

# Some issues in fiscal policy and central banking: the case of Turkey

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## 1. Introduction

Restricting the scope of discretion that policymakers can exercise has been much debated recently. With respect to monetary policy, the debate has led to the almost universally accepted proposition that central banks should be independent in monetary policy implementation. In the case of fiscal policy, the debate has gained pace only recently and has not resulted yet in an agreement on desirable mechanisms or institutional changes. A discretionary fiscal policy may alleviate business cycle fluctuations through expansionary public spending or tax cuts in recessions or through contractionary policy in expansions. But poorly implemented discretionary fiscal policy can affect macroeconomic stability adversely.

Whether fiscal policy is rules-based or discretionary, a key requirement for its effectiveness is correct and timely data on the fiscal positions of the various parts of the public sector. Measuring the fiscal stance correctly requires a comprehensive view of the government's fiscal activities and the accounts in which these activities are recorded. Account should be taken of disguised public liabilities, contingent liabilities such as umbrella guarantees for various loans and insurance schemes, quasi-fiscal activities and other liabilities. In most emerging countries, published budget data do not cover some important expenditures and budget laws cover only a portion of government expenditures, allowing politicians substantial scope for discretionary spending outside the budget.

Over the last decade, Turkey's economic performance has been weakened by fiscal inadequacies, including insufficient transparency and accountability of operations, a fragile financial system and short-lived stabilisation attempts, some of which ended in crisis. The lack of strong governments prevented the implementation of structural measures, which in turn gave rise to myopic policies. In the 1990s, Turkey attempted to stabilise the economy with monetary programmes (1990 and 1992), two IMF standby agreements (1994, 1999) and an IMF Staff Monitoring Programme (1998). However, both internal and external factors led to the failure of these efforts: the Gulf crisis together with the general election in 1991 led to the abandonment of the first monetary programme. The Central Bank of the Republic of Turkey (CBRT) could not implement the monetary programme of 1992 as the public sector was engaging in heavy domestic borrowing and using cash advances from the CBRT up to its limit. The unsustainable nature of fiscal policy and the external deficit triggered the crisis in early 1994. Following the crisis, the government announced a stabilisation programme and a standby arrangement was approved by the IMF. However, the government was not strongly behind the programme and the standby agreement ended in 1995.

Although the Asian crisis in 1997 had limited effects on Turkey, investor perceptions to emerging markets changed and the subsequent crises in Russia and Brazil eroded confidence, even though Turkey was trying to reduce inflation and stabilise the fiscal balances. In early 1998, the Turkish government embarked on a disinflation programme centred on fiscal adjustment, structural reforms and tight incomes policies. Significant progress was achieved in 1998, with the primary surplus of the central government rising to over 4% of GNP (excluding privatisation receipts). However, the fallout from the Russian crisis in mid-1998, political uncertainties, and two devastating earthquakes in August and October 1999 hampered progress. Moreover, some fiscal relaxation in the run-up to the elections and weaker economic growth led to a reduction in the primary surplus in the first half of 1999.

In a nutshell, inflation has resulted in high and unstable nominal and real interest rates, which reduced confidence in the Turkish lira. Financing the budget deficit through domestic borrowing has put further pressure on interest rates. As Boratav and Yeldan (2001) put it, "the public sector is trapped in a short term roll of domestic debt, a phenomenon characterised as *Ponzi-financing* in the fiscal economics literature. This clearly unsustainable process contributed to the loss of confidence in the 1990s". Banks replaced commercial lending with lending to government, which is very profitable for banks but impedes the effectiveness of the credit channel. When the government had to pay real interest rates of 20% or more on its debt, private capital moved away from job-creating activities into financial

investment. Moreover, high real interest rates based on a weak fiscal primary position have pushed public finances further along an unsustainable path.

Finally, in December 1999, with the support of the IMF, Turkey embarked on an ambitious three-year exchange rate based stabilisation programme aiming at decreasing inflation to single digits by end-2002. Ensuring effective fiscal management is the key to any country's stabilisation and disinflation programme when there are unsustainable fiscal balances. To this end, the programme was designed to strengthen budget preparation, execution and control, and to enhance transparency and accountability of fiscal operations. Accordingly, broadening the budget coverage through closure of extra-budgetary funds was the most striking aspect of the programme. In addition, the structural reform aspects aimed at medium-term sustainability, fiscal adjustment measures, lowering the burden of interest payments, improving transparency and reducing the contingent liabilities of the public sector.

However, Turkey has experienced two severe crises (November 2000 and February 2001) and redesigned its stabilisation programme with stronger fiscal adjustments to measurement, transparency and governance under the constraint of the need for an extensive restructuring in the banking sector.

The remainder of this paper analyses the interaction between monetary and fiscal policies in the Turkish economy over the last decade with special emphasis on the financial crises in 2000 and 2001. The second section begins with a review of fiscal policy rules by giving country experiences. The third section covers the interaction between monetary and fiscal policies, particularly stressing the need for policy coordination in the overall policy objectives and in crisis management. The fourth section explains the dynamics of the Turkish economy in the 1990s in the framework of fiscal balances and monetary policy. This section discusses the disinflation programme of 1999 and the following crises briefly. The fifth section emphasises the immediate policy responses of the CBRT and the Treasury to the crises and the following section the implications for the domestic debt stock. In this sense, the coordination between the CBRT and the Treasury, the restructuring of the banking sector and its costs to the CBRT and domestic debt stock are underlined.

## **2. The role of fiscal policy rules**

The use of rules-based macroeconomic policies is becoming popular in both developed and emerging economies. The major aim of fiscal policy rules is to establish discipline and credibility in the conduct of fiscal policies by removing discretionary intervention. Governments with a good reputation for fiscal prudence do not need rules. However, in other countries fiscal rules can provide a useful policy framework, contributing to stability and growth, if they are well designed at national and sub-national levels of government, combining simplicity, flexibility and growth-oriented criteria. They must be implemented in a transparent manner with the support of an appropriate institutional infrastructure and following careful preparation.

Fiscal policy rules differ in both design and implementation; see Kopits (2001). While Australia, Canada, New Zealand and the United Kingdom attach primary importance to transparency, the European Union, Argentina, Brazil, Colombia, Peru and Switzerland, as well as India's proposals, rely on numerical reference values for performance indicators. In federal systems with strong sub-national autonomy, the rules are sometimes assumed only by the central government (eg Argentina, India's proposals); in other federal systems, with concerns about potential bailouts and external spillovers of fiscal misbehaviour across jurisdictions, the rules are imposed on each government level in a coordinated way (eg Brazil, European Union).

The coverage and performance indicators of fiscal performance rules also vary among countries. For instance, in the European Union and New Zealand, budget rules cover general government; in Argentina and Peru, budget rules cover national government; and in Brazil and Germany, budget rules cover both national and sub-national governments. Furthermore, in Brazil, Canada, Switzerland and the United States, limits are put on the current balance as a proportion to GDP. In Argentina, the European Union and Peru, limits are put on the overall balance as a proportion to GDP.

In Turkey, particularly since the second half of the 1990s, fiscal policy has aimed at bringing the domestic debt stock under control by creating a sizeable primary surplus, increasing privatisation revenues and financing through external debt.

Until Turkey's recent disinflation programmes, fiscal policy was implemented in a more discretionary way. Although, every year, the government introduced consolidated budget figures consistent with the targeted macro framework, the discipline of the budget weakened through "supplementary budgets" as the actual expenditures were usually higher than planned. Furthermore, since the coverage of the consolidated budget was limited, a considerable portion of the expenditures of the extra-budgetary funds, municipalities and state economic enterprises were not reflected in the budget, though they worsened the public finances. Also, expenditures related to agricultural subsidies were carried out outside the budget process through public banks, resulting in the so-called "duty losses". This lack of transparency led to further deterioration in fiscal discipline and snowballing domestic debt dynamics.

The unsustainable nature of domestic debt following the 1994 crisis forced the policymakers to keep the primary balance in surplus. In this context, the "primary surplus" became a significant indicator of fiscal effort, rather than just a signal of commitment to trim down high interest payments and establish discipline in non-interest expenditures. Therefore, in order to strengthen the consolidated public stance permanently and create a sustainable debt structure, the disinflation programmes - in the late 1990s as well as the current one - have put limits on four different fiscal elements: the "primary balance of the consolidated central government", "the overall and primary balance of the consolidated government sector" and the "primary balance of the public sector".<sup>1</sup>

### **3. The interaction between monetary and fiscal policies**

Fiscal policy affects the success of monetary policy in various ways: through its impact on general confidence in monetary policy, through short-run effects on demand and also through modifying the long-term conditions for economic growth and low inflation.

An unsustainable fiscal policy raises doubts about monetary policy's overall focus on low inflation and stable growth. Dahan (1998) argues that a high level of public debt, a large budget deficit and a large share of short-term bonds are conditions under which it is more difficult to gain enough credibility to lower inflation by monetary measures alone. As noted in Section 4, this unsustainable situation in the 1990s necessitated a programme with strong fiscal fundamentals as well as monetary measures.

Changes in fiscal policy also affect monetary policy through their direct impact on demand. An adjustment of tax level affects company profits or disposable income and thereby economic decisions such as investment and consumption. This makes fiscal policy important when assessing economic activity and future inflationary pressure.

Another aspect of fiscal policy's interaction with inflation is related to fiscal effects on potential output. Lower corporate taxes may lead to more companies being established and in turn raise potential output. Similarly, lower tax on labour may generate an increased supply of labour and also influence wage formation. These are examples of the numerous ways in which changes in tax and expenditure systems are likely to modify economic opportunities and promote conditions for better growth performance without generating price pressure.

Although fiscal sustainability is a widely used term, there is no consensus on its definition. A sound fiscal policy may differ from one country to another, depending on the main characteristics of the economy such as the level of development; the position within the business cycle; whether there is inflation or deflation; and whether its external position is viable. In countries with high inflation such as Turkey, the operational deficit is a better indicator of fiscal stance. However, traditionally, the primary surplus and budget deficit are more closely monitored by the authorities and markets. In this sense, "financing strategy of the budget", "structure of debt stock" and "distribution of debt stock according to buyers" determine the monetary conditions.

On the other hand, the degree of monetary policy credibility is also an important factor that determines the fiscal position. As credible monetary policy implies an independent central bank, it prevents the monetisation of government debt to a certain degree, which means that fiscal deficit is more

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<sup>1</sup> The "consolidated government sector" includes the consolidated central government, extra-budgetary funds, local governments and non-financial state enterprises. The "public sector" adds the central bank and "duty losses" of state banks.

endogenous. Considering the Turkish case, the Treasury relied heavily on cash advances from the CBRT in 1990-94. Afterwards, with some practical arrangements, the Treasury's access to central bank sources was gradually lowered. In 1997, the CBRT and the Treasury engaged in a protocol that limited the CBRT's deficit financing further, and transferred to the CBRT the power and responsibility for setting short-term interest rates. An amended Central Bank Law in May 2001 made the CBRT autonomous in pursuing its primary objective of maintaining price stability as well as determining the monetary policy tools to achieve this goal. The new law prohibited direct lending from the CBRT to the Treasury and CBRT's purchases of government securities in the primary market. The transparency and accountability in preparation and implementation of monetary policy were also enhanced.

Another important aspect of interaction between fiscal and monetary policy is the need for a high degree of coordination in response to financial crises. The recent literature illustrates that the crises in the last decade were more global and potentially more damaging. Accordingly, well designed crisis management strategy is now one of the most challenging policy issues. Crisis management requires extremely strong coordination and quick responses in both fiscal and monetary policy and adjustment in external financing. In line with this argument, timely adjustments in the monetary policymaking process after the float in 2001 and restructuring operations in the banking sector, together with the overperformance in the government's primary balance, contributed significantly to Turkey's recent efforts to manage the crisis. Although the banking restructuring and the subsequent liquidity operation were at the expense of the CBRT's balance sheet and increased domestic debt stock, the Treasury would not have been able to roll over domestic debt without this well coordinated operation.

#### **4. The general framework of fiscal and monetary policy in the 1990s**

During the 1990s, developments in the Turkish economy were characterised by volatile economic growth, high inflation, unsustainable domestic debt dynamics and a fragile financial sector. As in many other emerging markets with open capital accounts, interest rates and exchange rates went through large swings associated with boom-bust cycles in international capital flows. This boom and bust cycle resulted in rising volatility of the growth rate; see Boratav and Yeldan (2001). Between 1990 and 1999, the economic growth rate averaged 3.9%, although real GDP contracted in 1991 due to the Gulf War, in 1994 due to the economic crisis, and in 1999 due to earthquakes.

##### **Public debt developments and fiscal policies**

In 1989, Turkey liberalised its capital account in an environment of macro-imbalances accompanied by a lack of prudential regulation and supervision in the banking system. The priority of the government was sustaining high economic growth at a time of increasing fiscal deficits.

In 1990, the CBRT announced a monetary programme in which it tried to control the credit extended to the public sector. The programme included an implicit inflation target. The lira was expected to appreciate under the programme as the aim of the CBRT was to reduce the share of lira-denominated items on its balance sheet. Meanwhile, the Treasury and the CBRT agreed on restricting cash advances to the Treasury. However, the volatility in financial markets due to the Gulf War in 1990, together with the early elections in 1991, forced a change in the CBRT's credit policy to the Treasury. This amended policy remained dominant until 1994.

Under this framework, foreign borrowing and cash advances from the CBRT were used heavily to finance the public deficits. The Turkish banking sector borrowed from foreign markets and sold these short-term funds to the Treasury, taking advantage of uncovered interest rate parity. Although these inflows aided the economy, macroeconomic management became difficult owing to the volatile nature of such inflows. "The arbitrage seeking inflows and outflows started to constitute a rising share within capital movements and contributed to rising external and domestic instability", as Boratav and Yeldan (2001) put it.

This way of financing fiscal deficits had important implications for the level of external indebtedness, future interest payments and monetary conditions. The ratio of short-term foreign debt to GNP doubled to 10% during 1989-93. Due to the high financing needs of the Treasury, the CBRT refrained from sterilising the capital flows. The major source of growth was the monetary expansion of the CBRT by increasing credit to the public sector without sterilising the capital flows accompanied by the high real

wages. The appreciation of the lira in 1989-93 eased inflation somewhat. However, the CBRT was unable to control its balance sheet during these years due to its important role in financing the Treasury; see Celasun et al (1999). Moreover, appreciation of the lira and the faster pace of economic growth led to a deterioration of the current account. As a result, a period of high economic growth and non-accelerating but high (50-60%) inflation ensued. This growth was implicitly financed by short-term external borrowing at the expense of higher interest rates. Public balances further deteriorated due to the increasingly high interest payments, which reflected the short-term nature of domestic debt instruments and very high real rates necessary to attract external funds and induce residents to shift portfolios towards lira-denominated assets; see Ekinici (1998).

In the last months of 1993, the government attempted to push down artificially the cost of domestic borrowing, by cancelling Treasury auctions, despite the deterioration in the fiscal stance. The Treasury thus had to rely heavily on central bank resources, which created excess liquidity in the market, and put further pressure on exchange rates. The margin between the market and the official exchange rates therefore started to widen. In early 1994, the rating agencies downgraded Turkish sovereign debt. This triggered the crisis. The unsustainable trend of short-term external borrowing finally came to a halt. In 1994, real output contracted by over 5% and inflation rose to triple digit rates.

A standby agreement with the IMF, the first in 10 years, set a ceiling on “net domestic assets” and a floor under “net international reserves”, together with an unannounced predetermined monthly exchange rate path. Meanwhile, the CBRT focused its monetary policy on achieving stability in foreign exchange markets rather than achieving price stability. The sterilised intervention policy of the CBRT led to a surge in reserves that enhanced the Bank’s resistance to domestic and foreign speculative attacks after 1995. In addition, the exchange rate policy was conducted in line with the forecasted monthly inflation rates, which ensured not only exchange rate stability but also competitiveness in the external sector and a sustainable current account. The use of cash advances from the CBRT decreased as a result of the attempts by the monetary authority to improve fiscal discipline.<sup>2</sup>

On the other hand, as the return to external markets became more difficult, the use of domestic markets increased. High public deficits, external net repayer position of the public sector, high and volatile inflation, the shallow domestic financial market and sterilised intervention policies of the CBRT led to sustained high real interest rates and a shortening maturity profile of domestic debt instruments. The recovery after the crisis was nevertheless quick as the growth rate increased to 6.6% in 1995. This was possible because domestic borrowing resumed in the third quarter of 1994. Owing to very high interest rates, new flows of short-term funds also became available; see Ekinici (1998).

To sum up, while in the first half of the 1990s the total debt stock increased due to high primary deficits of the public sector, in the second half it increased due to high real interest rates. The major reasons for primary budget deficits until 1994 were the persistent problems in the taxation system, backward indexation in incomes policies, the state economic enterprises’ weakened financial structure (due to government attempts to control inflation through holding down their prices), extra transfers to close the financing gap of the social security institutions and subsidies to the agricultural sector. Since 1994, the nature and maturity structure of domestic debt have also changed. During and after the 1994 financial crisis, the Treasury issued mostly short-term securities.

Table 1 shows the differing interaction between the monetary and fiscal stance during the 1990s. Between 1990 and 1993, the average ratio of the budget deficit to GNP was less than 5% and it was accompanied by sustained primary deficits, which were financed by monetary expansion through domestic credit creation. In the second half, the financing need of the budget increased and monetary policy was conducted through reserve accumulation.

### **Inflation and exchange rate developments**

During the 1990s, the inflation rate averaged 78%. The chronically high inflation was due to the methods of financing fiscal deficits, backward-looking inflation expectations, both direct and indirect effects of public price setting policy and indexation mechanisms in the labour and financial markets.

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<sup>2</sup> These cash advances were brought under control with the protocol between the CBRT and the Treasury in 1997.

Table 1

**Consolidated budget financing and government debt**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>Consolidated budget</b> (% of GNP)												
Revenues	13.9	15.3	15.8	17.6	19.2	17.7	18.0	19.6	22.2	24.2	26.9	28.9
Expenditures	17.3	20.5	20.1	24.3	23.1	21.8	26.3	27.2	29.1	35.9	37.1	44.8
Interest payments	3.5	3.8	3.7	5.8	7.7	7.3	9.9	7.7	11.5	13.7	16.3	22.9
Primary balance	0.2	-1.5	-0.6	-0.9	3.8	3.3	1.7	0.1	4.6	2.0	6.0	7.0
Budget balance	-3.3	-5.3	-4.3	-6.7	-3.9	-4.0	-8.3	-7.6	-6.9	-11.7	-10.2	-15.9
<b>Financing</b> (% of GNP)												
Foreign debt	0.0	0.3	0.4	1.1	-1.7	-1.0	-0.9	-1.5	-1.9	0.6	2.1	-2.5
Domestic debt	2.5	2.4	3.6	2.6	4.5	3.6	7.1	8.5	8.6	12.4	7.4	12.9
CBRT advances	0.1	1.7	1.6	2.7	1.3	1.2	0.0	-	-	-	-	-
<b>Foreign debt</b> (billions of US dollars)												
<b>Total</b>	<b>49.0</b>	<b>50.5</b>	<b>55.6</b>	<b>67.4</b>	<b>65.6</b>	<b>73.3</b>	<b>79.2</b>	<b>84.3</b>	<b>96.4</b>	<b>103.0</b>	<b>119.7</b>	<b>115.2</b>
Short-term	9.5	9.1	12.7	18.6	11.3	15.7	17.0	17.7	20.8	22.9	28.3	16.2
% of total	19.4	18.1	22.8	27.5	17.2	21.4	21.5	21.0	21.6	22.2	23.6	14.1
<b>Maturity of domestic borrowing</b>												
Average (days)	236	211	211	257	119	206	195	349	233	479	410	148

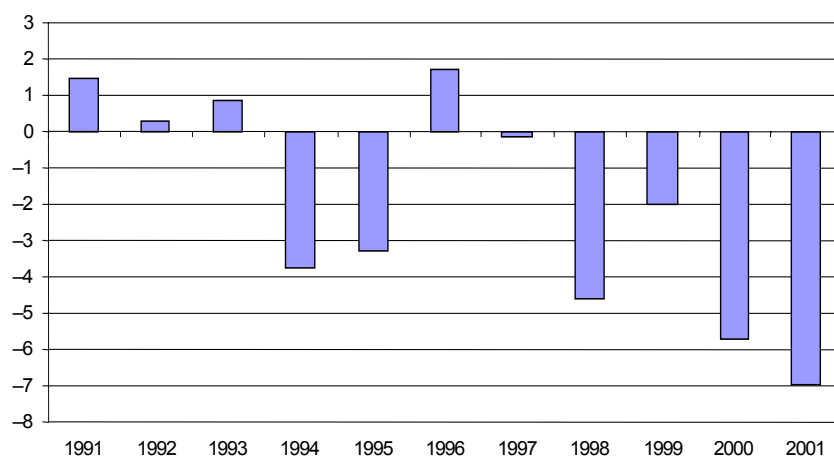
Source: Ministry of Finance.

Specifically, the postponement of price adjustments in public goods and services to post-election periods led to inflation exhibiting a cyclical pattern around elections. Between 1990 and 1999, the ratio of the budget deficit to GNP increased to 8.3% from 4.8%, and the ratio of total domestic debt to GNP increased to 29% from 14%. Moreover, the primary budget deficit, which averaged 0.8% to GNP during 1990-94, turned into an average surplus of 2.8% during 1995-2000 (Graph 1).

The foremost priority of economic policy in such a situation was to attain a lasting reduction in inflation through a comprehensive programme comprising fiscal discipline, structural reforms and privatisation. At the beginning of 1998, the government launched an IMF Staff-Monitored Programme, the first that set targets on fiscal balances (specifically, the primary surplus). However, the overall economic programme was not comprehensive enough to cover the needed structural reforms. The programme achieved some improvements in inflation and fiscal imbalances but could not relieve pressures on interest rates due to both the external and domestic shocks that had hit the economy. This gave rise to a surge in domestic debt, which in turn worsened macroeconomic imbalances further.

Against this background, a three-year comprehensive disinflation programme was initiated in conjunction with the IMF standby agreement in December 1999. The fundamental goals were to reduce inflation to single digits by end-2002, to provide fiscal discipline (Box 1), and to maintain debt sustainability over the medium term. The programme was expected to create a favourable environment to encourage economic growth. On the monetary side, the programme put in place a preannounced crawling peg regime with an exit strategy and tight monetary targets. However, during the implementation of the programme these strict targets to a certain extent gained greater importance in the eyes of market participants than the final objectives of low inflation and sustainable economic growth.

Graph 1  
**Primary balance/GNP**  
 In percentages



Source: Treasury.

Box 1

**Fiscal measures in the disinflation programme in 2000**

The key fiscal goal for 2000 was to raise the primary surplus of the public sector to a level sufficient to stabilise the net public debt/GNP ratio over the medium term. Sizeable privatisation receipts were also needed to limit the growth of the public debt ratio. The proposed level of the primary surplus was expected to affect inflation by alleviating the pressures on the currency and reducing real interest rates. This would, in turn, ease the debt dynamics and ensure the rollover of debt stock.

Attainment of the fiscal goals was to be monitored through a set of performance criteria and indicative targets:

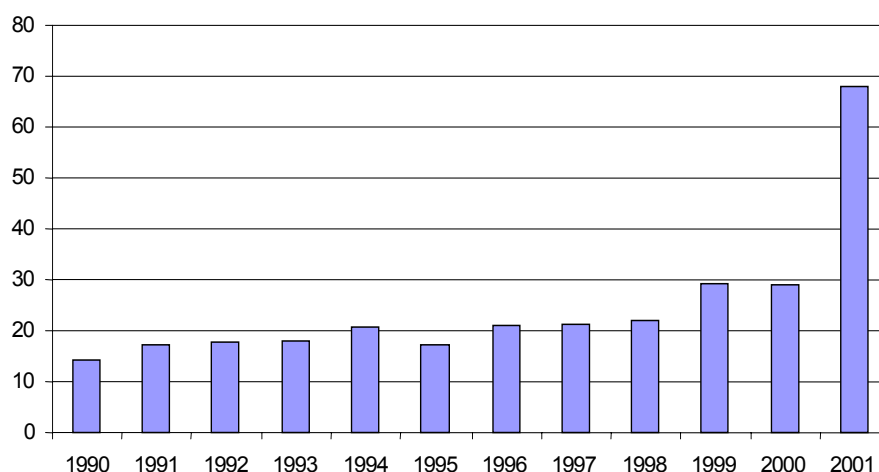
- A quarterly performance criterion was set on the primary surplus of the consolidated government sector (which includes the consolidated central budget, four key extra-budgetary funds, eight state economic enterprises, the unemployment insurance fund and the three social security institutions).
- As privatisation receipts would play a key role, a separate annual performance criterion was set on the primary surplus inclusive of privatisation receipts, with quarterly indicative targets.
- An indicative ceiling was set on the overall deficit of the consolidated government sector, excluding privatisation receipts, so as to monitor the developments not only of the primary balance, but also of interest payments.

The implementation of the programme initially reduced uncertainty in exchange rates and lowered the risk premium, leading to a decrease in nominal interest rates. This increased the volume of capital inflows and in turn interest rates fell further. By decreasing the burden of interest payments, this provided some relief in the budget. The primary surplus target was achieved and some progress made in curbing inflation. Due to reduced exchange rate uncertainty, the Treasury concentrated on issuing long-term, fixed rate bonds. Furthermore, in order to take advantage of disinflation, floating rate notes were issued and indexed to three-month T-bill interest rates. After the 2001 crisis, a considerable part of the domestic debt became indexed.

Over time, however, market confidence in the programme wavered as the developments in the Turkish economy were similar to those in other economies with similar programmes. These developments included a fast decrease in interest rates at the initial stage, initial improvement in economic activity followed by a slowdown, slow convergence of the inflation rate to the preannounced exchange rate, real appreciation of the domestic currency, erosion in trade and the current account balance. Weakened confidence in the disinflation programme led to large capital outflows and created liquidity problems in the domestic financial sector in November 2000 and February 2001. The problems were so pronounced that the government was forced to abandon the crawling peg.

The major difference between the 2001 crisis and previous ones was the huge banking bailout cost, which worsened the debt dynamics further. Together with state bank operations, the financing of bailout costs led to a diversification in the structure of the debt stock. On the one hand, the Treasury preferred to minimise its rollover risk. On the other hand, the buyers of the long-term bonds were mostly private banks. The share of the CBRT in purchases of new government bond issues thus decreased between 1995 and 2001 due to the CBRT's attempts to support fiscal discipline. However, in the context of the "liquidity operation of state and Saving Deposit Insurance Fund (SDIF) banks", the CBRT conducted direct buying operations from these banks.

Graph 2  
**Total domestic debt stock/GNP**  
 In percentages



Source: Treasury.

## 5. Fiscal and monetary developments after the 2000-01 financial crises

Following the 2000 and 2001 "two-tier" crises, the challenge has been to stabilise the economy; in particular, the two interrelated issues of the fragility of the banking sector and sustainability of public debt needed to be resolved. After floating the exchange rate, the CBRT's main aim was preventing imbalances in the payment system and regaining stability in the financial markets, as well as continuing the disinflation.

The new Transition Programme for Strengthening the Turkish Economy was initiated in May 2001. Its priorities were enabling a gradual return of confidence, alleviating financial market distress, and ensuring a healthy banking system and a continuing disinflation path. It also gave priority to banking sector reform as the crises had further weakened an already fragile financial sector, and the banks, which constituted the main portion of the financial sector, faced serious problems:

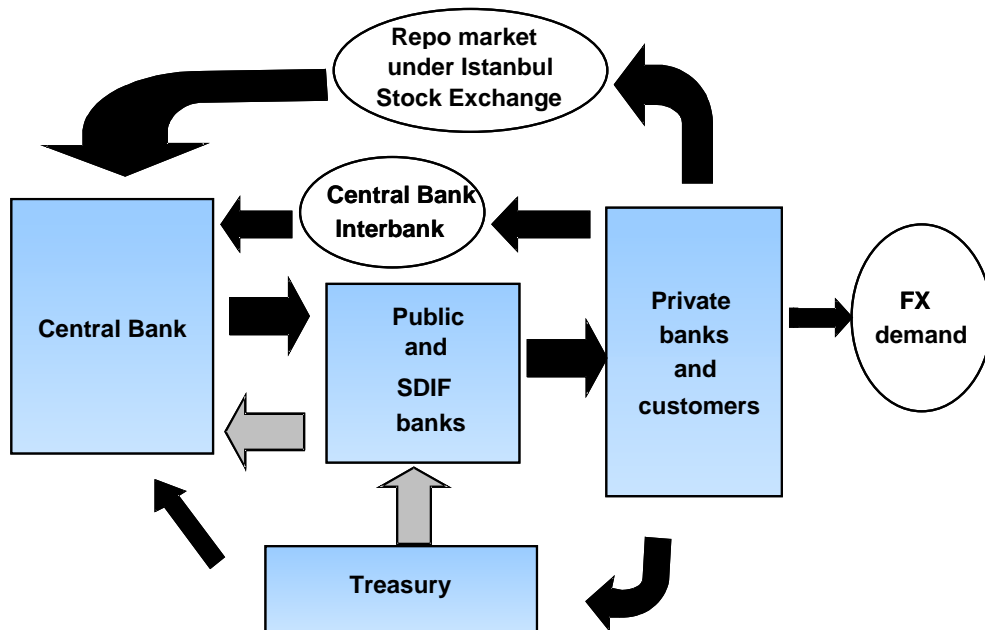
- sharp increase in funding costs owing to a surge in interest rates and maturity mismatch;
- capital losses due to declines in the value of government security holdings; and
- capital losses from high open positions, as a result of the rapid depreciation of the lira.

The main pillars of the restructuring were threefold: the removal of the destabilising effects introduced by the public sector banks; the resolution of SDIF banks; and the strengthening of the financial structure of the private banks, which had weakened significantly during the crises. The most important developments determining the stance of monetary policy were the financial restructuring of state banks, the resolution of SDIF banks, and the extent of liquidity operations aimed at removing the pressure exerted by these banks, especially on the overnight markets (see Box 2).



### Liquidity support operation for public and SDIF Banks

At the outset of the liquidity support operation, the Treasury issued government debt securities equivalent to 28% of GNP to cover public banks' duty losses and SDIF banks' negative capital balances. These special issue government bonds securitised TRL 26 quadrillion in duty losses of state banks. On the other hand, for the rehabilitation of SDIF banks, the Treasury also issued TRL 22 quadrillion of a special type of government bond. Meanwhile, to complement this process, the CBRT provided adequate liquidity in exchange for this paper so as to reduce the excessive overnight borrowings of state and SDIF banks from other banks and non-bank institutions. Accordingly, by the end of May 2001 state and SDIF banks eliminated their overnight borrowings amounting to TRL 14 quadrillion (9% of GNP), of which TRL 9 quadrillion was by state banks and the remainder by SDIF banks. From June 2001, they were no longer allowed to engage in overnight borrowing or accept overnight deposits. Through the elimination of short-term liabilities, the state banks started to determine deposit rates in line with the market and manage their loan portfolios more efficiently.



As a result of this operation, state and SDIF banks' pressure on interest rates was reduced at the expense of raising the net domestic assets of the CBRT to very high levels. The CBRT's domestic debt portfolio increased from TRL 1.5 quadrillion (8% of its assets) at the beginning of 2001 to TRL 26 quadrillion (45% of assets) by September, and to TRL 33 quadrillion (55% of total assets) as of end-2001 (Graph 3). Meanwhile, the use of IMF credit by the Treasury contributed to the excess liquidity in the market in the sense that the Treasury used a large portion of the IMF financing for lira payments in the domestic markets. Consequently, a vast amount of liquidity was injected into the markets. In order to limit the possible inflationary effect, the CBRT mopped up the liquidity via reverse repo transactions, borrowing transactions in the interbank market, and foreign exchange sales.

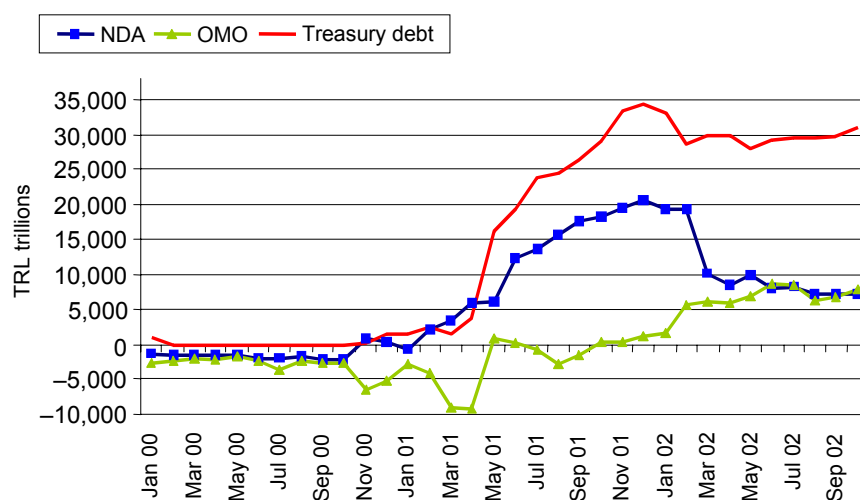
After the crisis in 2001, the size and composition of CBRT's balance sheet was determined by banking restructuring operations and the Treasury's use of external financing through the central bank. In other words, the CBRT's role in crisis management had led to a significant deterioration in its balance sheet. As can be seen from Graph 4, net domestic assets (NDA) had increased significantly compared to pre-crisis levels by end-2001, owing to the liquidity injection to the market.

Graph 3  
**Treasury debt to Central Bank/Central Bank assets**  
 In percentages



Source: Central Bank.

Graph 4  
**Developments in net domestic assets**



Source: Central Bank.

The increase in open market operations was the main source of expansion in NDA until May 2001. After May, there was a sharp increase in public credits as a result of the direct purchase of government papers by the CBRT in the restructuring process of the state and SDIF banks. Meanwhile, use of IMF credits by the Treasury for budget purposes resulted in a decrease in Net Foreign Assets

(NFA)<sup>3</sup> mitigated by an increase in NDA. The CBRT's foreign exchange sales and lending facilities to state and SDIF banks to control liquidity contributed to the decline in NFA. As the increase in NDA was more than the decrease in NFA, base money expanded by 35%, in line with the programme target and much lower than inflation.

As the maturity of the domestic borrowing was shortened and the cost of borrowing increased after the February crisis, the liquidity need of the Treasury increased. This situation created concerns about the domestic debt rollover. Accordingly, the Treasury conducted a voluntary domestic debt swap operation on 15 June 2001 to reduce the domestic debt service burden and facilitate a decline in interest rates, while assisting the banking sector in reducing its foreign currency exposure. The swap involved the exchange of some short-maturity lira government securities for a mix of one third in longer-dated lira securities and two thirds in foreign exchange indexed government bonds. Accordingly, a total of TRL 9.3 quadrillion (USD 7.6 billion) of government securities with an average maturity of six months were exchanged for those with an average maturity of 38 months. The private banks' on-balance sheet foreign exchange net open position decreased to USD 1.5 billion from USD 8.4 billion between end-2000 and end-2001.

## 6. How the recent crises affected the domestic debt stock

The restructuring of the banking sector after the 2000 and 2001 financial crises placed a substantial burden on public finances. The government securities that were given to state and SDIF banks in the restructuring process increased the domestic debt stock from 29% of GDP in 2000 to 66% in 2001. There was also a noticeable change in the structure of the stock and its holders, the amount of non-marketable debt stock held by the public sector and the maturity profile (Tables 2 and 3). The share of cash domestic debt stock in total debt stock declined to 48% in 2001 from 81% in the previous year, while the share of the non-marketable domestic debt stock in the total stock increased considerably from 19% to 52%.

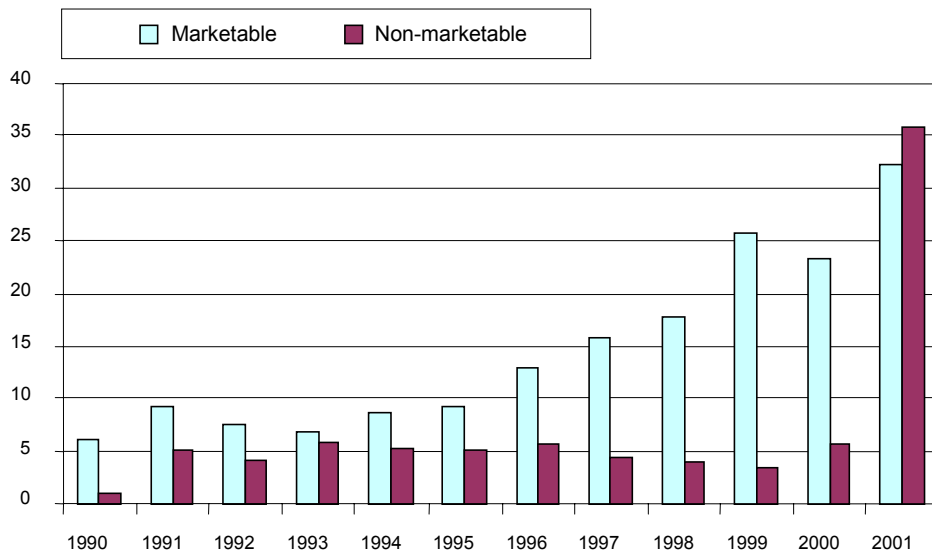
As can be observed from Table 3, another aspect of the banking operation was the significant change in the composition of domestic debt stock, mainly due to foreign exchange (FX) and FX-linked securities handed to SDIF banks, swap operations, credit from the IMF used to finance the budget deficit and FX-denominated borrowing from the domestic market. The floating rate notes and FX and FX-linked securities constituted the majority of the total domestic debt stock in 2001, while in 2000 fixed income and floating rate securities had accounted for the majority. The share of fixed rate securities decreased to 15% by end-2001, from 56% at end-2000. Meanwhile, the share of the FX-linked and FX-denominated debt in total debt increased to 36% as of end-2001, compared to 8% in 2000. Simply, the bulk of the exchange rate and interest rate risk of the banking sector has been transferred to the Treasury.

Meanwhile, the maturity of the cash domestic debt stock increased 10 months with respect to the previous year, and reached 19 months in 2001 owing to swap operations, IMF credit and FX and FX-linked public sales and direct sales. The average maturity of the non-cash domestic debt stock reached 50 months as a result of the restructuring of the CBRT's portfolio in October and the restructuring of the SDIF banks' portfolio in response to the deposit turnovers in December. Hence, the average maturity of the total domestic debt stock was 35 months in 2001. However, the maturity of the borrowing through the Treasury auctions declined to 4.7 months in 2001 from 13.8 months in 2000.

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<sup>3</sup> After the use of IMF credit, CBRT international reserves increased together with the liabilities to the IMF, leaving net international reserves unchanged. Afterwards, as the Treasury started to use this credit from its lira deposit account at the CBRT, NDA increases and excess liquidity in the market were mopped up by the CBRT's foreign exchange sales, thus in turn decreasing net international reserves.

Graph 5  
**Structure of domestic debt**  
 In percentages to GNP



Source: Treasury.

Table 2  
**Distribution of domestic debt by buyers**

	2000		2001	
	TRL trillions	% share	TRL trillions	% share
<b>Cash</b>	<b>29,591</b>	<b>100</b>	<b>58,354</b>	<b>100</b>
Market	22,987	78	32,963	56
Public sector	6,607	22	25,423	44
Central bank	0	0	13,768	24
State banks	2,731	9	4,253	7
SDIF	152	1	132	0
Other	3,724	13	7,270	13
<b>Non-cash</b>	<b>6,829</b>	<b>100</b>	<b>63,837</b>	<b>100</b>
Central bank	0	0	18,778	29
State banks	2,911	43	22,722	36
SDIF	3,850	56	19,514	31
Other	68	1	2,823	4
<b>Total</b>	<b>36,420</b>		<b>122,191</b>	

Source: Central Bank of the Republic of Turkey (2001).

Table 3  
Structure of domestic debt

	1999		2000		2001	
	TRL trillions	% share	TRL trillions	% share	TRL trillions	% share
Cash	20,400	89	29,591	81	58,354	48
Fixed	15,465	68	19,421	53	17,745	15
Flexible	3,809	17	8,992	25	11,426	9
FX-denominated	1,125	5	1,178	3	7,133	6
FX-linked	0	0	0	0	22,050	18
IMF credit	0	0	0	0	13,768	11
Swap/tap	0	0	0	0	7,740	6
Public sales	0	0	0	0	542	0
Non-cash	2,520	11	6,830	19	63,837	52
Fixed	418	2	1,018	3	0	0
Flexible	2,102	9	3,997	11	49,513	41
FX-denominated	0	0	1,814	5	12,389	10
FX-linked	0	0	0	0	1,935	2
Total stock	22,920	100	36,421	100	122,192	100
Fixed	15,883	69	20,439	56	17,745	15
Flexible	5,911	26	12,989	36	60,939	49
FX-denominated	1,125	5	2,992	8	19,522	16
FX-linked	0	0	0	0	23,985	20

Source: Central Bank of the Republic of Turkey (2001).

## 7. Conclusion and future challenges

This paper presents the general framework of fiscal balances and monetary policy of the Turkish economy over the last decade, particularly emphasising the role of consistent policymaking in stabilising the economy. There are some lessons that can be drawn from the Turkish experience:

- The capital account liberalisation has to be accompanied by - and preferably preceded by - an overhaul of the country's capacity to supervise, regulate and manage financial institutions, so that the domestic financial system can properly cope with the complications of the free capital movements. After Turkey liberalised its capital account, the arbitrage-seeking inflows and outflows started to constitute a rising share within capital movements and contributed to rising domestic instability, which in turn necessitated higher interest rates on domestic assets. In addition, the availability of foreign capital eased the financing constraint of the governments and delayed the achievement of fiscal discipline.
- The perceived fiscal unsustainability in Turkey led to macroeconomic instability. The government's capacity to use fiscal policy as a countercyclical instrument weakened, its access to external financing became subject to high risk premia, and its ability to attract potential foreign investors was impaired. There was also a traditional friction in fiscal policy,

namely procyclicality bias.<sup>4</sup> This created risks to economic stability in the short-term, exacerbated debt accumulation, and jeopardised the long-term sustainability of public finances.

- Debt sustainability has been an important issue on the fiscal agenda for years - particularly in the second half of the 1990s - due to the high level of domestic debt stock with short-term maturity. In this sense, recent currency crises together with the fragile banking sector aggravated the concerns over the debt sustainability as the surge in interest rates placed a substantial burden on public finances. The dynamics of domestic debt is influenced by the expected cost of debt servicing, which is in turn affected by the market's perception of fiscal sustainability: see Heller (2002). Turkey's experience after the 2001 crisis shows in order to roll over the domestic debt, the Treasury had to assume higher exchange rate and interest risk.
- The budget coverage has 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, high and persistent inflation has also resulted in "supplementary budgets" being the norm whenever expenditures exceed appropriations. The fact that governments could spend public resources outside the budget has increased their discretion and reduced the transparency of the budget. In line with this argument, Turkey would be able to strengthen fiscal balances permanently through a high-quality, transparent budget process, good governance and a well managed expenditure and revenue administration accompanied by well designed macro measures. As noted by Heller (2002), a government should have a realistic understanding of factors (the aggregate price level and interest rate, key commodity prices, level of economic activity) that determine the dynamics of key fiscal variables. Besides, a government should have the capacity, within the framework of budgetary legislation, to intervene in a flexible and timely manner, to influence the broad fiscal aggregates and, in particular, to correct deviations as they may emerge.
- It is essential to ensure effective coordination between fiscal and monetary policy as inappropriate fiscal policies can damage the credibility of monetary policy. Turkey started to implement programmes with strong fiscal fundamentals only at the end of the 1990s. Bank restructuring and the liquidity support operation after the 2001 crisis provide examples of good operational coordination between the two policies.
- Monetary and fiscal policies are designed and implemented by different authorities with their own objectives and limitations. Sometimes these authorities are obliged to make a shift in the weight of the variables in their objective function due to unexpected domestic and external developments. The joint determination of objectives and policies by the monetary and fiscal authorities is a fundamental requirement for consistent policymaking, but it should not undermine the target of medium-term price stability.
- The multi-year macro budgetary framework is an important prerequisite for clarifying the priorities among competing budgetary objectives and facilitating consideration of intertemporal budgetary trade-offs. Such a framework can also improve allocation and institutional discipline. A multi-year budgetary framework, together with the Treasury Act which will become effective in 2003, and the already amended Central Bank Law, should enhance the joint credibility of the policies. This would help ease medium-term monetary policy implementation, and in turn increase the reliability of monetary policy objectives.

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<sup>4</sup> Fiscal policy is subject to extensive political constraints: electoral concerns, the need to strike deals with opposition parties, or to favour certain constituencies such as public sector unions. The complex political game that leads to the formulation of fiscal policy often brings about departures from optimal and prudent policies.

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