The 2001 Crisis is the Result of the IMF Program

The 2000 Turkish disinflation program adopted the *monetary approach to balance of payments* as its theoretical foundation for the determination of the liquidity generation mechanism and the resolution of the balance of payments equilibrium This approach, which provides the underlying frame of reference for almost all IMF-style austerity programs, expects the real exchange rate to be in long run equilibrium at its purchasing power parity level, and maintains that the domestic supply of money be endogenized in a regime of open capital account.

Accordingly, the program limited the monetary expansion to changes in the net foreign asset (NFA) position of the Central Bank (CB), and fixed the Bank's stock of net domestic assets (NDA) at its December 1999 level. It was further announced that the CB would be allowed to change its net domestic asset position within a band of +/- 5 percent of the monetary base, to be revised at three-month intervals. The implication of the rule necessitated the following identity.

Monetary Base = Net Foreign Assets + Net Domestic Assets

Consequently, as a result of the restrictions set on the upper ceilings of the net domestic assets, the program limited the monetary expansion to increases in the stock of net foreign assets.

According to this rule, the liquidity generation mechanism available to the CB practically entailed a monetary regime of a semi-currency board reminiscent of its Argentinean counterpart. Within this mechanism, the monetary policy is restricted to the direction of the foreign exchange flows, and as such, the most important element to be able to sustain the liquidity needs of the economy would depend upon the proper continuation of the foreign credit flow into the system.

The expansion of the monetary base was ultimately linked to the foreign exchange inflows indicating that the CB was committed to the strict rule of no-sterilization throughout the program. Therefore, it was expected that the available liquidity in the domestic economy would be managed by the interest signals inherent in smoothly operating financial markets; rising domestic interest rates would invite foreign inflows allowing for monetary expansion. Excess liquidity in turn, would be signaled through lower rates of interest, allowing foreign capital outflows to balance the equilibrium level of liquidity in the domestic financial markets.

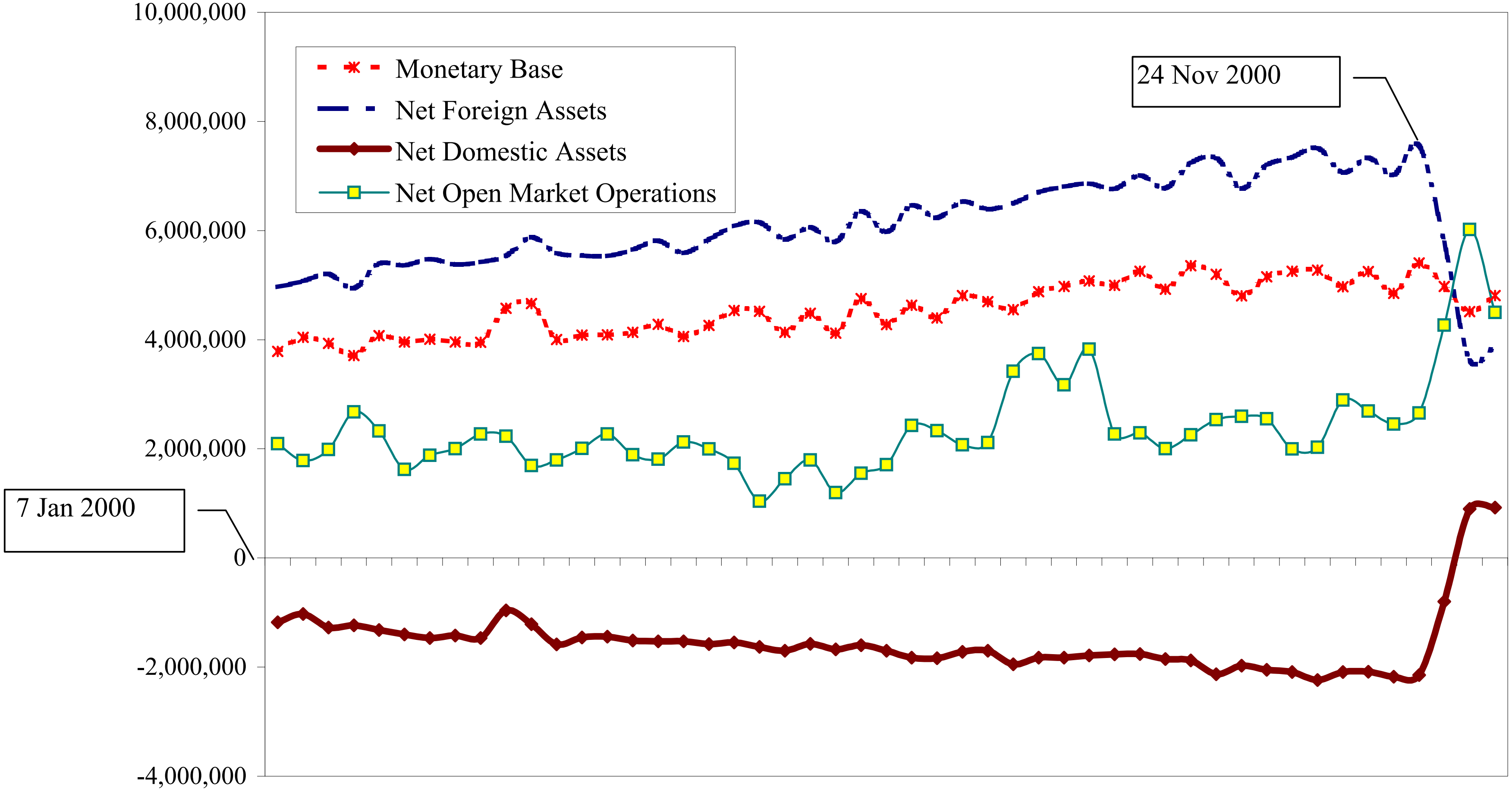
Figure 1 portrays the evolution of the liquidity mechanism under the first 10 months of the program's implementation. The figure discloses the paths of the monetary base, open market operations (OMOs), the net foreign assets (NFA), and the net domestic assets (NDA) of the Central Bank, as measured by the end-of-week observations, January 7 to December 1, 2000. As can be seen, the CB played the role of a currency board quite successfully until November, the first sign of the culminating crisis. Until then, the monetary base had expanded by only 7.6 percent, while the total assets of the CB increased by a total of 15 percent, mostly because of the rise in foreign inflows during the summer months. All along, the CB conducted its open market operations with the intent to steer the NDA within the limits of the program.

The basic message that emerges from the data in Figure 1 is clear: Turkish monetary authorities have *successfully* implemented the monetary program within the given targets, conditioning the CB operations to net foreign inflows. In this sense the outbreak of the November crisis –and the ultimate collapse of the program in February 2001– cannot be attributed to any divergence from the monetary targets.

Similarly, the fiscal operations were in line with both the revenue and the expenditure targets, and the non-interest primary balance on the consolidated budget succeeded in attaining the end-of-year target by as early as September. Consolidated budget data tabulated from the Under-secretariat of Treasury and the Ministry of Finance reveal that budget revenue realizations were actually higher than the targeted values by 3.6 percent in 2000, and by 5.1 percent in 2001. On the other hand, expenditures remained 0.2 percent lower than the 2000 target, and the 2001 targets were exceeded by only 1.7 percent so far. Consequently, during the years in question, public management expenditure and revenue targets were achieved and the primary (budget) surplus as a ratio to national income (including privatization and other non-fiscal revenues) increased to 6.1 percent in 2000, and to 6.7 percent in 2001. This "success" in the public sector balances was attained by restricting expenditures on public services through the extraordinary forced shrinkage of public investments, and by way of extraordinary taxation possibilities particular.

Clearly, the fiscal austerity objectives reached were far below the program's target. Crisis conditions emerged in due course, mainly as a result of the increasing fragility in the financial system. This fragility, in turn, was generated by the uncontrolled and excessively volatile capital flows with an exceedingly speculative component. Under the liberalized capital account system, capital inflows intrinsically necessitated a higher rate of return on domestic assets in comparison to the rate of depreciation. This commitment stimulated further foreign capital inflow, and the domestic currency continued to appreciate inviting an even higher level of speculative capital inflow. See Table on Fiscal and Financial Fragility of Turkey.

Figure 1. Monetary Base, Net Domestic Assets, Net Foreign Assets and Net Open Market Operations (7 Jan 2000 - 1 Dec 2000, End-of-week Observations, Millions TL)



Developments in the Consolidated Budget

	2000			2001		
	Realization	Target		Realization	Target	
	A	B	A/B	A	B	A/B
Revenues	33,756.4	32,585.5	103.6	51,812.0	49,300.0	105.1
Tax Revenues	26,526.8	24,000.0	110.5	39,768.0	37,710.0	105.5
Direct taxes	10,861.9	9,585.0	113.3	15,647.0	12,741.0	122.8
Indirect Taxes	15,664.9	14,415.0	108.7	18,135.0	18,083.0	100.3
Expenditures	46,602.6	46,713.3	99.8	80,379.0	78,999.0	101.7
Personnel Exp.	9,982.1	9,899.8	100.8	15,203.0	14,630.0	103.9
Investment Exp.	2,472.3	2,351.7	105.1	4,139.0	3,749.0	110.4
Interest Expenditures	20,439.9	21,132.3	96.7	41,064.0	41,268.0	99.5
Transfers to SEEs	885.9	594.6	149.0	1,201.0	1,100.0	109.2
Other Transfers	9,211.1	8,894.5	103.6	8,030.0	7,162.0	112.1
As a Ratio the GDP (%)						
Budget Balance	-10.3			-15.4		
Interest Expenditures	16.4			22.2		
Non-Interest Budget	6.1			6.7		
Net Domestic Borrowing	7.5			12.7		
Domestic Debt Stock	29.0			59.5		

Source: Undersecreteriat of Treasury (www.treasury.gov.tr)

Table 1. Financial and Fiscal Fragility in the Turkish Economy

	1995	1996	1997	1998	1999	2000	2001	2002
As Ratios to the GNP (%)								
Current Account Balance	-1.4	-1.3	-1.4	1.0	-0.7	-4.8	1.4	-1.0
Foreign Debt Stock	42.8	46.2	47.8	47.2	55.7	59.1	76.9	73.1
Domestic Debt Stock	14.6	18.8	21.4	22.5	29.3	28.7	69.2	54.0
Budget Balance	-4.0	-8.3	-7.6	-7.0	-11.6	-11.6[a]	-18.2[a]	-14.3
Non-Interest (Primary) Budget	3.4	1.7	0.1	4.7	2.1	5.7	6.7	4.7
Public Sector Borrowing Req.	5.2	8.8	7.6	9.2	15.1	11.9	16.5	12.5
Fragility Indicators								
Short Term Foreign Debt / CB International Reserves (%)	128.7	104.2	95.1	105.4	98.9	127.6	85.9	56.5
M2Y / CB Inter. Reserves (%)	354.0	314.1	287.8	321.8	329.4	381.4	380.6	174.3
Currency Substitution[b]	54.8	50.9	48.6	45.1	45.2	44.1	56.0	56.2
Interest Paym. on Dom. Debt / Total Tax Revenues (%)	43.9	59.2	41.7	61.0	66.4	63.7	103.4	87.0
Interest Paym. on Dom. Debt / Net New Dom. Borrowing (%)	93.7	83.1	63.5	97.9	87.5	137.8	47.2	187.2
Net New Dom. Borrowing / Domestic Debt Stock (%)	52.4	57.8	52.4	49.5	49.3	37.1	70.2	18.5

Sources: SPO *Main Economic Indicators* ; Undersecreteriat of Treasury, *Main Economic Indicators;*

a. Exclusive of transfers from the CB, interest revenues and privatization receipts.

b. (Rate of Dollarization): Ratio of foreign exchange deposits to total deposits of residents.