MACROECONOMIC MANAGEMENT WITH OPEN CAPITAL ACCOUNTS: THE TURKISH CASE

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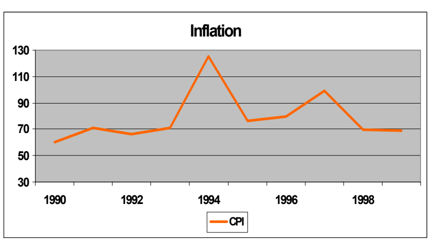
DEVELOPMENTS IN 1990's

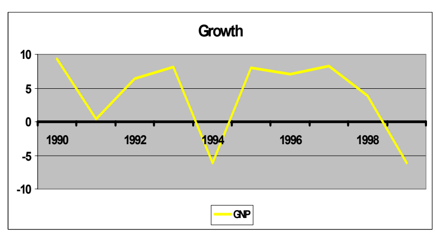
- Turkey liberalized fully the capital account in 1989
- 1990's was a lost decade with extreme volatility
- High and variable inflation (80%)
- Growth below potential with extreme volatility (4%)
- Financial markets, interest and exchange rates went through large swings associated with boom-bust cycles in international capital markets

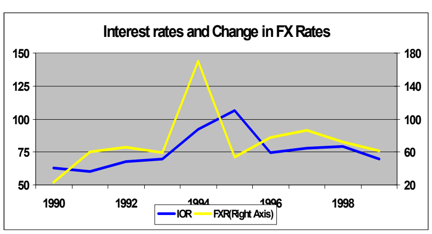
DEVELOPMENTS IN 1990's

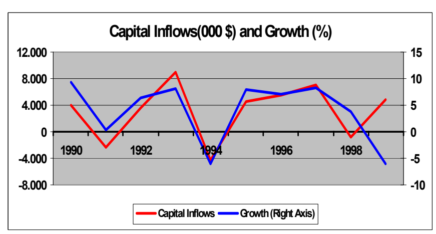
- PSBR have doubled from10 percent to 20 percent and there was a rapid build-up of public debt
- Poorly supervised financial system, depending on high interest rates on government debt and carrying large fx open positions

DEVELOPMENTS IN 1990's









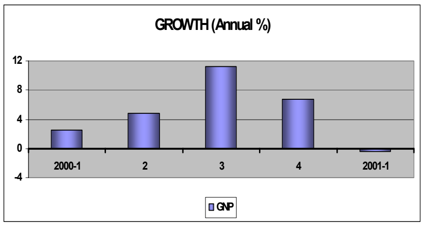
EXCHANGE RATE BASED STABILIZATION (2000)

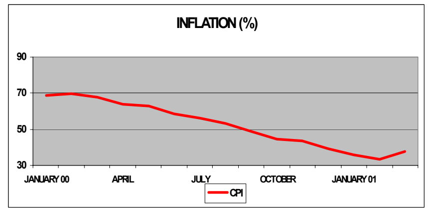
- At the end of 1999 an exchange rate based stabilization program was launched
- The program with a pre-announced exit strategy from the peg reduced the inflation and interest rates.
- While domestic demand is booming current account worsened due to a rapid appreciation of the currency

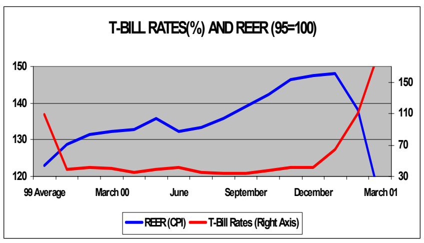
EXCHANGE RATE BASED STABILIZATION (2000)

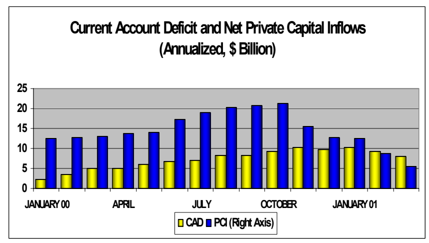
- Peg reduced the exchange rate risk, induced capital inflows, increasing open positions and vulnerabilities in weakly regulated banking sector
- The first test of the peg by speculators came in late 2000.The ensuing currency and financial crisis encountered in February 2001 led to the collapse of the program

EXCHANGE RATE BASED STABILIZATION (2000)









INFLATION TARGETING AND FLOATING EXCHANGE RATES (2001-05)

- In response to crisis government changed the economic management team and launched an ambitious program to establish quickly reform credentials and bolster investor confidence
- The program was based on floating exchange rate, strong and sustained fiscal adjustment, a strong emphasis on dissinflation and front-loaded structural reforms
- IMF supplied substantial outside financial assistance
- Increased liquidity in international markets reduced the cost of borrowing
- Single party government increased percieved political stability
- Strengthened EU anchor improved expectations

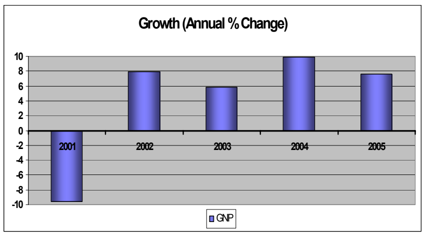
INFLATION TARGETING AND FLOATING EXCHANGE RATES (2001-05)

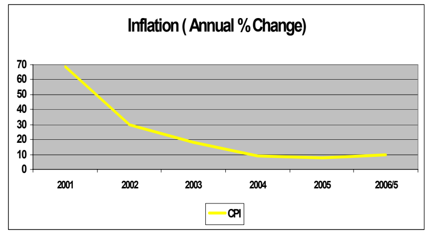
- To deal with financial crisis;
  - A blanket guarantee for the liabilities of the taken-over private banks was introduced
  - State banks were re-capitalized ($ 30 billion)
  - Weakest private banks were intervened
  - Supervisory and regulatory framework strengthened in line with international best practices

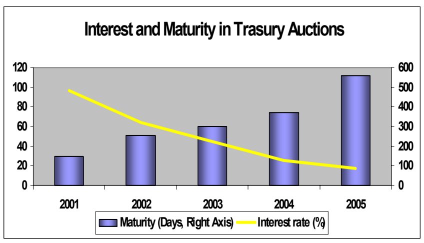
THE OUTCOME UNDER THE NEW PROGRAM

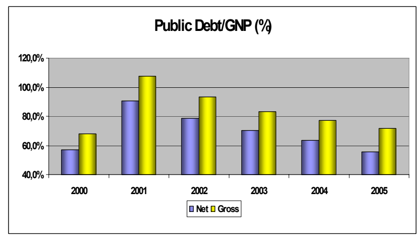
- **Positive**
  - Recovery has been rapid, growth resumed in 3 quarters.
  - Annual average growth was more than 7,5 % during 2001-05
  - A dramatic decline in inflation to single digit levels not seen since 1970's
  - Rapid improvement in financial market confidence as witnessed by a substantial decline in interest rates
  - Substantial decline in government debt

THE OUTCOME UNDER THE NEW PROGRAM





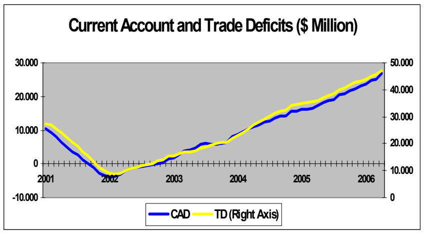


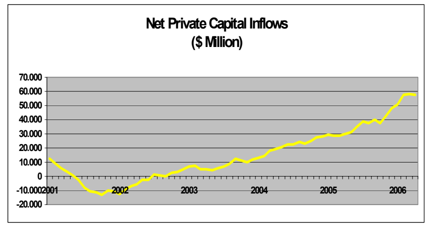


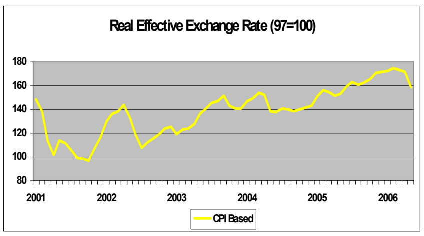
THE OUTCOME UNDER THE NEW PROGRAM

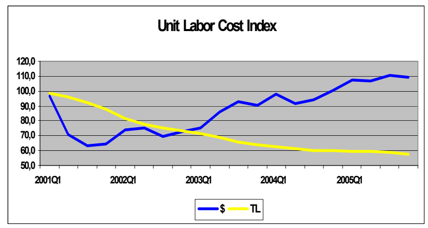
- **Negative**
  - Rapidly widening current account and trade deficits
  - Substantial private capital inflows mainly in the form of portfolio investments and debt, sensitive to sudden climate changes in international markets
  - Rapid appreciation of the currency and increasing unit labor costs in $ despite increases in labor productivity
  - Increasing downward rigidities in inflation
  - Slow down of the structural reforms

THE OUTCOME UNDER THE NEW PROGRAM









Lessons to be drawn

- Flexible exchange rate does not prevent appreciation and ensuing deterioration in external balance in case of large inflows, creating new vulnerabilities
- Politicians prefer to watch boom cycles as the market's discipline on them weakens
- Sterilization of the inflows by the central bank is costly and inflation targeting central banks prefer to rely on appreciation,
- There is a need to control inflows through a coordinated game between central banks, financial supervisors and fiscal authorities