(1) Available as the same classification since 1983.

(2) Average of 1975 and 1979.
### Table 2: Capital Flows (million US dollars)

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<td>593</td>
<td>2978</td>
<td>3721</td>
<td>411</td>
<td>809</td>
<td>1491</td>
<td>1353</td>
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<td>6</td>
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*Source: Central Bank.*
### Table 3: Public Sector Accounts

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<tbody>
<tr>
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*Source: SPO.*
## Table 4: Consolidated Budget

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<td><strong>(percent of GNP)</strong></td>
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<tr>
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<tr>
<td>Tax Rebates</td>
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<tr>
<td><strong>(percent of total)</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Total Expenditures</td>
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<td>41.4</td>
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<td>Tax Rebates</td>
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*Source: SPO.*
Table 5: Indicators of Financial Deepening (percent of GNP)

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<td>F/X Deposits</td>
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<td>M2Y</td>
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<td>Financial Assets</td>
<td>26.4</td>
<td>32.1</td>
<td>52.7</td>
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</table>

Source: CBRT, CMB.

Table 6: Composition of Banking Sector Balance Sheet (percent)

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<td>Assets</td>
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<tr>
<td>Liquid Assets</td>
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<td>33.9</td>
<td>36.3</td>
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<td>Credits</td>
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<td>46.0</td>
<td>41.3</td>
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<tr>
<td>Fixed Assets</td>
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<td>Other Assets</td>
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<tr>
<td>Total Assets</td>
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<table>
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<th>Liabilities</th>
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<tr>
<td>Deposits</td>
<td>48.9</td>
<td>57.4</td>
<td>61.3</td>
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<tr>
<td>Non-Deposit Liabilities</td>
<td>9.0</td>
<td>14.4</td>
<td>18.3</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>35.0</td>
<td>20.0</td>
<td>11.5</td>
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<tr>
<td>Capital</td>
<td>6.3</td>
<td>6.4</td>
<td>6.1</td>
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<tr>
<td>Profit</td>
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<td>2.7</td>
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<td>Total Liabilities</td>
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<td>100.0</td>
<td>100.0</td>
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Memorandum items:

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<tbody>
<tr>
<td>Total Assets / GNP</td>
<td>42.0</td>
<td>44.9</td>
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Share of Public Banks as Percent of Total Banking Sector

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<tr>
<td>Total Assets</td>
<td>44.3</td>
<td>44.7</td>
<td>38.7</td>
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<tr>
<td>Credits</td>
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<td>45.1</td>
<td>37.1</td>
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<td>Deposits</td>
<td>37.0</td>
<td>40.4</td>
<td>44.0</td>
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</table>

Source: Banks Association of Turkey.
Table 7: Labor Market Developments (aged 15+, thousand persons)

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<tr>
<td>Labor Force</td>
<td>15619</td>
<td>17,309</td>
<td>19,930</td>
<td>21,331</td>
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<td>Employment</td>
<td>13813</td>
<td>15,430</td>
<td>18,221</td>
<td>19,702</td>
<td>20,578</td>
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<td>Unemployed</td>
<td>1807</td>
<td>1,879</td>
<td>1,709</td>
<td>1,629</td>
<td>1,451</td>
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<td>Unemployment rate (%)</td>
<td>11.6</td>
<td>10.9</td>
<td>8.6</td>
<td>7.7</td>
<td>6.6</td>
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Employment by Sectors (%)

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<tr>
<td>Agriculture</td>
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<td>52.1</td>
<td>47.4</td>
<td>43.4</td>
<td>34.9</td>
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<td>Industry</td>
<td>13.8</td>
<td>14.9</td>
<td>15.6</td>
<td>16.4</td>
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<tr>
<td>Services</td>
<td>31.3</td>
<td>33.0</td>
<td>37.0</td>
<td>40.2</td>
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</table>

Source: SPO, SIS.

Table 8: Developments in Wages, Productivity, and Employment in Manufacturing Industry

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<td>Growth Rate of Real Wages</td>
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<tr>
<td>Mean</td>
<td>5.38</td>
<td>-1.73</td>
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<tr>
<td>Standard Deviation</td>
<td>10.54</td>
<td>16.56</td>
<td>17.41</td>
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<td>Coefficient of Variation</td>
<td>1.96</td>
<td>-9.58</td>
<td>4.03</td>
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<td>Growth Rate of Real Average Labor Productivity</td>
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<tr>
<td>Mean</td>
<td>1.03</td>
<td>5.41</td>
<td>4.99</td>
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<td>Standard Deviation</td>
<td>9.25</td>
<td>8.95</td>
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<td>Coefficient of Variation</td>
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<td>Growth Rate of Annual Average Employees</td>
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<td>Mean</td>
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<td>1.51</td>
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<td>Standard Deviation</td>
<td>4.25</td>
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<td>Coefficient of Variation</td>
<td>0.76</td>
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Source: SIS.
Table 9: Health Indicators

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<td>Life Expectancy at Birth (years)</td>
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<td>61</td>
<td>63</td>
<td>66</td>
<td>67</td>
<td>69</td>
<td>69</td>
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<td>Infant Mortality per 1000 live infants</td>
<td>140</td>
<td>111</td>
<td>63</td>
<td>65</td>
<td>51</td>
<td>39</td>
<td>35</td>
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<tr>
<td>Population per Bed</td>
<td>409</td>
<td>422</td>
<td>394</td>
<td>428</td>
<td>412</td>
<td>409</td>
<td>384</td>
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<tr>
<td>Population per Physician</td>
<td>2572</td>
<td>1858</td>
<td>1642</td>
<td>1391</td>
<td>1115</td>
<td>925</td>
<td>807</td>
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<tr>
<td>Population per Dentist</td>
<td>10972</td>
<td>7996</td>
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<td>5371</td>
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Source: SIS, SPO.

Table 10: Health Expenditures

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<tr>
<td>Total Health Expenditures / GNP (%)</td>
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<td>Public / Total (%)</td>
<td>51.4</td>
<td>46.9</td>
<td>58.5</td>
<td>63.2</td>
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<tr>
<td>Private / Total (%)</td>
<td>48.6</td>
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<td>Health Expenditures per Capita ($/PPP)</td>
<td>86.5</td>
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Source: SPO.

Table 11: Rate of Schooling

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<tr>
<td>Primary Education †</td>
<td>76.3</td>
<td>77.3</td>
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<td>Intermediate Education</td>
<td>20.1</td>
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<td>38.5</td>
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<td>Higher Education</td>
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<td>15.7</td>
<td>22.4</td>
<td>27.8</td>
</tr>
</tbody>
</table>

Source: SPO.

† Eight years primary education (primary school + secondary school).
REFERENCES AND RESOURCES


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APPENDIX: LEGISLATIONS CONCERNING THE CAPITAL ACCOUNT

Restrictions on Capital Flows before the 1980s, Decree No: 17

During the period between 1962 and 1983, Decree No: 17 was effective. According to Decree No: 17, following restrictions were applied to capital flows:

- The foreign exchange deposit accounts were permitted to open only for non-obligatory part of the foreign earnings sourcing from exports and invisible transactions.
- The banks were authorized to hold foreign exchange position under certain limits, which were strictly controlled.
- The payments of invisible transactions were accomplished by the Central Bank.
- Most of the foreign exchange allocations (such as, touristic, cultural travels, port expenses etc.) were accomplished by the central bank.
- On the arrivals or departures, Turkish currency, foreign exchange, foreign currency notes, securities, precious metals and stones were to be declared by travelers.
- Real estate income and sales were blocked at the Central Bank purchased by with or without converting foreign exchange (except funds which invested for touristic purposes).
- The transfer of income and profits obtained from the investments in Turkey by non-residents was prohibited.
- Buying and selling of foreign securities by residents were restricted, and buying and selling of Turkish securities by non-residents were realized through the permission of the Ministry of Finance.
- The exporters were required to bring their export earnings into the country within three-months.
- The imports were realized within the framework of annual plan (i.e., Liberation lists and fund lists.) Permits were set by the Central Bank.
Bank confirming the instruction of the Ministry of Commerce. The value of imports had to be transferred only in foreign exchange.

**Capital Account Liberalization after 1980, Decree No: 28, 30, 32**

The main rules of the Decrees No: 28 and 30 are as follows:

- The administration of foreign exchange and foreign trade has been assigned to the Undersecretariat of Treasury and Foreign Trade. The Undersecretariat transferred the authority of foreign exchange control to the Central Bank.

- Daily fixing of the exchange rate implemented by the Central Bank from May 1, 1981 onwards has been maintained. A new approach has been brought forward in determining the value (exchange rate) of Turkish lira against foreign currencies.

- Freedom has been given to commercial banks to set their exchange rates within a margin of plus/minus 6 percent, the basic exchange rate declared by the Central Bank.

- The transfer of foreign exchange obtained from the liquidation or sale of real estate purchased with foreign exchange has become free.

- The foreign exchange position limits of the commercial banks have been eliminated and the maximum amount of foreign exchange the banks can keep has been set to be 40 percent of their short-term commitment.

- Banks and special financial institutions have been given authority to conduct foreign exchange transactions according to their needs and hold foreign exchange assets within the margin of certain ratios set by the Central Bank, such as liquidity ratio and currency risk ratio.

- These institutions are obliged to surrender, at least 20 percent of their foreign exchange and foreign currency notes earnings sourcing from exports, invisible transactions to the Central Bank and have to keep reserve requirements in the Central Bank for the foreign exchange deposits opened by residents and non-residents and corporate bodies.
• The limitation in the import of Turkish lira (banknotes and coins) has been eliminated.

• The restrictions on travel abroad have been abolished. The residents are given the opportunity to by foreign exchange up to US dollar 3000 when traveling abroad.
### APPENDIX II: STRUCTURAL REFORMS AND LEGISLATION AFTER 1999

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<thead>
<tr>
<th>Type of Regulation</th>
<th>Note</th>
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<tr>
<td><strong>Banking Regulations</strong></td>
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<tr>
<td>Creation of Banking Regulation and Supervision Agency (BRSA)</td>
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<td>June 1999</td>
<td>Done</td>
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<td>Lowering the limit on the commercial banks’ net open foreign position</td>
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<td>Done</td>
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<td>Amendments in the Banks’ Act</td>
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<td>December 1999</td>
<td></td>
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<tr>
<td>Regulations Related to Credit Provisions</td>
<td></td>
<td>December 1999</td>
<td>Done</td>
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<tr>
<td>Amendments in the Tax Regulations to Allow the Deductibility of Provisions</td>
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<td>December 1999</td>
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<tr>
<td>Modifications related to the Capital Adequacy and Foreign Exchange Limit</td>
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<td>December 1999</td>
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<tr>
<td>Banks’ compliance with the remedial measures</td>
<td>In the year 2000</td>
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<tr>
<td>Naming of the Board of BRSA</td>
<td>Until April 1,2000</td>
<td>March 2000</td>
<td>Done</td>
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<tr>
<td>Amendments in the accounting rules</td>
<td>Until May 1, 2000</td>
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<tr>
<td>Regulations related to credit limits</td>
<td>Until July 1, 2000</td>
<td>December 1999</td>
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<tr>
<td>Implementation of capital</td>
<td>Until July 1,</td>
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</table>
## The Impact of Globalization on the Turkish Economy

<table>
<thead>
<tr>
<th>Type of Regulation</th>
<th>Note</th>
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<th>Result</th>
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<tbody>
<tr>
<td>adequacy rules</td>
<td>2000</td>
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<tr>
<td>Amendments in the capital adequacy rules</td>
<td>Until July 1, 2000</td>
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<tr>
<td>BRSA’s being in full operation</td>
<td>Until September 1, 2000</td>
<td>September 2000</td>
<td>Done</td>
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<tr>
<td>New accounting standards</td>
<td>Until January 1, 2001</td>
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<tr>
<td>Regulations related to risk management</td>
<td>Until January 1, 2001</td>
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<tr>
<td>procedures</td>
<td></td>
<td></td>
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<tr>
<td>Restructuring of the public banks</td>
<td>Until January 1, 2001</td>
<td>November 2000</td>
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<tr>
<td>Measure taken related to the unpaid duty</td>
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<td>losses</td>
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<tr>
<td>Public announcement</td>
<td>Until January 15, 2001</td>
<td>January 2001</td>
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<tr>
<td>clarifying the nature and scope of the</td>
<td></td>
<td></td>
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<tr>
<td>guarantee fully protecting depositors</td>
<td></td>
<td></td>
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<tr>
<td>and other creditors</td>
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<tr>
<td>Protocol between the Treasury and the</td>
<td>Until January 15, 2001</td>
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<tr>
<td>SDIF on the modalities governing the</td>
<td></td>
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<tr>
<td>financing of the above guarantee’s</td>
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<tr>
<td>operation</td>
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<tr>
<td>SDIF’s having the authority to borrow</td>
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<td></td>
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<tr>
<td>resources from the Treasury as needed</td>
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<tr>
<td>SDIF’s borrowing a loan of 6.1 billion US dollar</td>
<td>November 16, 2000</td>
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</table>
### The Impact of Globalization on the Turkish Economy

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<tbody>
<tr>
<td>from the Treasury</td>
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<tr>
<td>New regulation for ownership of banks</td>
<td></td>
<td>November 5, 2000</td>
<td>Done</td>
</tr>
<tr>
<td>SDIF’s proceeding with its announced schedule to sell all banks under its control</td>
<td></td>
<td>November 16, 2000</td>
<td>Done</td>
</tr>
<tr>
<td>Receipt of expression of interest letters by the potential investors</td>
<td>By December 15, 2000</td>
<td>December 15, 2000</td>
<td>Done</td>
</tr>
<tr>
<td>Notification of potential investors of approval</td>
<td>Until December 22, 2000</td>
<td>December 22, 2000</td>
<td>Done</td>
</tr>
<tr>
<td>Giving information about the banks to the approved potential investors and asking</td>
<td>Until January 15, 2001</td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Provision of information on banks for sale and giving access to detailed</td>
<td>Until February 20, 2001</td>
<td></td>
<td></td>
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<tr>
<td>information about banks (due diligence)</td>
<td></td>
<td></td>
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<tr>
<td>Receipt of request for bids</td>
<td>Until April 24, 2001</td>
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<tr>
<td>Selection of the buyer(s)</td>
<td>Until May 7,</td>
<td></td>
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<tr>
<td>Type of Regulation</td>
<td>Note</td>
<td>Date</td>
<td>Result</td>
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<tr>
<td>-----------------------------------------------------------------------------------</td>
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<tr>
<td>for each packages</td>
<td>2001</td>
<td></td>
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</tr>
<tr>
<td>The financial restructuring of Etibank and BanKapital and announcement of detailed plans for their resolution</td>
<td>Until February 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The timetable for the resolution of Demirbank</td>
<td></td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Prompt intervention of any bank that becomes insolvent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Handling the resolution of any bank intervened in the future similar to those described in the above paragraph</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Setting up an asset management unit (AMU)</td>
<td></td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Transfer of non-performing loans of banks to be resolved to the AMU</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Making of the announcement about the AMU’s performance ahead of the transfer of that assets to the AMU</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Conversion of the stock of duty losses of Halk Bank and Ziraat Bank into securities bearing market interest rates</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The interest on the stock of duty losses will accrue in 2001. At a rate equal to the monthly weighted average of Treasury bill and discount bond rates times 1.33 for Ziraat Bank and time 1.60 for Halk Bank

Proceeding the strategy to privatize the state banks on the basis of the law enacted in November 2000

Adoption of new regulations on internal risk management systems and on adjusting capital adequacy requirements to reflect market risks

Being effective of the mentioned regulation

Adoption of a tax regulation providing for the full deductibility of the provisions

Elimination of the deductibility of general provisioning

Reduction of the reserve requirement coefficient on Turkish lira deposits from 6 percent to percent

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<tr>
<th>Type of Regulation</th>
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<tr>
<td>The interest on the stock of duty losses will accrue in 2001. At a rate equal to the monthly weighted average of Treasury bill and discount bond rates times 1.33 for Ziraat Bank and time 1.60 for Halk Bank</td>
<td></td>
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</tr>
<tr>
<td>Proceeding the strategy to privatize the state banks on the basis of the law enacted in November 2000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adoption of new regulations on internal risk management systems and on adjusting capital adequacy requirements to reflect market risks</td>
<td>Until February 1, 2001</td>
<td>February 2001</td>
<td>Done</td>
</tr>
<tr>
<td>Being effective of the mentioned regulation</td>
<td>As of January 1, 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adoption of a tax regulation providing for the full deductibility of the provisions</td>
<td>Until April 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elimination of the deductibility of general provisioning</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction of the reserve requirement coefficient on Turkish lira deposits from 6 percent to percent</td>
<td>Starting January 12, 2001</td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Type of Regulation</td>
<td>Note</td>
<td>Date</td>
<td>Result</td>
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<tr>
<td>--------------------</td>
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</tr>
<tr>
<td>Issue of regulation redefining indirect exposure to shareholders</td>
<td>Until February 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The SDIF and state banks’ overnight position will be reduced by at least two-third from the March 16, 2001 (including the elimination of overnight positions vis-à-vis commercial banks.)</td>
<td>Condition for the completion of the IMF’s 6th and 7th reviews</td>
<td>Done</td>
<td></td>
</tr>
<tr>
<td>The SDIF and state banks’ remaining overnight position will be eliminated.</td>
<td>Condition for the completion of the IMF’s 8th review</td>
<td>(As of mid-June 2001).</td>
<td>Done</td>
</tr>
<tr>
<td>The stock of repos of the SDIF and state banks with the CBRT not to exceed TL 7 quadrillion</td>
<td>Condition of the completion of the IMF’s 8th review</td>
<td>By end-May 2001</td>
<td>Done</td>
</tr>
<tr>
<td>All state and SDIF banks will be subject to maturity guidelines and uniform deposit rates for different maturity ranges. These guidelines will include limits on the overnight borrowing from commercial banks and other market sources.</td>
<td></td>
<td></td>
<td>Not Realized.</td>
</tr>
<tr>
<td>Governance of Ziraat and Halk will be strengthened through the establishment</td>
<td>Condition for the completion of</td>
<td>April 2001</td>
<td>Done</td>
</tr>
</tbody>
</table>
## The Impact of Globalization on the Turkish Economy

<table>
<thead>
<tr>
<th>Type of Regulation</th>
<th>Note</th>
<th>Date</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>of a common and politically independent governing board, reporting to Treasury, and the appointment of new management.</td>
<td>the IMF’s 6th and 7th reviews</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The financial restructuring of state banks (the elimination of remaining duty loss, a recapitalization to cover any negative net worth, the replacement of existing government papers bearing below-market yields, and an increase in the banks’ risk-weighted capital adequacy ratio to 8%) will be completed.</td>
<td>Condition for the completion of the IMF’s 6th and 7th reviews</td>
<td>May 2, 2001</td>
<td>Done</td>
</tr>
<tr>
<td>After the above financial restructuring is completed, these banks will be required to fully comply with all BRSA regulations applicable to commercial banks.</td>
<td>After the completed financial restructuring</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The implementation of these reforms will be overseen by independent outside auditors in each bank.</td>
<td>To be appointed in May 2001</td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Emlak Bank will be closed and its liabilities and some of its assets</td>
<td>By end May 2001</td>
<td></td>
<td>Done</td>
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<tr>
<td></td>
<td>Condition for</td>
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<tr>
<td><strong>Type of Regulation</strong></td>
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<td><strong>Date</strong></td>
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<tr>
<td>------------------------</td>
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</tr>
<tr>
<td>Sumerbank will be recapitalized by the SDIF to cover the bank’s negative net worth using transferable securities similar to those used in the state banks and with a currency composition to provide cover for its FX deposit liabilities.</td>
<td>Condition for the completion of the IMF’s 6th and 7th reviews</td>
<td>By end July 2001</td>
<td>Done</td>
</tr>
<tr>
<td>Sumerbank will be put up for sale with bids to be received by end-September 2001. If no viable bids are received at that time, the bank will be liquidated.</td>
<td>Bids to be received by end-September 2001</td>
<td>Put up for sale on May 31, 2001.</td>
<td></td>
</tr>
<tr>
<td>The remaining 7 SDIF banks will be recapitalized to cover their negative net worth.</td>
<td>Condition for the completion of the IMF’s 6th and 7th reviews</td>
<td>Done</td>
<td></td>
</tr>
<tr>
<td>The four banks (from the 7 banks except Demirbank, Bank)</td>
<td>By end-May 2001, June 15, 2000</td>
<td>Done</td>
<td></td>
</tr>
<tr>
<td>Type of Regulation</td>
<td>Note</td>
<td>Date</td>
<td>Result</td>
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<tr>
<td>-----------------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>Ekspres and Iktisat Bank) for which there are presently no interest bidders will be organized in a second transition bank or put into liquidation.</td>
<td>Condition for the completion of the IMF’s 8th review</td>
<td></td>
<td></td>
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<tr>
<td>After the closure of 8 of the SDIF banks, the remaining SDIF banks will be sold, put into liquidation, or otherwise resolved.</td>
<td>By end-2001 Condition for the completion of the IMF’s 12th review</td>
<td>By end-2001</td>
<td></td>
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<tr>
<td>Sumerbank will transfer all its non-performing loans above TL 75 billion to Collection Dept. of SDIF.</td>
<td>By end-July 2001</td>
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<tr>
<td>Other SDIF banks will have started their transfers by end-July.</td>
<td>To be completed by end-October 2001</td>
<td></td>
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<tr>
<td>The BRSA is requiring all capital deficient banks to present detailed capital strengthening plans.</td>
<td>By end-April 2001 Prior action for the IMF’s 6th and 7th reviews</td>
<td>Done</td>
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<tr>
<td>Amendments to Banking Law will be approved by the Parliament. The changes include; (a) establishing special commercial courts and giving SDIF special</td>
<td>Condition for the completion of the IMF’s 6th and 7th</td>
<td>May 29, 2001</td>
<td>Done</td>
</tr>
<tr>
<td><strong>Type of Regulation</strong></td>
<td><strong>Note</strong></td>
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<td><strong>Result</strong></td>
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<tr>
<td>debt recovery powers,</td>
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<td>reviews</td>
</tr>
<tr>
<td>(b) strengthening the</td>
<td></td>
<td></td>
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<tr>
<td>protection of staff and</td>
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<tr>
<td>management of the BRSA</td>
<td></td>
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<tr>
<td>and SDIF against law</td>
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<tr>
<td>suits arising from</td>
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<td>carrying out their</td>
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<td>official duties, (c)</td>
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<td>defining the concept</td>
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<td>of “own funds” to</td>
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<td>permit the application</td>
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<td>of new connected</td>
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<td>lending limits on a</td>
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<tr>
<td>consolidated basis,</td>
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<tr>
<td>(d) broadening the</td>
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<tr>
<td>definition of credit</td>
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<td>exposure to include</td>
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<td>derivatives, (e)</td>
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<tr>
<td>providing for the full</td>
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<td>tax deductibility of</td>
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<td>specific loan loss</td>
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<td>provisions.</td>
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</tbody>
</table>

Connected lending regulation will be adopted.

<table>
<thead>
<tr>
<th>Structural Benchmark</th>
<th>Within one month on approval of amendments to the Banking Law</th>
</tr>
</thead>
</table>

Foreign exchange exposure will carry a capital charge under the recently issued market risk regulation that becomes effective on January 1, 2002. The Banking Law will be amended to include derivatives in the definition of “credit” to

To become effective on Jan. 1, 2002.
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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>limit the overall exposure to individual (and related) counterparties.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Accounting standards for banks will be brought in line with international standard.</td>
<td>Structural Benchmark</td>
<td>From the beginning of 2002</td>
<td></td>
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</tbody>
</table>

**Fiscal Management**

<table>
<thead>
<tr>
<th><strong>Task</strong></th>
<th><strong>Date</strong></th>
<th><strong>Result</strong></th>
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</thead>
<tbody>
<tr>
<td>Taking stock of existing contingent liabilities</td>
<td>Until January 1, 2000</td>
<td></td>
</tr>
<tr>
<td>Closing of 20 budgetary funds</td>
<td>Until February 1, 2000</td>
<td></td>
</tr>
<tr>
<td>Identification of unnecessary extra-budgetary funds</td>
<td>Until April 1, 2000</td>
<td></td>
</tr>
<tr>
<td>Elimination of extra-budgetary funds</td>
<td>Until June 1, 2000</td>
<td>2 extra-budgetary funds were eliminated</td>
</tr>
<tr>
<td>Closing of 25 budgetary funds</td>
<td>Until August 1, 2000</td>
<td>25 budgetary funds were closed</td>
</tr>
<tr>
<td>Introducing accounting and reporting for the consolidated central budget</td>
<td>In the year 2001</td>
<td></td>
</tr>
<tr>
<td>Implementation of an integrated financial information system</td>
<td>In the year 2001</td>
<td></td>
</tr>
<tr>
<td>Changes in government</td>
<td>Until January</td>
<td></td>
</tr>
<tr>
<td><strong>Type of Regulation</strong></td>
<td><strong>Note</strong></td>
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<td>------------------------</td>
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</tr>
<tr>
<td>guarantees</td>
<td>1, 2001</td>
<td></td>
</tr>
<tr>
<td>Closing of 16 budgetary funds</td>
<td>Until June 1, 2001</td>
<td></td>
</tr>
<tr>
<td>Creation of no new budgetary or extra-budgetary funds</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Fiscal Management and Transparency**

<table>
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</thead>
<tbody>
<tr>
<td>Submission to Parliament and enactment of the law that envisages the closure of the 21 budgetary funds and 4 Extra-Budgetary Funds (EBF)</td>
<td>By mid-February 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The enactment of the law that envisages the closure of the 15 budgetary funds and 1 EBF</td>
<td>Until July 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Creation of no new budgetary funds or EBF</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elimination of all budgetary funds (with the exception of DFIF-Support Price Stabilization Fund)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Limiting the number of EBF’s to 6</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Submission to Parliament a law on public finance and debt management</td>
<td>Until July 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Type of Regulation</td>
<td>Note</td>
<td>Date</td>
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</tr>
<tr>
<td>Inclusion in the monthly reports of the Treasury a “lending minus repayments” item</td>
<td>In the year 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Setting in the 2001 budget law explicit limits on the issuance of new guarantees in 2001</td>
<td></td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>Completion of the implementation of a computerized accounting system</td>
<td>By mid 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completion of a new budget classification in line with international standards</td>
<td>Until June 1, 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initiation of the necessary studies to move toward accrual-based accounting</td>
<td>In the year 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The remaining 15 budgetary funds (except Support Price Stabilization Fund needed to channel the proceeds from WB loans) will be closed.</td>
<td>Structural Benchmark</td>
<td>July 3, 2001</td>
<td>Done</td>
</tr>
<tr>
<td>2 extra-budgetary funds (except the Social Aid &amp; Solidarity Fund, the Defense Fund, the Promotion &amp; Publicity Fund, the SDIF, and the Privatization Fund) will be closed.</td>
<td>Structural Benchmark</td>
<td>July 3, 2001</td>
<td>Done</td>
</tr>
</tbody>
</table>
### The Impact of Globalization on the Turkish Economy

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<tbody>
<tr>
<td>In order to improve control and transparency, all revenues provided by law no.34187/39B (mostly from motor vehicle taxation) will be channeled into the budget.</td>
<td></td>
<td>To be implemented in the 2002 budget</td>
<td></td>
</tr>
<tr>
<td>The number of the revolving funds will be at least halved.</td>
<td>Structural Benchmark</td>
<td>By end 2001</td>
<td></td>
</tr>
<tr>
<td>A comprehensive financial and economic auditing of the revolving funds operations will be carried out.</td>
<td>By end-May 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Based on the findings of the report for the revolving funds, further steps will be identified.</td>
<td>By end-June 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A law on public finance and debt management that defines clear borrowing rules and limits for the public sector, and incorporates into the budget on-lending and debt guarantee operations of the treasury will be submitted to the parliament.</td>
<td>Structural Benchmark</td>
<td>By end-June 2001</td>
<td>Done</td>
</tr>
<tr>
<td>In the monthly reports of the Treasury, a “lending minus repayments” item</td>
<td>As of May 2001, and to be included in</td>
<td>May 2001</td>
<td>Done</td>
</tr>
<tr>
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<tr>
<td>will be included following the IMF’s Government Finance Statistics standards, thus expanding the coverage of the budget balance to include net treasury payments of guaranteed debt.</td>
<td>the 2002 budget</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A mid-year Economic and Fiscal Update will be published.</td>
<td>In July 2001</td>
<td>In July 2001</td>
<td></td>
</tr>
<tr>
<td>In the draft budget submitted to parliament for 2002 will be accompanied by the account and financial outlook for: (a) all extra-budgetary funds and social security institutions (including a report on social security contribution arrears), (b) revolving funds, (c) contingent liabilities of the treasury, (d) all SEEs (including state-owned banks, (e) local authorities.</td>
<td>Structural Benchmark In October 2001</td>
<td>In October 2001</td>
<td></td>
</tr>
<tr>
<td>The 2002 budget will include the implications for projected medium-term current spending of public investment programs.</td>
<td>In October 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Type of Regulation</td>
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<td>Date</td>
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</tr>
<tr>
<td>The implementation of a computerized accounting system that will allow a better monitoring of spending and costs in government units will be completed.</td>
<td>By mid-2001</td>
<td>Pilot Region system started.</td>
<td></td>
</tr>
<tr>
<td>A new budget classification in line with international standards will be completed.</td>
<td>By end-June 2001</td>
<td>Done (The new classification will be implemented in six pilot agencies for the 2002 budget).</td>
<td></td>
</tr>
<tr>
<td>The necessary studies to move towards accrual-based accounting will be initiated.</td>
<td>In 2001</td>
<td>Done (Treasury and IMF staff held technical discussions on how to move toward accrual-based accounting system, May 2001).</td>
<td></td>
</tr>
<tr>
<td>A public procurement law in line with UN standards (UNCITRAL) will be submitted to Parliament.</td>
<td>Structural Benchmark</td>
<td>By October 15, 2001</td>
<td>A three-pronged plan initiated, including a</td>
</tr>
<tr>
<td>A more systematic approach to enhance governance in the public sector, with a view of defining and implementing</td>
<td>In 2001</td>
<td></td>
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</tbody>
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### The Impact of Globalization on the Turkish Economy

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<tr>
<td>any legal and ethical measures will be adopted.</td>
<td>Public Expenditure and Institutional Review which is complete, an International Conference on Promoting Good Governance and Anti-Corruption in Turkey that will be held in September, and a law to streamline the prosecution of public officials.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Increasing the Role of Private Sector and Foreign Capital in the Turkish Economy

The expected yield from *privatization of 2001* receipts is lowered to US$1 billion (in addition to the US$2 billion already cashed from operations concluded in 2001).
The Impact of Globalization on the Turkish Economy

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<tr>
<td>2000).</td>
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<tr>
<td>The 2002 privatization proceeds are expected to rise to US$3.5 billion.</td>
<td></td>
<td>In 2002</td>
<td></td>
</tr>
<tr>
<td>The parliament will approve the <em>legislation</em> containing the followings;</td>
<td>Condition for the completion of the IMF’s 6\textsuperscript{th} and 7\textsuperscript{th} program reviews</td>
<td></td>
<td>Done</td>
</tr>
<tr>
<td>(a) authorization of divestiture of up to 100% of Turk Telekom, excluding a golden share which will remain with the government, (b) reservation of 5% of the shares of Turk Telekom to employees and small investors, (c) allowance of foreign ownership of the shares of Turk Telekom of up to 45%, while not excluding majority foreign participation in a strategic investor consortium that could acquire a majority share, (d) revise the composition of the tender committee, which takes decisions by simple majority, as follows; two representatives from the Privatization Agency, two from the Ministry of Transportation, and one from the Treasury, (e) remove the monopoly</td>
<td></td>
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<tr>
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<tr>
<td>of Turk Telekom on fixed lines and other telecommunication services effective from the date the government shareholding falls below 50%, (f) transfer all licensing authority for telecommunication services and infrastructure to the Telecommunication Regulatory Authority, (g) give Treasury, as owner, the authority to amend Turk Telekom’s Articles of Agreement without the approval of the Ministry of Transportation and to appoint the board and management team of Turk Telekom.</td>
<td>In order to ensure full commercialization of Turk Telekom, the members of the new professional board and management team appointed by the general assembly of Turk Telekom will have recognized qualifications and experience. The board and management team will have members with relevant private</td>
<td>June 29, 2001</td>
<td>Done</td>
</tr>
</tbody>
</table>
The board of directors of Turk Telekom will adopt a comprehensive corporatization plan. This plan will:
(a) introduce international standards, financial controls, and management procedures, adequate to ensure unqualified audit opinion,
(b) bring staffing levels in line with the real operational requirements of the company,
(c) address the need to expand both internet and rural access.

With regard to TUPRAS, the PA will carry out a further public offering that will increase the private sector stake in the company to 51%.

The Tobacco Law—which liberalizes the tobacco sector, phases out the support purchases of tobacco, and allows for the sale of TEKEL assets—will be approved by Parliament.

ERDEMIR will be privatized through a merger with ISDEMIR and additional sale of

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<td>sector experience.</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>The board of directors of Turk Telekom will adopt a comprehensive corporatization plan. This plan will: (a) introduce international standards, financial controls, and management procedures, adequate to ensure unqualified audit opinion, (b) bring staffing levels in line with the real operational requirements of the company, (c) address the need to expand both internet and rural access.</td>
<td></td>
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<tr>
<td>With regard to TUPRAS, the PA will carry out a further public offering that will increase the private sector stake in the company to 51%.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Tobacco Law—which liberalizes the tobacco sector, phases out the support purchases of tobacco, and allows for the sale of TEKEL assets—will be approved by Parliament.</td>
<td>Condition for the completion of the IMF’s 8th review</td>
<td>June 20, 2001</td>
<td>Done</td>
</tr>
<tr>
<td>ERDEMIR will be privatized through a merger with ISDEMIR and additional sale of</td>
<td></td>
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<td>Type of Regulation</td>
<td>Note</td>
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<tr>
<td>shares on the ISE.</td>
<td></td>
<td></td>
<td>The deadline was changed as October 31, 2001.</td>
</tr>
<tr>
<td>The government will privatize those <em>thermal electricity generation</em> and <em>electricity distribution assets</em> remaining in state hands after the June 30 2001 deadline for the transfer of operating rights stipulated in the electricity market law. The PA will engage investment advisors to conduct these transactions under a timetable consistent with the market reform strategy set forth in the law.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>A program for the sale of <em>lands owned by the state</em> will be defined.</td>
<td></td>
<td>In May 2001</td>
<td>Done. (The new law passed the Parliament before the summer recess).</td>
</tr>
<tr>
<td>A law fully implementing the constitutional amendment on <em>international arbitration</em> will be passed by the Parliament.</td>
<td>Structural Benchmark</td>
<td>Before the Parliament’s summer recess (July 1)</td>
<td>Done (June 21, 2001).</td>
</tr>
<tr>
<td>A comprehensive study on <em>administrative barriers to investment</em> will be completed with the assistance of the</td>
<td></td>
<td>By end-June 2001</td>
<td></td>
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</tbody>
</table>
The Impact of Globalization on the Turkish Economy

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<tbody>
<tr>
<td>Foreign Investment</td>
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<tr>
<td>Based on this mentioned study, an action plan-containing deadlines and institutional responsibilities-to streamline procedures that a company must undertake to establish and operate a business legally in Turkey, will be submitted to the Council of Ministers.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>An extensive review of the commercial law, the land development law, and other laws affecting the investment environment will be completed.</td>
<td></td>
<td>By September 2001</td>
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</tbody>
</table>

Fiscal Policy and Public Debt Management

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<table>
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<tr>
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<tbody>
<tr>
<td>The primary surplus of the public sector is targeted at 5.5% for 2001.</td>
<td>At end-2001</td>
<td>Done.</td>
</tr>
<tr>
<td>The primary surplus of the public sector is targeted at 6.5% for 2002.</td>
<td>At end-2002</td>
<td></td>
</tr>
<tr>
<td>The public debt-to-GNP ratio is expected to fall</td>
<td>At end 2002 and 2003</td>
<td></td>
</tr>
</tbody>
</table>
The primary surplus of the consolidated central government (excluding privatization proceeds, transfers of profits from the CBRT, and interest receipts) is targeted at 5.1% of GNP in 2001 (against 4.6% in 2000), and at 5.6% in 2002.

<table>
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<tbody>
<tr>
<td>The primary surplus of the consolidated central government (excluding privatization proceeds, transfers of profits from the CBRT, and interest receipts).</td>
<td>Prior action for the completion of the IMF’s 6th and 7th reviews</td>
<td>In early May 2001</td>
<td>Realized (Increased by over 20% on May 25, 2001).</td>
</tr>
<tr>
<td>Petroleum Consumption Tax (PCT) will increase by 15% (after a 20% increase in April).</td>
<td>Prior action for the completion of the IMF’s 6th and 7th reviews</td>
<td>In early May 2001</td>
<td>Realized.</td>
</tr>
<tr>
<td>VAT rates will increase by 1%.</td>
<td>Prior action for the completion of the IMF’s 6th and 7th reviews</td>
<td>By April 2001</td>
<td>Realized (Increased by 40% in May 2001).</td>
</tr>
<tr>
<td>The minimum contribution base relevant for social security payments will be increased in line with the existing regulations.</td>
<td>Prior action for the completion of the IMF’s 6th and 7th reviews</td>
<td>By April 2001</td>
<td>Realized (Increased by 40% in May 2001).</td>
</tr>
<tr>
<td>PCT will be raised every month by at least WPI inflation.</td>
<td>As of June 2001</td>
<td>Realized (Increased by 16% on June 27, 2001).</td>
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<tr>
<td>With the increase in PCT mentioned above, the yield</td>
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<tr>
<td>of this tax will rise by 0.4% of GNP with respect to 2000.</td>
<td></td>
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</tr>
<tr>
<td><strong>The health premia and co-payments will be increased as part of the reform of the social security institutions.</strong></td>
<td>Before the summer 2001 parliamentary recess (July 1)</td>
<td>Realized (Lower limit increased by 40% while upper limit increased 5 times, May 2, 2001).</td>
<td></td>
</tr>
<tr>
<td>As part of the amendments to the Banking Law, the full deductibility of the specific loan loss provisions that banks are mandated to make based on bank supervision regulations will be effective.</td>
<td>As of second quarter of 2001</td>
<td>Realized.</td>
<td></td>
</tr>
<tr>
<td><strong>Real spending (adjusted for the transfer of the Public Participation Fund to the central government) will be cut by about 8%. Adjusting current expenditure, transfers, and investment by less than the inflation target will save 1.5% of GNP. Saving of 0.3% of GNP will be generated by cuts in “other current expenditures” during the implementation of the</strong></td>
<td>Approval of a supplementary budget in line with these figures will be a condition for the completion of the 8th review</td>
<td>In 2001</td>
<td>Realized (June 14, 2001).</td>
</tr>
</tbody>
</table>
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<tbody>
<tr>
<td>Credit subsidies will be eliminated as of January 2002.</td>
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<tr>
<td>Civil servants’ salaries will be raised by 5% in July 2001. However, if cumulative CPI inflation exceeds the salary increases granted up to July, salaries will be adjusted by that difference before end-2001. The number of civil servants will not increase in 2001.</td>
<td></td>
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</tr>
<tr>
<td>The primary position of the state enterprises is projected to move from a deficit of 1.5% of GNP in 2000 to a broad balance in 2001. The following measures will be taken for this purpose.</td>
<td>In 2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) SEEs’ tariffs and prices will be increased in line with their increased costs due to the depreciation of the Turkish lira and the revised inflation target.</td>
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<tr>
<td>(b) SEEs’ operating expenses, including their wage bill, will be reduced in real terms.</td>
<td></td>
<td></td>
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<tr>
<td>(c) Sugar beets quotas will be cut from 12.5 to 11.5 million tons, and</td>
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<tr>
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<tr>
<td>increase in support price of sugar beets will be by no more than targeted inflation.</td>
<td></td>
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<tr>
<td>(d) The volume of <em>support purchases of cereals</em> and offload additional gain stocks will be limited.</td>
<td></td>
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<tr>
<td>(e) In parallel to the introduction of <em>direct income support to farmers</em>, support price increases will be kept at most at targeted inflation.</td>
<td></td>
<td>In 2001</td>
<td>Partially realized (exceeded targeted inflation).</td>
</tr>
<tr>
<td>i. The margin for the support price for wheat over old prices will be further reduced to at most 20 percent subject to the provision that the increase will not exceed targeted inflation.</td>
<td></td>
<td>By June 2001</td>
<td>Partially realized (the increase by a weighted average of 63.4 %, exceeded targeted inflation)</td>
</tr>
<tr>
<td>ii. The tariff on grain imports will be lowered to at most 45 percent.</td>
<td></td>
<td></td>
<td>Realized.</td>
</tr>
<tr>
<td>(f) The average price of <em>electricity sold by TEAS</em> will be maintained at US$4.5 cents/kwh and accordingly fees and tariffs of TEDAS will be increased, allowing the latter to cover the cost of purchasing electricity from TEAS.</td>
<td></td>
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<tr>
<td>(g) The policy of subsidizing LPG will discontinue.</td>
<td></td>
<td></td>
<td>Realized</td>
</tr>
<tr>
<td>(e) All discounts and exemptions on SEE products and services will be eliminated.</td>
<td></td>
<td>By June 2001</td>
<td></td>
</tr>
<tr>
<td>(f) No worker will be transferred from the companies in the PA portfolio, funds and revolving funds to the SEE or to the consolidated budget. Overtime payments will be strictly limited.</td>
<td></td>
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</tr>
<tr>
<td>The rolling out of the tax identification numbers (TINs) to owners of bank accounts, users of banking services, and participants in financial transactions will begin.</td>
<td></td>
<td>In September 2001</td>
<td></td>
</tr>
<tr>
<td>(TINs) will be gradually extended by lowering the threshold for mandatory tax registration.</td>
<td></td>
<td>Through June 2002</td>
<td></td>
</tr>
<tr>
<td>The necessary tax regulation for TINs will be enacted.</td>
<td>A condition for completing the eighth review</td>
<td>By end-May 2001</td>
<td>The necessary TIN General Announcement was made on June 19, 2001.</td>
</tr>
<tr>
<td>The stock of private sector tax arrears, which stood at 2 percent of GNP at end-2000 will be reduced.</td>
<td>Structural benchmark</td>
<td>By end-2001</td>
<td></td>
</tr>
</tbody>
</table>
The wage contracts for public sector workers will be adjusted for inflation exceeding the targets, but not before the end of each six-month period. The adjustment will not, however, exceed 80 percent of the difference between actual and projected inflation, and there will be no such adjustment for the first six-month period.

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<td>The wage contracts for public sector workers will be adjusted for inflation exceeding the targets, but not before the end of each six-month period. The adjustment will not, however, exceed 80 percent of the difference between actual and projected inflation, and there will be no such adjustment for the first six-month period.</td>
<td>Partially realized (May 22, 2001) (The adjustment for the second period of 2002 was decided to reflect not 80% but all the difference between actual and projected inflation).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>