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# Does Turkey Need a New Standby Agreement?

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**Summary**
Since 1960, nineteen Standby arrangements have been signed. With these agreements, significant progress has been made in Turkish economy: inflation has fallen to the lowest level since 1986, the public debt-to-GNP ratio has been falling, and interest rates have declined rapidly. IMF's immediate goals concern exchange rate stability and balance of payments, and evaluations of IMF programs tend to concentrate on these two objectives. Yet, whether or not the IMF programs have positive effects on these short-term goals, what ultimately matters is that they induce economic growth and do not concentrate on incomes.

## Standby Agreements in Turkey

What are the economic factors that push a country to seek financial assistance from the International Monetary Fund? What sorts of government policy commitments are most closely related with the fund approval of a financial arrangement? These are the kinds of questions frequently asked in developing countries. The purpose of IMF's standby is to address short-term economic problems. The standby agreements provide general support of a country's balance of payments and international reserves while the country takes policy action to address its difficulties. The IMF also focuses on the macroeconomic performance of world economies, as well as on macroeconomic and financial sector policy. Given the history of IMF agreements in Turkey, the first Standby with IMF was signed in 1961. As the economic boom ended suddenly in the mid-fifties, agricultural production and the primary foreign exchange earning sector was impaired by the bad weather conditions that caused the real gross domestic investment to fall substantially. This was the beginning of Turkey's economic crisis and the need for external loans and eventually the IMF-imposed stabilization programs. Nine stand-by arrangements took place between 1961 and1970. Due to achieved improvement in the balance of payments and reduction in imports during this period, the proposed amount of funds, SDR 90 million, have not been used by the 1961, 1962 and 1965 stand-by arrangement. These arrangements were completed in due time and only SDR (Special Drawing Rights) 31 million was used. Although the 1964 stand-by arrangement was revised two times, it was eventually cancelled and the proposed funds

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were not used. The 1969 stand-by was also cancelled since a new government came to power and intended to prepare a new program. The new government's program had provisions for reforming institutions, harmonization of policies and many radical policies. Thus, with these two arrangements only SDR 29 millions was used over the proposed amount of SDR 48.5 million.

Due to the first and second oil crises of 1973 and 1979, Turkey rescheduled its debt with consecutive agreements signed with OECD countries in 1978 and with commercial banks in 1979 and 1980. With these agreements, both the government debts and commercial debt repayments were rescheduled. Despite the fact that the relief brought about by the capitalization of interest payments in rescheduling content, rescheduling increased Turkey's external debt stock in the 1970s. Due to these developments, Turkey intended to have IMF stand-by at the end of 70s and the beginning of 80s. Because of the poor performance criteria, the 1978 and 1983 stand-by arrangement were cancelled and new 1979 and 1984 stand-by arrangements took place. These arrangements were also cancelled because of the same reason. As a result, only a total of SDR 545 million used over 1 SDR billion.

Following a period of financial disorder at the end of 1970s, the Turkish government announced a structural adjustment policy in 1980. The 1980 structural adjustment program introduced some radical policies. Turkish economy was transformed from an inward to an outward orientated economy. The integration into the international economy brought liberalization of the foreign trade system. During this period, Turkey improved the balance of payments and high growth rates. The 1980 Standby was completed successfully and the entire proposed amount of money was used[2].

In the beginning of the 1990s, public expenditure was increased due to populist policies, such as increasing the public wage bill, implementing generous agricultural support policies, supporting poorly performed state owned economic enterprises (SEE), meeting the increased cost of military operations in the South-eastern region of the country, and making increased interest payments after 1992. The government preferred to focus on short-term solutions rather than more structural changes. However, these policies did not solve the problem but only postponed it. The budget deficit did not decrease but increased. The snowball effect on domestic debt stock and the interest payments on domestic debt steeped up whilst on the revenue side, there was no considerable improvement[3]. Turkey had another Standby in 1994 but this Standby arrangement was cancelled in 1995 because of poor performance. At the end of 1990s, Turkey failed to execute many of the measures accompanying reform. Coupled with political instability, this led to a crisis, which was due to its failure to implement the necessary institutional changes needed for a market economy. Foreign currency expenditure grew as a result of the liberalization of imports while revenues in foreign currency shrank. This led to the increased indebtedness of the country.

[2] Binay, S. (2004) *Tarihsel Süreçte IMF* (in Turkish), Central Bank of Turkey, Ankara, Turkey.
[3] Candemir, H.B. (1994) *External Debt and Internal Transfer Problem: The Case of Turkey: 1980-1990*, The Central Bank of the Republic of Turkey Research Department, Discussion Paper No:9404, January.

Taking into consideration the effects of high inflation and interest rates on Turkey's economic performance over the last 25 years, the government focused on an economic program which aimed to free the country from inflation and enhance the prospects for growth and for a higher standard of living for all parts of society. Thus, a disinflation and fiscal adjustment program was initiated on December 22, 1999 supported by a Standby arrangement with the International Monetary Fund. From December 1999 to 2004 (during the 17. and 18. Standby), SDR 24 billion was suggested and SDR 20 billion was used.

With the 17. and 18. Standby agreement, output grew significantly while inflation fell to single digits, the best performance since 1986. By bringing order to economic policymaking and to the management of public finances, the confidence of citizens and investors were restored, allowing interest rates to drop to their lowest levels in decades. The strict control of public finances and debt reduction continued to be the foundation of Turkey's economic strategy with macroeconomic stability successfully established. Turkey focused on improving the quality of government spending and taxation to make fiscal adjustment sustainable and easier to implement. The Government and the Turkish Central Bank were determined to safeguard the success in reducing inflation. In fact, they were able to bring the inflation down to single digits during the program period. In order to reduce inflation, Turkey remained committed to fiscal discipline and maintaining the independence of the Central Bank in line with European Union standards.

In order to maintain financial sector stability, Turkey introduced a new Banking Law in the early 2000s. The banking law improves the supervisory and regulatory framework, restructure the state banks, and accelerate asset recovery. Turkey applied a comprehensive agenda of reform to enhance the investment climate, improve Turkey's medium-term growth prospects, and lower unemployment. Moreover, Turkey continued to strengthen its international reserve position, as part of Turkey's strategy for increasing flexibility to external shocks. To support this reform program, Turkey requested a new three-year Standby arrangement with the Fund (May 2005–May 2008)[4]. This IMF arrangement is also one of the most successful Stand-by arrangements IMF has ever had. Currently the 19th arrangement is being implemented and will be finalized in May of 2008. Among the 18 Standby arrangements, only eight Standby arrangements in 1963, 1966, 1967, 1968, 1970, 1980, 1999 and 2002 were completed successfully

**The Evaluation of Standby Agreements in Turkey**

The reason for governments that enter into agreements with the IMF is to ensure better economic conditions for the country. The effect of IMF agreements on the economy is still controversial. Scholarly opinion is also divided: statistical findings about the effect of IMF agreements on the economy, especially on the economic growth, range a wide spectrum of possibilities.

[4] http://www.hazine.gov.tr/imf_niyetmektubu_19Standby.htm.

IMF's immediate goals concern exchange rate stability and balance of payments, and evaluations of IMF programs tend to concentrate on these two objectives. Yet, whether or not the IMF programs have positive effects on these short-term goals, what ultimately matters is that they induce economic growth and do not concentrate on incomes. Indeed, the Articles of Agreement state that the mission of the IMF is to ''facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. The IMF puts economic growth as the primary objective".[5]

The standard argument in favor of these programs is that once the economy is stabilized, deficits are eliminated or reduced, and the balance of payments is improved, which in turn leads to growth. As we look at the IMF standby agreements in Turkey, the programs are based on three pillars: reducing budget deficits, using concretionary monetary policy to reach targeted inflation, and applying structural reforms including privatization, large scale layoffs in public enterprises, and abolition of any form of subsidies. Together with structural reforms, the creation of independent regulatory institutions and increased transparency has also helped the program in Turkey. In addition, to increase investment and encourage foreign investors, the parliament passed laws that established the principle of equal treatment for foreign and domestic investors. This regulations allowed foreign investors to purchase real estate and streamlined investment procedures. Successful achievement of the fiscal and monetary targets would enhance credibility of the Turkish government ensuring reduction in the country risk perception. This would enable reductions in the rate of interest that would then stimulate private consumption and fixed investments, paving the way to sustained growth. [6]

Even though IMF standby agreements contribute positively to Turkish economy, these standby agreements still receive some critics from different economists, private sectors, unions and nonprofit organizations.

- The main indicators of macroeconomics are still short of the rates seen in the emerging market economies, while unemployment and inflation and public debt are still high.
- IMF standby agreements are criticized for unemployment rate in Turkey. The unemployment problem is a hot topic in Turkish politics. Turkish government put its action plan to increase employment. Lessening high levels of labor regulation and taxation could decrease the unemployment rate, increase labor force participation, and reduce the large informal sector. But, bureaucratic formalities still remain and significant workforce programs are not applied and supported[7].

[5] Przeworski, A and J. Raymond Vreeland (2000) "The Effect of IMF Programs on Economic Growth", *Journal of Development Economics*, Vol. 62, 385–421.
[6] http://www.bagimsizsosyalbilimciler.org/Yazilar_Uye/VYDec05.pdf.
[7] http://www.hazine.gov.tr/guncelduyuru/DEI_20070309_IMF_IVMADDE_ING.pdf.

- In order to decrease the inflation rate to one digit, higher interest rates are used; and this policy has reduced credit growth and decreased the pace of domestic demand and economic growth.
- Given European Union harmonization goals and the pressures of the IMF, government officials have been warning that if the country does not take some urgent measures and introduce some new arrangements in social security, the country will not be able to sustain the existing system for long. This reform should consider future developments, ensure the long-term financial stability of the social security system and regulate assistance to the poorest. Thus, government should consider the unions' demands.

The new IMF standby agreement covers reforms to maintain growth seen recently in Turkish economy. Immediate priorities should be given to measures that secure long-term fiscal savings, and increase productivity and employment.

**Conclusions and Policy Recommendations**

As we look at the results of the standby agreements, significant progress has been made towards achieving the program's goals. Inflation has fallen to the lowest level since 1986, the public debt-to-GNP ratio has been falling, interest rates have been declining gradually, output growth has been resuming, and industrial production has been accelerating. Moreover, the floor on the primary surplus of the consolidated government sector was met by the improvement of the public finance administration and its transparency. Additionally, another significant reform happening in Turkey is the financial sector. Banks are now responsible to independent and professional bodies. The changes in governance have also been complemented by three other steps: a complete financial restructuring of the system to protect depositors and creditors and permit parts of the system to return to life; ridding banks of unprofitable activities; and a toughening of supervision to ensure that past problems do not occur.[8] These results have been achieved through the strict implementation of the policies, which have boosted credibility in both domestic and international financial markets, as also reflected in upgrades by major credit rating agencies.

The shape and level of relations between IMF and Turkey are important for today and future. There is a consensus that crises in emerging markets will continue to occur because of financial market failures as well as shortcomings in national policies and international supervision mechanisms. There is also a wide agreement that the IMF should be involved in the management and resolution of such crises in order to limit the damage to the economies concerned, prevent contagion and reduce systemic risks.[9]

In order to limit the damage to the economies concerned, prevent contagion and reduce systemic risks, continue with IMF and also reach targeted results:

[8] http://echeat.com/essay.php?t=27759.
[9] Akyuz, Y (2005) *Reforming the IMF: Back to the Drawing Board*, Third World Network, Geneva.

- Turkey should use disciplined fiscal policy to allow decline debt ratios, facilitate disinflation, and reduce real interest rates. Even though indicators deviated from program targets, Turkey should remain committed to prudent budgetary policies in the future.
- Whenever the economy grows quickly and the current account deficit increases, economists tend to be become worried in order to grow rapidly without creating a current account deficit. Since Turkish economy's ability to produce is excessively dependent on imports, Turkey needs to reduce its dependence on imports. But this is not easy without attracting foreign capital. Turkey needs to develop sectors which produce semi-finished goods.
- A contraction monetary policy should be conducted in the period ahead. This policy approach reflects Turkey's commitment to achieving the inflation target.
- High interest rates and slowing credit growth dampened domestic demand. This will decrease the job opportunities. Thus, if Turkey decides to continue with IMF, the new IMF standby agreements should focus on creating employment opportunities.
- In order to increase employment opportunities, Turkey should introduce reforms to reduce labor market rigidities and financial burdens on employment. These restrictions cause low employment ratios and a large informal sector. Low rate of labor participation rate ultimately reduces economic growth.
- Turkey should commit itself to improving the efficiency and financial performance of SEEs and continue structural reforms. On the fiscal side, efforts to implement the revised social security reform, bolster efficiency in the health and energy sectors, and strengthen tax collections will be key to safeguard the medium-term fiscal position and make room for tax cuts on labor and financial transactions.
- A comprehensive agenda of reform should be pursued to improve the investment climate for domestic and foreign investors. Advancing privatization, especially in the banking and energy sectors, will further improve the investment climate.

The next IMF standby agreements should include strong and important reforms. If reforms are applied on time, this will affect expectations of people positively at the domestic level. Turkey's economy is likely to get a new acceleration as it did in 2002. Whether Turkey should continue with the IMF at all, Turkey has to have a rather close relationship with the IMF. The arrangement with IMF has some advantages for Turkey. One of them is the message to the markets. This suggests that Turkey is serious in pursuing the stability program and that it is in close cooperation with the IMF. This message would positively affect all parties concerned in their perception of the Turkish economy. Secondly, if Turkey does not make a Stand-by agreement with the IMF, it will have to start to pay its debts to the IMF. Even though the total of debt to the IMF is not huge, this debt will be found from outside countries and institutions. This will increase the debt stock of Turkey. Thirdly, in order to lessen the international recession and reduce the effect of mortgage crisis, Turkey needs more collaboration with IMF for the next two or three years.