Statement by Philippe Peeters
Date of Meeting: July 12, 2001

**Turkey: Country Assistance Strategy**

The Turkish economy has been undergoing a period of unprecedented change since 1999. Since the early 90’s, the country had been suffering from rising inflation, volatile economic growth and worsening social indicators. Short-lived coalition governments and ensuing political uncertainty had prevented to address the underlying structural causes of poor economic performance.

After the Asian and Russian crises, drastic reductions in international capital flows to emerging markets and worsening terms of trade contributed to further deterioration of the already weak economic fundamentals of the Turkish economy.

Rising interest rates and shortening maturities increased concerns over the sustainability of the debt stock. In December 1999, the government embarked on an IMF supported disinflation program which was complemented with ambitious structural reforms in sectors ranging from social security to energy; agriculture to banking.

The disinflation program was designed around the pegged exchange rate as the main pillar of the program. At the same time, the fiscal policy was geared towards alleviating the pressures on the currency and also reducing the real interest rates to ease the debt dynamic. Structural reforms were confined to a dual, but supplementary role of assuring short-term sustainability of fiscal consolidation and improving medium-long term growth prospects. All structural reforms have been highly informed by and based on the diagnostic work jointly carried out by the Bank.

On many accounts, the 1999 program could be considered as successful: Inflation was nearly halved to 30%, interest rates declined and GNP grew by 6%. However, as the report highlights, some key structural reforms were delayed, local currency appreciated and, as the current account deficit widened sharply, the sustainability of the peg became questionable. The credibility of the program was severely undermined in November 2000 when a seeming liquidity crunch in the banking system quickly evolved into a systemic solvency crisis.

Although the Government decided to augment the program by signing a Supplementary Reserve Facility with IMF and acting swiftly to speed up the reform process in December 2000, it proved to be difficult to restore the confidence. The currency could not withstand the second test in February 2001 and the Government had to float the currency. It lost two third of its value in a matter of weeks.
The float coupled with high interest rates came as a blow to an already fragile banking system and significantly increased the cost of the new program. It is estimated that the domestic debt stock will have increased by 24% of GNP by the end of this year mainly owing to the issuance of securities to recapitalize the banks; GNP is estimated to contract by at least 3%; and inflation is expected to bounce back to a 50-60% range. The CAS Progress Report highlights that the current crisis will exacerbate already weak social indicators and inequalities. The economic downturn caused large lay-off in the corporate sector, and the unemployment rate is estimated to increase from 6.3% to 8.3%.

The Government acted immediately to confine and counter the short-term consequences of the crisis and responded by putting together a strengthened macro policy framework and a more ambitious reform strategy that has also been supported by the IMF. The major difference of the new program is the emphasis and key role assigned to structural reforms. Although the content of the reforms have hardly changed, the time frame has been pulled forward and new dimensions have been added to restore confidence and minimize social costs. The CAS Progress Report eloquently elaborates upon these aspects of the program. It suffices to underline that the reforms attack the roots of poor economic performance and recurrent crises, by the same token helping fundamentally change and modernize the political-economy of public policy making.

The full account of the crisis is yet to be done. However, it has soon become clear that its impact, both in terms of economic and social costs, exceeded by far the previous crises the country had experienced. It shattered the political-economic foundations of public policy making and triggered an undaunted demand for a more radical and immediate change. As the CAS progress report notes, “there is a wider recognition among the population, civil society and the private sector that de-politicization of economic decision making is an urgent task”. Cognizant of this demand, the government moved fast to pass critical laws that would fundamentally alter the public policy framework by transferring the primary responsibility of making allocative decisions to the market forces. During June alone, eight laws were passed by Parliament. Given the number of people who would be affected by these reforms, it is only normal that these laws are thoroughly discussed within the government and the parliament, and also that political tensions arise during the legislative process. However, surfacing of these tensions have affected market confidence and led to doubt about the willingness of the coalition government to pursue an ambitious reform program going forward.

The confidence of economic agents and markets has not been fully restored. This is the result of heightened risk perception and lower financial tolerance due to large losses incurred by the economic agents, and especially the financial institutions. With the abandonment of the exchange rate as the main nominal anchor, it seems that the pace and procedure of structural reforms have become the only visible indicators and thus the most critical factors to gauge the credibility of the new program. Although this sentiment pressures the government to deliver all the measures in a timely fashion, it may also create unwarranted risk perception by making every democratic discussion an indicator of weak commitment. A proper assessment of commitment should take into account the outcome more than the procedure of the reform process.
A more objective assessment would take into account that the same government had outlived earlier expectations, endured two crises, and kicked off back in 1999 a historic change process.

It is also true that the crises unveiled without doubt the real costs of political interventions into the working of the economy and rendered shortsighted populist policies unpopular in the eyes of the public at large. Although the ongoing structural reform program entails drastic cuts in subsidies and requires major sacrifices from various segments of society, there is a widely shared comprehension that it is the only way to attain long-term viability. This comprehension is the main explanation for the proved resilience of the population and it is also what makes minimal the risk of social backlashes.

Nonetheless, until the reform process instills its own momentum and credibility, the role of the Bank in this transition period becomes a key factor as a provider of technical assistance, as well as knowledge in its areas of comparative advantage. Bank’s support to mitigate the consequences of the crisis and the social costs of the reform process in due course is equally important. The indispensable role of the Bank, as an invaluable partner providing both lending and non-lending services at critical junctures, has become much more visible.

We think that the revised assistance strategy fulfills these requirements and therefore deserves support. Nevertheless, it should be stressed that the program success hinges on the momentum of the reform process. We consider that the authorities’ commitment, and more importantly the public support, will help this momentum go forward.