Policy reassessment in light of the end-2000 financial crisis

Summary

At the end of 1999, Turkey embarked upon an ambitious stabilisation programme, aimed at achieving single digit inflation by 2002. Central to the programme have been firm monetary and exchange rate policies, set so as to provide a nominal anchor for reducing inflation expectations, sounder public finance aimed at eliminating the principal source of inflation pressures, and wide-ranging structural reforms designed to liberalise and modernise the economy. Significant progress was made during 2000. But a severe banking crisis blew up in late November, accompanied by a massive capital outflow. The crisis revealed a number of important stress points in the programme, located in the vulnerability of the banking sector and the sensitivity of foreign confidence to a widening current account deficit against the background of delays to the structural reform programme. An IMF-led emergency package has succeeded in normalising the situation and policies have become stronger in the light of the crisis, due to the renewed momentum that has been given to the structural reform programme. The crisis has resulted in much higher real interest rates, which put a burden on the budget and banking system and will undermine economic performance if long sustained. However, in the short term they contribute to stability in that they help (via slower growth) to contain the current account deficit and also provide support to the exchange rate anchor, which is crucial for guiding inflation expectations. Most importantly, they underscore the commitment to meet the original end-2001 inflation target, and as markets become convinced that the target can be met, capital inflows should resume and interest-rate risk premia should fall. Strengthening the banking system and following through on privatisation commitments are key elements in

re-establishing policy credibility. For the longer term, the challenge is to recapture growth momentum and translate it into sustained economic convergence, as a basis for prospective entry into the European Union. Boosting per capita income requires a major reorientation of government functions from interventionism to guaranteeing the framework conditions for a strong market economy. The structural component of the programme recognises this and contains the necessary ingredients for successful change in this direction, provided it is fully implemented. It contains initiatives in areas as diverse as budget control, liberalisation and privatisation of utilities, banking, social security, and agriculture. In parallel, the 1999 earthquakes have concentrated attention on the need to improve the management and planning of urban and regional development, which should help to bring overdue changes to the structure of economic governance, including fiscal federal relations. Successful completion of all aspects of the stabilisation programme and related governance reforms would ensure that Turkey enters the 21st century with a more modern, market-oriented and efficient economy, able to meet its economic and social goals.

How did the crisis develop?

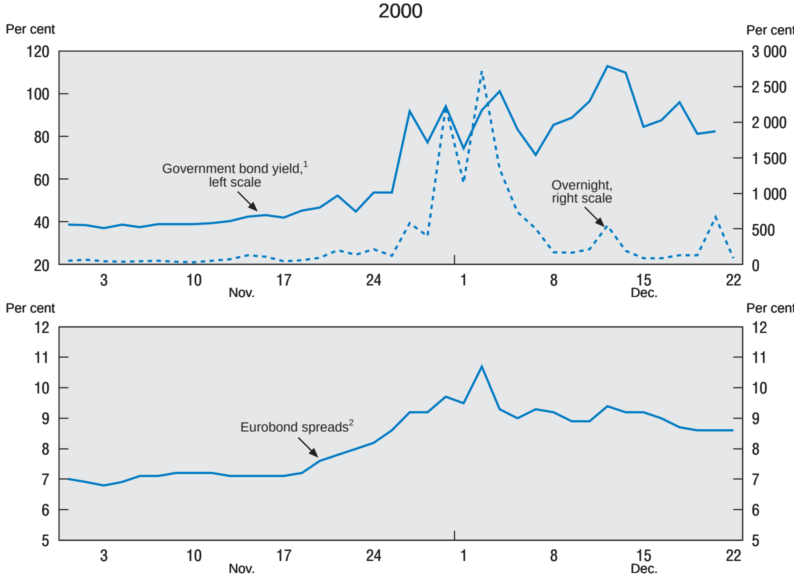
The trigger for the crisis was the emergence of financial problems in some, typically mid-sized, banks which had positioned themselves aggressively for continuing declines in interest rates via longer term investments which were highly leveraged by short-term funds. The underlying tensions appear to have been the widening current account deficit and delays to the privatisation programme which were causing interest rates to rise from September, and more markedly from around mid-November. The above-mentioned banks were forced to sell their government bond holdings at a loss to maintain liquidity in the face of the increasing cost of funds. Consistent with its monetary policy goals, the central bank was at first constrained from stepping in to ease these liquidity problems. Around 20 November, as rumours about the illiquid banks spread, first-tier banks cut their lines of credit to the interbank market and international participants exited the overnight market, unwilling to accept Turkish bank risk. This exacerbated market pressures and hence portfolio losses of the exposed banks.

These events resulted in an increasingly severe liquidity squeeze, pressure on overnight interest rates and government bond yields, widening Eurobond spreads, and growing bank distress. The squeeze had its counterpart in an excess dollar demand and pressure on central bank foreign exchange reserves. To protect the banking system and to limit the rise in interest rates, the central bank suspended its net domestic asset target and provided massive liquidity to the system during the week of 22-30 November. But despite this injection of liquidity, overnight rates climbed to triple digits around 28 November as capital outflow accelerated due to growing fears that the programme was no longer sustainable. To stem the reserves outflow, the central bank announced a return to its net domestic asset upper limit, which was to be reset as of 1 December at its 30 November value. However, overnight rates continued to rise up to 2000 per cent, as liquidity being supplied to the market again became short.

The capital outflow was only halted, and devaluation fears allayed by the announcement on 6 December of a large IMF package amounting to over $10 billion, including $7.5 billion from the Supplemental Reserve Facility (SRF),[1] in addition to $5 billion from the World Bank,[2] aimed at supporting the government's pledge to address the recent turmoil by strengthening the financial sector and accelerating privatisations. On the same day, the markets were reassured by the decision of the independent Banking and Supervision Agency to take over the nation's sixth largest private bank (Demirbank), which had been a main source of the liquidity problems, under the deposit insurance fund. International and domestic confidence was also bolstered by an announcement by the Treasury that it would provide a full guarantee of the deposits and credits of Turkish banks. The following week, the Treasury secured a $1 billion syndicated loan from international banks meeting in London, to signal their support for the programme.

As of the end of December, overnight interest rates had fallen to under 100 per cent, and Eurobond spreads had narrowed, while the benchmark government bond yields remained in the neighbourhood of 80 per cent, still double pre-crisis levels (Figure A). The net domestic assets of the

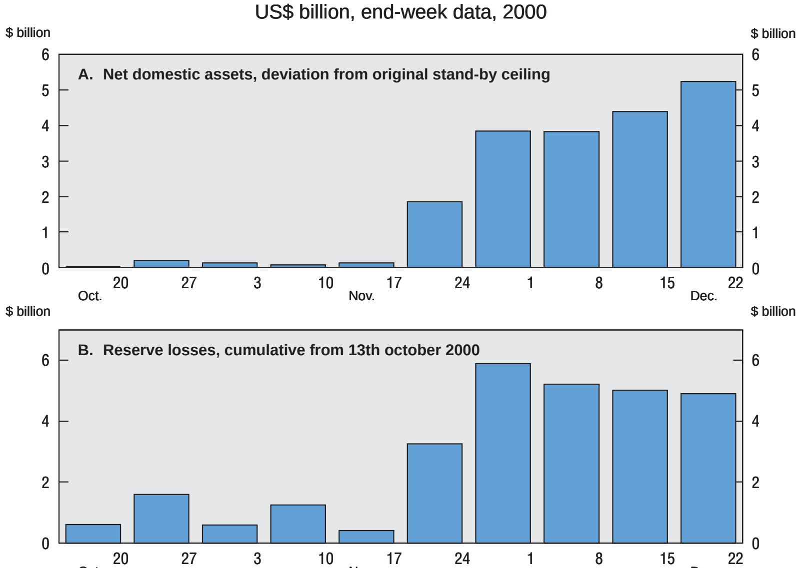
Figure A. **Interest rate developments**
2000



1. Secondary market, composite of original maturity.
2. OECD calculation based on yield spread between Turkish and Euro-$ government bond with 10-year maturity.

Source: Central Bank of Turkey, Bloomberg.

Figure B. **Central bank net domestic assets and gross reserves**
US$ billion, end-week data, 2000



Source: Central Bank of Turkey.

central bank remained some $5 billion above their original stand-by target level of $1.75 billion (Figure B). The reserves outflow had been arrested and partially reversed; in all more than $6 billion in central bank reserves (around one-quarter of the total) flowed out during the crisis. These reserve losses will be gradually replenished by the SRF inflows over the course of the coming year.

Why is the banking system weak?

The *Survey* describes at some length the fragility of the Turkish banking system which made it susceptible to such a crisis. It also describes the substantial steps taken to strengthen supervision, especially through the establishment of an independent bank supervision agency and the introduction of internationally accepted prudential and accounting rules. The loss of investor confidence which led up to the crisis had its roots in the vulnerability of the banking system during the process of adjustment to a low inflation regime. This included the unmasking, due to greater competition, of bad management practices in particular among smaller banks. More generally, there was a heightened exposure to interest and default risks as banks turned to consumer lending and other operations that incurred growing maturity mismatch to replace former high-yielding uncovered bond arbitrage, but often without having developed the expertise to deal with these risks. Exposure to exchange risk also grew sharply: banks' net open positions nearly doubled during the first nine months of 2000 as they continued to make use of very short-term foreign funding to lock in longer-term domestic nominal yields (*i.e.*, before falling as expected in parallel with inflation).[3] The new bank supervisory authority was a catalyst in revealing how deep-rooted the problems have been and how slowly they have been addressed. But, having become operational only a little more than two months prior to the crisis, it had not been able to forestall the development of these problems.

An action plan to rehabilitate eight banks under the administration of the deposit insurance fund since end-1999 was announced by the new Banking Board on 16 November. This contained the following main points: *i*) a timetable running to end-April 2001 was specified for the sale of the banks to eligible bidders; *ii*) the banks would be run jointly by a board of six independent experts until they were sold; and *iii*) the Board would receive $6.1 billion from the Treasury in the form of bond issues in order to recapitalise the banks under administration.[4] Unease about the banking system grew despite, or perhaps in reaction to these major initiatives. The failure to close or resolve more rapidly the balance-sheet problems of the bad banks meant that they had to offer high deposit interest rates in order to keep operating, while benefiting from public protection, fostering moral hazard and "unfair" competition in the sector at large. In this respect, the action plan of the new Banking Board was perceived as too slow, while remaining silent on the possible need for more bank takeovers. In particular, the $6.1 billion bond issue for bank bailouts was seen as raising government debt and adding pressure to credit markets. Ongoing criminal investigations, since late October, into some of the banks in receivership greatly added to market nervousness, given the potential for repercussions in the remainder of the sector.

What were the macroeconomic tensions?

The *Survey* also describes two sources of macroeconomic tension which could provide an explanation for the increase in interest rates even prior to the crisis, namely the growing current account deficit and the overshooting of the inflation target in 2000. Even so, the assessment given in the *Survey* is that neither of these tensions would have been sufficient in themselves to derail the stabilisation programme, provided the 2001 inflation target was adhered to, fiscal policy was tightened to reduce excess demand and the structural reform programme progressed as planned.

The growing external imbalance was evidence of an unsustainable boom in demand, exacerbated by the impacts of higher world oil prices and the weakening of the euro. The 2000 deficit was projected by the OECD at 4.6 per cent of GDP, but more recently by the authorities at 5 per cent. Inflation was clearly above target, indicating problems in reducing expectations to levels consistent with wage moderation and the preservation of Turkish competitiveness. Moreover, monthly inflation rates continued to rise since mid-year, as the demand boom fed into consumer prices.[5] The latest figures show a year-end inflation overshoot of 14 per cent, compared with 10 per cent estimated by the OECD in the *Survey*. The implied likely real appreciation of the exchange rate over the 2000-01 period would now be somewhat higher than the 20 per cent that was estimated in the *Survey*.

In mid-November, in advance of the crisis, new fiscal measures were taken to address the widening current account deficit and the slow convergence of inflation. The primary surplus target (IMF definition) was raised from 3 per cent of GDP in 2000 to 5 per cent in 2001. OECD calculations, based on the *Economic Outlook* 68 (*December* 2000) projections for Turkish growth, suggest that this represented a tightening in the structural budget stance between the two years of some 5 per cent of GDP. However, the growing political difficulties in implementing the structural reform programme may have had a negative impact on sentiment. The inability to sell a block share of Turk Telekom accounted for about half of the $4 billion shortfall in 2000 privatisation receipts while complications in the contracting process for energy privatisations delayed the inflow of direct investments into that sector. The failure to pass state banking privatisation legislation, in turn, delayed the approval of a $780 million World Bank loan. These delays obviously affected both fiscal policy and the capital inflows necessary to finance the growing current account deficit. Legislation was finally passed on 15 November to deal with the state banks. These banks are to be privatised by 2003 (with an extension of 1½ years if necessary). In preparation, they will pass from state enterprise to corporate status and the estimated $21 billion in their outstanding duty losses will be taken over by the Treasury.

What are the implications for the stabilisation programme?

Despite the crisis, the government has confirmed that it would maintain the integrity of the disinflation programme. The details of the government's revised programme for 2001 were made known with the release of a new Letter of Intent on 21 December. The overriding priority has been signalled as reaching the original inflation target of 12 per cent by the end of 2001 and limiting the current account deficit to within 3½ per cent of GNP. The exchange rate regime is unchanged as is the incomes policy. Fiscal policy has been adjusted to cope with an implicitly weaker growth picture, with unchanged targets for the primary surplus, implying an even more severe degree of fiscal tightening in cyclically-adjusted terms. Tax measures have been announced as the principal means, and the intention is to further increase taxes if inflation and current account slippage persist. The intention of the original (1999) letter was to put more of the adjustment on the side of spending, but this has been abandoned, as expenditure reductions still amount to only ½ per cent of GDP. The tax measures remain largely *ad hoc* extensions of temporary measures.

The monetary framework has undergone some adjustment. The end-quarter target for net domestic assets of the central bank will be gradually lowered over the first six months of the year to eliminate about 50 per cent of the excess net domestic assets (NDA) created during the crisis, while remaining within a narrow corridor around this downward path within quarters. In the event of higher-than-expected capital inflows, NDA limits will be lowered in order to avoid an excess increase in the money supply, in turn limiting the potential downward movement in interest rates. In this sense, the "no-sterilisation" rule has been relaxed in favour of an element of monetary policy autonomy. After July, with the gradual move to a more flexible monetary regime during the period of widening exchange rate bands, NDA targeting will become even more flexible. The central bank would at the same time shift toward inflation targeting, an important step in the direction of clarifying the medium term framework.

Structural policies are being implemented more rigorously. As part of the measures taken to restore confidence, tenders for 33.5 per cent of Turk Telekom (plus rights on the executive committee) and 51 per cent of Turkish Airlines (with the state continuing to hold a privileged share) were announced on 14 December, and the electricity law (to liberalise and privatise the sector) was submitted to Parliament. A timetable has been set for receipt of bids and completion of the sales (structural benchmarks) and for enactment of the electricity law (a structural performance criterion). Total privatisation receipts of $6-7 billion are now targeted for 2001. Other structural benchmarks or performance criteria have been set for: the balances of the state enterprises in the electricity sector (benefiting from upward adjustments in energy prices), the sale of the eight banks (the strategy for the other three banks taken over by the deposit insurance fund more recently will be announced early in the year), the introduction of new banking regulations on internal risk management (to be adopted soon and implemented as of 2002), the incorporation of extra-budgetary funds into the budget (the government intends to keep six extra-budgetary funds, in contrast to its November statement that all such funds would be eliminated), and the support prices for wheat (which will follow inflation targets).

What are the chances of success?

The crisis has forced a major re-adjustment of the macroeconomic parameters of the programme which should ease the tensions noted earlier. Higher real interest rates should lead to a significant weakening of domestic demand and growth, and in this sense help both in bringing the current account back under control and in moving toward achieving the inflation targets. The decision to pass through crude oil price increases into consumer prices could have a one-off effect on headline inflation, but is necessary in order to arrest the large deficits which have emerged in the state energy sector enterprises. However, the faith of the public in the inflation targets may have been shaken by the crisis, potentially complicating the task of incomes policy in breaking the inertia of inflationary expectations. A notable gap in the programme has been that there is no effective institutional framework in place that would allow for forward-looking wage agreements to be struck in the private and state enterprise sectors and to assure an equitable distribution of the costs of disinflationary adjustment. Thus far, civil servants, minimum wage earners, and farmers have borne the brunt of the adjustment, as their incomes are subject to state influence and control. Other sectors, notably unionised and white-collar workers and bond holders, have reaped large real windfalls from the decline in inflation, as they have continued to benefit from nominal wage growth or interest rates incorporating previous higher levels of inflation. Moreover, under new legislation to strengthen the banking system, commercial banks will contribute little to the large structural tax effort this year, as generous tax deductions are the main instrument for voluntary mergers and consolidation of the banking system. Therefore, it would appear to be even more important to follow the *Survey's* advice to achieve a social consensus and to bring state enterprise workers' wages into line with inflation targets, which will help to balance the social burden of tighter fiscal and incomes policies.

At the same time, fiscal goals have become more difficult because higher real interest rates are likely to persist for a while. This faces the banks and government with higher funding costs, adding to bank fragility and, *ceteris paribus*, raising the fiscal deficit and debt. Accelerated bank takeovers and recapitalisation of public sector banks will imply a one-time, perhaps large increase in the public debt, which even though cost-effective (in the sense that delayed action would have implied greater costs later on), may further impact negatively on the government's debt service. The Treasury has now taken on the domestic and foreign liabilities of the entire banking sector as a contingent liability. Thus, new tensions have arisen on the fiscal side, and have been partly reflected in the introduction of further new tax measures. It will be important that the primary surplus be raised sufficiently to prevent fiscal balances from worsening and feeding into inflation expectations (for which there is ample precedent in the past), if necessary by reducing expenditure. The challenge for banking reform is likewise now greater than prior to the crisis, in particular as unlimited Turkish lira-deposit insurance – introduced after the 1994 crisis, just recently reformed and now, in effect, reintroduced – was a major source of banking system moral hazard in the past.

What about monetary policy?

The credibility of the disinflation effort, and adherence to the monetary framework, in particular the "no-sterilisation" (quasi-currency board) rule whereby capital inflows and outflows are to be the sole source of money supply changes, has been made more difficult to maintain because of slowness in addressing the problems of bank fragility and the impediments (evident in delays in the privatisation process) which inhibit the inflow of foreign capital. Looking forward, the challenge is to return to a framework conducive to capital inflows, especially direct investment. The episode shows that abandonment of the monetary rule, and *a fortiori*, the aim of price stabilisation, would make this goal more difficult. Turkey's experience has shown that the extra liquidity created simply flows out through the capital account and drains reserves given the necessity to stick to the pre-committed exchange rate depreciation path in line with inflation targets. If the exchange rate path were to be abandoned, there would be an inevitable return to the previous unsustainable configuration of high and volatile inflation and real interest rates. Timely and transparent action to pre-empt bank problems from developing into insolvency or systemic proportions seems to be an important corollary of these lessons. In hindsight, an earlier take-over of the banks with evident liquidity problems (or even earlier prompt corrective actions to forestall liquidity problems from arising in the first place), might have defused the incipient crisis. The commitment to implement by 2002 the legislation on internal bank risk management (including risk-adjusted capital adequacy ratios) is an encouraging step in this direction and fulfils a *Survey* recommendation, although coming later than hoped for.

Overall implications of the crisis

While the crisis has had the effect of exposing major tensions in the programme, it has forced a stronger focus on reform, and has had a salutary effect in underscoring the importance both of transparency and of staying on track on structural reforms in order to sustain capital inflows. In this respect it has also reinforced the main message of the *Survey*, namely that the stabilisation programme has to be seen as a whole. Within the programme, the impressive progress that is being made on economic "fundamentals" – particularly in the domain of fiscal and monetary policy – is dependent on the rigorous implementation of comprehensive structural reforms. The acknowledgement of this reality has evoked a clear commitment to the programme, supported by rapid and effective action from the international community. The authorities are demonstrating by their actions a resolve to preserve the progress achieved thus far. Rigorous implementation offers the prospect for a gradual normalisation in interest rates which will further relieve tensions. In sum, the renewed urgency in introducing reforms to and/or restructuring the budget, the private banking sector, the public sector banks and the utilities scheduled for privatisation have re-established the integrity of the stabilisation programme. The nature of these reforms are discussed in the *Survey*.

Notes

1. The SRF is a short-term loan facility for countries in balance of payments crisis but demonstrating sound policies. It carries a relatively high interest rate and will be released in seven payments until 15 November 2001. The first tranche of $2.25 billion was made available on 22 December, along with $550 million for the 4th/5th tranches of the regular stand-by (with $2.35 billion remaining).
2. On 22 December 2000 the World Bank approved the new Country Assistance Strategy for Turkey which aims at support of up to $5 billion for a three-year period. As a first step in implementing the strategy the Bank also approved two operations for Turkey: a $778 million Financial Sector Adjustment Loan (FSAL) to support the government's efforts to reform the financial sector and a $250 million Privatisation Social Support Project (PSSP) to mitigate the negative impact of privatisation of the state-owned enterprises. The first tranche of the FSAL ($385 million) was disbursed on 22 December 2000.
3. The exposure to exchange risk may be larger than is apparent, moreover, because some of the forward cover taken in order to satisfy bank supervision regulations is of dubious quality.
4. In accounting terms, these bonds are a liability of the deposit insurance fund, to be exchanged for the bad loans from the balance sheets of banks under its administration. Revenues from the sale of the banks and the recovery of bad assets, as well as the contributions of the banking system to the deposit insurance fund, will be used to repay the Treasury. The bonds are tradeable, though they are considered as non-cash debt since they are not auctioned in the primary market.
5. The rise of world energy prices, on the other hand, did not feed through into final consumer prices during this period as they were absorbed in the form of rising deficits of the state economic enterprises in the energy sector.