THE POLITICAL ECONOMY OF TURKISH INFLATION

After the Second World War, its geo-strategic position between Europe, Asia, the Middle East and the Soviet Union propelled Turkey into the founding membership of the OECD. As a by-product of the Cold War, Turkey, despite the fact that all quantitative and qualitative indicators would have placed the country in a category of third world underdevelopment, enjoyed membership in the exclusive club of developed economies. Despite this fortunate beginning, the performance of the Turkish economy in the last half century has not been breathtaking: average GNP growth at 4.7 percent was substantial but well below the 6 to 9 percent range attained by other more successful economies with a similar, if not worse, initial conditions. Relatively high population growth at 2.7 percent during the same period further reduced Turkey's rank in per capita income growth tables. Yet simply because it was not a miracle economy, it would be unjust to call the Turkish post-war experience in economic development a failure; rather, it was somewhere in between the two extremes, what I call "mediocre" for lack of other satisfactory adjectives.

The indicator that singles out Turkey from its peers in the newly industrialized economies, particularly over the last two decades, is the behavior of its inflation. Turkey is the only mid-income and sizeable open economy with relatively developed market structures that has managed to sustain average annual inflation rates around 60 percent for a long period of time without either falling into hyperinflation or successfully reducing it to reasonable levels.[1] Recent Turkish macroeconomic history, including the crisis of 1999 and the current disinflation program, can only be presented and analyzed adequately by understanding Turkish inflation, whence it came and to where it is going.

THE ECONOMY OPENS TO THE WORLD

In the first three decades following the Second World War, Turkey, like many other developing economies, adopted an inward looking import substitution and industrialization strategy. An overvalued currency and strict import controls, often involving full bans on all domestically produced goods, resulted in a complex structure of administrative intervention. Bureaucratic controls extended to all important prices and markets, including the financial markets; however, the private sector dominated in Turkey. Private firms undertook all production in agriculture, trade and services and a substantial part of industry. The contradictions inherent in a system that tries to combine a command economy with a dominant private sector made the economy extremely rigid and vulnerable to external shocks, especially those that affected the external deficits. The five-fold increase in oil prices in 1974, combined with the political isolation resulting from Turkey's military intervention in Cyprus the same year, proved fatal. By the end of the 1970s, structural deficits in the current account had brought production to a standstill and pushed consumer inflation to three-digit levels. As a result, Turkey suffered from falling

[1] There has been remarkably little academic interest in Turkish inflation or the problems that it has caused. Turkey’s currency crisis in 1994 predated Mexico’s, but no references of it can be found in recent literature on currency crises.

real wages, black markets, shortages of basic goods and other typical signs of a failing economic system. The depth and intensity of the crisis, and the need for international support convinced both policymakers and the public that undertaking the necessary reforms to create a more market friendly and export oriented development strategy was imperative.

We can divide the last two decades of the twentieth century into four distinct sub-periods, each associated with an important event:

- **1980-83**: A stabilization program was implemented under a stand-by agreement with the IMF and continued under a military government. The program entailed a massive devaluation of the Turkish Lira and substantial hikes in indirect taxes.[2] Foreign exchange was made available by a large infusion of funds both from international institutions and NATO allies.
- **1983-89**: Market reforms undertaken by Prime Minister Turgut Özal were aimed at breaking the administrative structures of the command economy by lifting quantitative restrictions on imports, liberalizing interest rates, simplifying the procedures for foreign direct investment and promoting exports of goods and services (tourism), while strengthening the basic infrastructure of the economy, especially in telecommunications and transport.
- **1989-1996**: The liberalization of the capital account and the design of a program for the reduction of import tariffs helped to finance a politically motivated "populist cycle," which exploded in 1994 when GNP shrank by 6.2 %. The convertibility of Turkish Lira resulted in the dollarization of the economy and large short-term capital inflows ("hot money").
- **1996-1999**: The Customs Union Agreement with the European Union signaled the end of the transition from a closed command economy to an open market economy. However, high inflation, and the resulting macroeconomic instability and volatility persisted, and Turkey entered the new millennium with the most serious economic crisis it has ever faced. GNP growth was negative for the last six quarters of the century, turning 1999, with a growth rate of -6.4 percent, into the worst year since the early 1940s.

Table 1, comparing the last year of three separate decades, 1979, 1989 and 1999, in terms of GDP and indicators of the relative openness of the economy, presents some interesting results. In a relatively short period of 20 years, the structure of the economy was transformed with remarkable success from near autarcky to a fully integrated open economy. In 1979, Turkey was an exporter of primary commodities, and its heavily protected industries had no chance of competing in either international or domestic markets. In 1999, Turkish firms competed effectively in the single EU market. This increased integration into the world economy is also reflected in the steady decrease of the percentage contribution of worker's remittances to the foreign exchange earnings.

[2] In the Turkish context this takes the form of price increases of the products of State Economic Entreprises (SEEs) on basic inputs such as electricity, energy, iron and steel, etc. and low elasticity consumer goods such as tobacco and alcohol.

Table 1

	1979	1989	1999
(in Millions of US$)			
GDP	92.774	107.012	183.755
Exports	2.261	11.780	29.326
FX Revenues	4.798	22.472	53.249
Imports	5.069	15.792	40.692
FX Spending	6.271	21.511	54.613
Current Account+ Net Errors	-762	1.932	535
Gross FX Reserves	1.726	9.314	34.133
(in Percentages)			
Industrial Exports/ Total Export	34,7	78,9	90,0
Workers Remittances/ FX Revenues	35,3	13,5	8,5
FX Revenues / GDP	5,2	21,0	29,0
FX Spending / GDP	6,8	20,1	29,7
(Cur.Acc.+ Net Errors) / GDP	-0,8	1,8	0,3
Gross FX Reserves / GDP	1,9	8,7	18,6

Source : Central Bank , State Planning Organization

Table 2 summarizes the overall development of the economic the key indicators during the last three decades. The contrast between the variables of real economy, which all show definite signs of improvement, and the behavior of prices, which only seem to increase, justifies the contention that high persistent inflation is the puzzle of the Turkish economy. Comparing the 1990s with the 1980s, it is evident that inflation caused the fall in the growth rate, from 5.22 percent to 3.96 percent, and the increase in output volatility, demonstrated in the increase in the standard deviation of GDP growth, from 3.33 to 5.64 in the 1990s.

Recurrent foreign exchange shortages prior to 1980 and the currency crisis of 1994 left an important mark on Turkey's collective memory, resulting in an disproportionate focus on the dangers of (imaginary) current account deficits. As the

figures clearly demonstrate, foreign exchange earnings and current account balances constitute the healthiest parts of the economy. Thus, the diseases that are reflected in high inflation and poor growth performance have to be sought elsewhere.

Table 2

Average annual change	1970-79	1980-89	1990-99
GDP	5,03	5,22	3,96
* St.Dev. Of GDP growth	2,99	3,33	5,64
CPI Inflation	24,8	39,9	78,9
Turkish Lira Depriciation	9,2	44,1	78,7
Exports (shuttle trade incl.)	16,5	14,8	12,5
Imports	23,0	7,9	10,3
FX revenues/GNP	-3,4	8,8	9,0
FX expenditures/GNP	2,0	2,2	7,0

Source : Central Bank , State Planning Organization

PUBLIC SECTOR DEFICITS AND HIGH INFLATION

The consensus opinion on the causes of inflation points to the large deficits in the public finances. However, this may not be the case. Economic theory and empirical evidence prove that the monetization of the often large public deficits is always the "original sin" from which high inflation emerges, as it did in Turkey in 1980s and early 1990s. Following this logic, if large public deficits persist, then price inflation should accelerate, eventually reaching hyperinflation—however that is defined. Therefore, we should not witness a steady-state of high inflation. Yet, in the Turkish economy since 1994, inflation has reached a steady-state, with rates fluctuating around an annual average of 80 percent, occasionally falling to 60 percent or rising past 100 percent. Strangely, it's the latter that describes the Turkish economy since 1994, not the former.

There is much confusion about the actual magnitude and the impact of the public sector deficits in Turkey for two principal reasons. The first is political: Turkey's government expenditures budget is not nearly as binding as it is in other countries. Successive governments have found ways of undertaking substantial spending outside the budget. As well, it is very difficult for economists and the public opinion to keep track of their creative and devious accounting procedures. The result is that the official budget deficit is often only a small portion of the actual public sector borrowing requirement.

The second reason is due to inflation. The nominal interest rate on domestic public debt is linked to inflation. Even if the real interest rate is constant, higher inflation translates into higher nominal interest payments on domestic debt and therefore a bigger nominal budget deficit. For this reason, in a high inflation environment, economists prefer

to work on the primary balance (public deficit/surplus before interest payments) or operational balance (real deficit/surplus after the monetary correction in interest payments).

Table 3

	1993	1994	1995	1996	1997	1998	1999
Public Sector Balances (% of GDP)							
Primary Balance	-5.6	1.0	3.9	-1.3	-2.0	1.6	-1.6
* of which the budget	-2.5	3.5	3.4	1.3	-0.2	4.1	2.1
Net Interest Payments	6.0	10.1	9.1	11.9	11.0	16.4	20.0
Nominal Public Balance	-11.7	-9.1	-5.2	-13.1	-13.1	-14.8	-21.6
Monetary Correction	2.6	4.8	4.9	6.0	10.2	11.5	10.3
Operational Balance	-9.1	-4.2	-0.3	-7.1	-2.9	-3.3	-11.3
Annual change % (year end)							
CPI (Year-end)	71.1	125.5	76.0	79.8	99.1	69.7	68.8
WPI (Year-end)	60.3	149.1	65.6	84.9	91.0	54.3	62.9
Basket Dev. (Year-end)	63.4	179.6	65.9	69.0	78.1	57.9	61.0
Public Debt (% of GDP)							
Gross debt/gdp (unadjusted)	41.9	52.3	49.3	55.5	53.3	53.5	NA
Net debt/gdp (adjusted)	27.1	31.0	30.2	34.8	31.8	33.7	NA

Source: IMF

Table 3 summarizes the state of the public finances for the period 1993 to 1999.[3] There is no doubt that the "populist cycle" initiated in 1989 by Özal caused large and unsustainable public sector deficits, contributing to the currency crisis of 1994. However, in the subsequent five years, from 1994 to 1998, primary deficits existed in only two years. In the other three years, the public sector budget had a surplus before interest payments. The average operational deficit (corresponding to zero inflation) for the five year period is 3.5 percent of GDP. This deficit is reasonable when compared to other countries with single digit inflation rates. The last row in Table 3 clearly indicates that the increases in the ratio of net public debt to GDP are very small, further confirming that public sector deficits were not large enough to justify Turkey's high inflation and currency depreciation.

[3] The figures include the deficits and net debts of all public entities, calculated by the IMF. The data is from "Turkey: Selected Issues and Statistical Appendix" IMF Staff Country Report No.00/14 (Washington DC: February 2000) p. 143, 147, except for 1993, which was calculated by the author and 1999, which was revised by the author in view of the final published figures. 1993 has been included as a year of reference.

Two other points need to be made. First, there is no meaningful relationship between the size and directional change of the public sector deficit and inflation/devaluation in the short run. Secondly, and more revealing, is the incredible volatility of the public sector deficits from year to year. At first sight, this fact seems in sharp contrast with the conventional wisdom, which says that fiscal policy does not allow large adjustments in the short run. In Turkey, however, it evidently does. This provides the link between politics and inflation, even in the absence of the monetization of public deficits. The fog surrounding the figures caused by high inflation allows large swings in public spending that go unnoticed by the markets and the public opinion. The government can undertake populist policies without paying the short-term price for them in the financial markets.

The figures also permit us to come up with a diagnosis on the relationship between public sector deficits and inflation—for all practical purposes the causality is reversed. In other words, high inflation is the reason why relatively reasonable operational deficits in public finances are transformed into very large nominal public deficits. This is a typical case of "multiple monetary equilibria."[4] With these real magnitudes, the Turkish economy could easily sustain much lower levels of inflation provided an appropriate monetary anchor could be found.

"CURRENCY SUBSTITUTION"

The answer to the puzzling observations discussed above lies in the state of Turkey's currency, the Turkish Lira. In the 1990s, the most important structural weakness of the Turkish economy was the total collapse of confidence by its citizens in the currency of the country. In other words, the economic characteristics established above, such as high persistent inflation and currency devaluation, falling average GDP growth rate, currency crisis, large public sector deficits and overall volatility in the economy, can only be explained by careful analysis of the monetary and other policies which have led to the slow replacement of the Turkish Lira by hard currencies, such as the United States dollar and the Deutsche Mark, in public life. This process, common to other economies with similar inflationary problems, is called currency substitution or dollarization.

Economics textbooks attribute three basic functions to a national currency: a medium of exchange, a unit of account and a store of value. Obviously, at inflation and devaluation rates averaging 80 percent, fluctuating between 54 percent and 150 percent, the last two conditions become absolutely meaningless, thus putting the first under heavy pressure. Anyone who lived in Turkey for any length of time or visited regularly knows that everyday life requires a fluency in the exchange rate. You cannot do any shopping, except for bread, cheese, milk and other necessities, if you don't know the value of the

[4] See M. Ucer, "Turkey's Inflation Myths: Observations on the 1998 Program," unpublished paper, July 1999.

US dollar or the Deutsche Mark, which provide the only reference point for intertemporal price and revenue comparisons.

It is no surprise that the void created by the lack faith in the national currency has been filled by currencies of other countries in which citizens have confidence. Obviously, the intensity and speed of currency substitution is dependent on the economic policy framework and the institutional set-up. The liberalization of the capital account in 1989 allowed domestic residents to purchase and hoard or freely deposit foreign exchange. This in turn created a domestic market for foreign currencies and resulted in foreign exchange kiosks (*döviz büfesi*) on every main street even in the most remote cities in Anatolia.

Table 4

	1979	1989	1993	1999
(in Million US$)				
Currency in circulation	4,627	3,217	4,666	3,577
M2Y + Repo	17,001	28,844	42,973	87,716
FX Deposits	-	6,654	17,316	41,091
FX dep./M2Y+Repo (%)	-	23.1	40.3	46.8
(as Percentage of GDP)				
Currency in circulation	5.0	3.0	2.6	1.9
M2Y + Repo	18.4	26.6	23.7	47.2
M2 + Repo	18.4	20.5	14.1	25.1
FX Deposits	-	6.1	9.5	22.1

Source : CB

Table 4 summarizes the fate of the Turkish Lira and the extent of the dollarization for the last two decades. During that period, the real value of the Turkish Lira in circulation fell steadily in absolute terms from the equivalent of US$ 4.6 billion in 1979 to US$ 3.6 billion in 1999 while Turkish GDP doubled (see Table 1). The amount of Turkish Lira in circulation fell from 5 percent of GDP in 1979 to 1.9 percent in 1999. The year 1993 is included in the table because dollarization gained momentum after the currency crisis of 1994. In Turkish parlance, M2Y is the money supply including bank deposits in foreign currency; Turkish Lira Repurchase Agreements (repo) also became very popular after 1994 because they earn high interest rates with very short maturity (often overnight, at most one week), thus have a very limited devaluation risk.

While the size of Turkish financial system, as a share of GDP, actually doubled from 1979 to 1999[5], the increase in liquidity was absorbed by non-Turkish Lira assets. At

[5] High inflation prevents the development of a large financial sector. The relatively small size of the financial sector has contradictory consequences: it is too small to make a meaningful contribution to the growth potential of the economy during good days; because it is too small, it cannot make things worst during a crisis. That's why banking sector problems are neglected in our analysis. Obviously, the

the end of 1999, only half of total liquid assets in the country were held in Turkish Lira (currency + Turkish Lira deposits). However, this analysis ignores cash in foreign currency held by domestic residents. There is no significant empirical research on this; informal estimates vary from US$ 5 billion to US$15 billion, which should be added to the figures above.[6]

The dilemma facing Turkish authorities is quite evident. The harder they try to increase seigniorage - revenues the government gains by printing Turkish Lira - the more residents substitute foreign exchange for Turkish Lira, reducing the monetary base on which the government makes these revenues. However, this is a relatively minor cost compared to the constraints imposed by widespread currency substitution on monetary policy, which we will analyze in the next part.

Before moving on to more technical policy issues, I would like to offer a meta-economic interpretation for dollarization. Dollarization reflects an important characteristic of Turkish society: When faced with a collective problem, citizens instinctively search for a private solution. High persistent inflation is something that touches every member of society. The solution to inflation requires the action of public authorities, who are also the causes of inflation, Central Bank, Treasury nad so on. Instead of concerted political action to discipline the legislative and executive branches of the government, Turkish citizens choose to protect themselves from the immediate effects of inflation by substituting sound foreign currencies for risky local currency. This creates further moral hazard, because the population now believes that they have thus obtained immunity from the hard costs of high inflation and will be even more passive towards collective solutions.

"PHONEY MONEY" IS NO FUN[7]

After the currency crisis in 1994, a substantial depreciation of the Turkish Lira led to rapid increases in merchandise exports at a time when the Turkish producers were discovering new markets in the transition economies, especially Russia[8]. With GDP growth rates ranging from 7 to 8 percent for three consecutive years from 1995 to 1997,

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regulation of financial institutions became a much more important issue during recent years as the ratio liquid assets/GDP reached 50 %.

[6] By extrapolating from the "currency in circulation" ratios of low inflation countries of a comparable size and level of development, our conservative estimate for cash in foreign currencies in circulation in Turkey is US$ 15 billion.

[7] Professor Rudi Dornbusch of MIT, during a conference in December 1998 at the Koc University in Istanbul, used the expression “dinky money” for the currencies of small economies, practically meaning everybody except US, EU and Japan. Upon his lead, I called the Turkish Lira “dandik,” a Turkish slang/diminutive word corresponding to English “phoney,” which gained immediate popularity as it fit perfectly well with the daily experiences of the man in the street. See: R. Dornbusch: "When Funny Money is No Joke," Financial Times, 3 January 2000.

[8] We must draw attention to the remarkable flexibility of the labor markets in Turkey: real wages fell by 25-30 % in 1994 (and did not recover much since then) without causing any social or political unrest, explaining to a large extend the speed and intensity of the recovery after 1995.

economists looked rather silly with their strong convictions about the output costs of high persistent inflation and their demands for immediate disinflationary policies. Most people were happy with the way things were going; nobody wanted to listen to pessimistic lectures on the dangers of the volatility and fragility caused by inflation.

Suddenly, and unexpectedly, from the second quarter of 1998 onwards, the picture was rapidly reversed. Economic activity first slowed then went into a free fall that lasted until the end of 1999. Several independent factors were at work, some due to domestic economic developments and economic policies, others to external shocks of an economic or political nature.

By the end of 1997, the investment boom of the post-1994 crisis was beginning to wear off, as all investment booms do sooner or later, due to the over-capacity in textiles and related industries. Meanwhile, the minority government headed by Yilmaz (and supported by the Republican People's Party) began tightening fiscal policy as soon as it came to power in the summer of 1997, resulting in much better fiscal discipline in 1998. The Central Bank supported Yilmaz's stabilization efforts through tighter monetary policy. Despite a booming tourism industry and shuttle trade with Russia, GDP growth rate fell from 8.7 percent in the first quarter to 3 percent in the second quarter and 2.4 percent in the third quarter.

The external shock of the Russian crisis, at the end of August 1998, had two important implications for Turkey. On the demand side, shuttle trade and exports to Russia received a large blow, reducing foreign demand in the economy at a time when domestic demand was very weak. On the financial side, the flow of short term foreign capital reversed, as liquidity dried up in international financial markets, especially for emerging economies, putting heavy pressure on both foreign exchange reserves of the Central Bank and interest rates.

Unfortunately, this is not the end of the story. In 1999, the capture of PKK leader Öcalan and his trial affected Turkish tourism greatly, leading to a substantial fall in the number of visitors and tourism revenues. Finally, in August 1999, a major earthquake hit the northwestern part of the country, claiming over 15,000 lives and causing large economic losses.

Table 5 summarizes the progress of the economy in 1998 and 1999 on a quarterly basis. The last two rows give the GDP growth rate and the current account balance. Most interesting are the top three rows, which represent monetary policy during this period. Let us begin by asking some simple questions. What is the normal response of monetary policy to a slowdown in the economy? You would expect it to loosen; that is, interest rates should go down. The monetary authorities try to alleviate the negative effects of the fall in domestic or international demand by lowering interest rates, thus raising domestic consumption and investment expenditures. Exactly the opposite happened in Turkey. The same logic applies to the exchange rate: surpluses in the current

account balance should lead to a slower nominal depreciation of the currency; yet again the opposite happened in Turkey.

Table 5

	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4
(as percentage)								
Nominal interest rate (O/N) (*)	120.1	105.9	102.4	119.2	117.0	115.7	101.0	100.8
FX basket depreciation (*)	90.1	49.7	28.7	68.0	74.8	64.7	50.3	84.6
Real interest rate (FX basket)	16.9	40.9	73.7	27.6	23.3	29.3	39.4	17.3
GDP Growth Rate	8.7	3.0	2.4	-1.4	-8.9	-1.8	-5.6	-6.1
Current Account (bill.US$)	-1.1	-0.2	1.4	1.7	1.3	-1.4	0.1	-1.4

(*) compounded annually

The paradoxical behavior of the monetary variables is a direct consequence of the dollarization of the economy. Faced with disturbances, real or imaginary, the reaction of the citizens is to increase their demand for foreign currencies. Any event perceived to have a negative effect on the economy immediately triggers a domestic attack on the Turkish Lira, and therefore forces the monetary authority to increase interest rates so as to convince citizens to not forgo the Turkish Lira. Under these circumstances, the objective of monetary policy is no longer output or price stability, but that of preventing a domestic attack on the currency before it leads to a meltdown in the foreign exchange markets.

Therein lies the real cost of persistent high inflation. Conditions that create the need for low interest rates, such as preventing a recession, also increase the risk of a domestic attack on the Turkish Lira, making things worse by requiring higher real and nominal interest rates. The actual figures for Turkey are in Table 5. While the economy was shrinking at an average rate of 6 percent throughout 1999, the real overnight interest rates averaged 25 percent or more.[9] Thus, with "phoney money,"[10] Turkey's solution to fight against deep recession is to increase the real interest rates.

Economic policy makers are paralyzed against stopping this vicious circle. Both external shocks and high interest rates reduce GDP, and therefore tax revenues. A bigger public deficit increases the risk premium on public Turkish Lira debt, leading to further hikes in the interest rates. The government tries to control the deficit by higher indirect taxes, pushing inflation up. Nominal depreciation of the currency follows, further

[9] The real interest rate is calculated on the official foreign exchange basket of "1 Dollar + 0.77 Euro" to minimize the impact of the dollar-euro parity fluctuations.

[10] In an op-ed, I made an analogy between high inflation and AIDS. In the latter, death results not from HIV, the virus that causes AIDS, but from otherwise non-deadly diseases, like pneumonia. High inflation itself may seem almost irrelevant when things are moving well for the economy, especially if the population has learned to protect itself from its visible negative effects. However, it amplifies the damage immensely once the going gets bad by the constraints it imposes on monetary and fiscal policy. See A. S. Akat, "AIDS Nasýl Öldürüyor?" *SABAH Newspaper*, 17 September 1995.

increasing both inflation and the "risk premium." Interest rates jump again, leading to further cuts in spending and the economy and policy makers are back to square one. This, in a nutshell, is the story of the great Turkish recession of 1999.

TAMING OF THE SHREW

The vicious circle described above also explains why disinflation suddenly became so visibly popular in Turkey by the fall of 1999. As the truth started to sink in that the recession would only get deeper unless a serious fight against inflation was initiated, Turks learned the hard way, thanks to the crisis, that the illusion of private salvation from inflation disappeared as soon as the economy hit rough seas. Meanwhile, the elections in April 1999 had produced a relatively strong coalition partnership headed by Bülent Ecevit. The new government's first and most urgent task was to return the Turkish economy to a path of healthy growth. Less than six months after the vote of confidence in the Parliament, the government signed a three-year Standby Agreement for a disinflation program with the IMF based on the explicit target of reducing inflation to single-digit figures by 2002.

The program is not only about reducing inflation. It also tries to achieve structural transformations, mainly in public finance, but also in other areas of the economy. Many of these transformations have either no, or very little, short-term direct impact on disinflation but will contribute to better economic performance in the long run. These include pension reform, large scale privatization, transparency of public accounts, rationalization of agricultural subsidies and better regulation of the banking sector. A detailed study of the reforms falls outside the scope of this paper.

The method used in the immediate fight against inflation further confirms this paper's main theme that Turkish inflation is fundamentally a "nominal anchor" problem. This problem originates from accommodating monetary and exchange rate policies and can be solved by redefining the currency through a strong "anchor" coupled with automatic mechanisms for self-correction. The IMF first proposed a currency board system to permanently resolve all aspects of persistent high inflation, pointing to the successful examples of Argentina and Bulgaria.[11] However, the proposal did not excite the corridors of power in Ankara. The compromise was the adoption of a quasi-currency board for the duration of the disinflation program with a gradual exit strategy starting in mid-2001 and ending in 2003.[12]

The program works as follows: Nine-months to a year in advance, the Central Bank announces the daily exchange rate of the "basket," reducing the exchange rate risk to zero for the period. For 2000, the annual nominal depreciation of the Turkish Lira against the basket was fixed at 20 percent, roughly one third of its level in 1999. The

[11] For online information on currency boards try www.erols.com/kurrency or www.stern.nyu.edu/~nroubini.

[12] For more information on the use of the exchange rate for disinflation see A.J. Hamann, "Exchange-Rate Based Stabilization: A Critical Look at the Stylized Facts," IMF Paper WP/99/132, October 1999.

government also announced indicative inflation targets for 2000 of 20 percent and 25 percent for the Wholesale Price Index (WPI) and the Consumer Price Index (CPI), respectively. WPI inflation will go to 10 percent for 2001 and 5 percent for 2002, the last year of the disinflation program. At the same time, all discretion is taken away from monetary policy, with well defined "performance criteria" on the Central Bank balance sheet, implying that money creation is strictly limited to purchases of foreign currency by the Central Bank. For all practical purposes, for 18 months from 1 January 2000 through 1 July 2001, Turkey has a currency board.

The end of the currency board starts in July 2001, when the exchange rate is allowed to move within a band. In the second semester of 2001, the exchange rate will be allowed to fluctuate within a 7.5 percent band, which will gradually increase to 22.5 percent in the last semester of 2002. The band will disappear altogether in 2003 as the Central Bank regains its full authority for discretionary monetary policy.

Typical IMF-backed programs place strong emphasis on tight fiscal policy. Most of the performance criteria relate to the budgetary and non-budgetary outlays of the public finances. A word of caution: tight fiscal policy does not play a direct role in disinflation but works towards the containment of domestic demand to prevent the formation of a "bubble", as the Turkish Lira undergoes real appreciation in the early phases of the program. This is vital because a buoyant domestic demand coupled with an overvalued currency will result in large and unsustainable current account deficits, which in turn may force premature devaluation on the currency after 2001 or 2003. This devaluation could reignite the inflationary spiral before the economy settles into its low inflation path.

As soon as it became operational, the "nominal anchor" produced the expected results. In a matter of weeks in January 2000, overnight interest rates fell from above 100 percent to below 40 percent—further proof that the high real interest rates reflected the high risk premium attached to the Turkish Lira by the markets and not the real saving-investment supply and demand imbalances. A bold step away from "phoney money" towards sound money was sufficient to lower interest rates to unheard-of levels. The fall in the CPI and WPI was slower, as can be expected for an economy with such a long history of high inflation. Nevertheless, it is fair to assume that year-end inflation will at least halve to around 30 percent by the end of the first year of the disinflation program.

WHO IS TO BLAME?

We have already identified two categories of social actors as being responsible for the persistence of inflation. The first were the politicians, who understood the freedom of action offered by the thick fog created around the public finance figures by high inflation, which allowed them to pursue populist policies without having to worry about the immediate reactions of the markets and the public opinion. The second were the citizens, whose illusions of individual salvation from the negative effects of high inflation through

dollarization resulted in a high degree of apathy or benign neglect towards inflation. However, with these two classes, the picture is far from complete.

The third social actor, not mentioned above, but whose silent accommodation of the inflationary process has nevertheless been the ultimate cause of its persistence, is the bureaucratic establishment of Ankara. Not the hundreds of thousands of clerks and low grade civil servants who fill the over-manned layers of the capital city, but rather, the elite corps of sophisticated *inspecteurs de finance* who monopolize the top jobs in the Treasury and the Central Bank.[13] The political economy of Turkish inflation is not intelligible without analyzing their attitude as well as the incentive system through which they operate.

This analysis of Turkish inflation must have already caused serious question marks in the minds of those readers familiar with the experiences of other countries with similar problems. If inflationary pressures from the fiscal deficits were negligible as the figures in Table 3 imply, why did the Treasury-Central Bank bureaucracy so willingly accommodate high inflation through monetary and especially exchange rate policies? What prevented these officials from undertaking a program similar to the one implemented with the IMF in 2000 two or three years ago, preventing the very painful contraction of the economy in 1998-99?

The key to the puzzle can be found in the behavioral constraints and the attitudes of the bureaucracy: I wish to highlight two factors. The first involves the "risk-averse" characteristics common to all public servants in Turkey due to the incentive system inherited from the Ottoman administration ("kapýkulu"). In this system, the rule is to maximize job security instead of public interest. The whole system works on the basis of "negative selection," promoting those taking no initiative and risking no failure. An active foreign exchange rate policy to reduce inflation carries certain risks; whereas a risk-free rule, such as “depreciation of the Turkish Lira in line with inflation,” continues to accommodate inflation.

The second is the widespread fear, firmly engraved in the minds of the Turkish elite, of a pending shortage of foreign exchange. This fear is aggravated by the real possibility of a domestic attack on the Turkish Lira because of dollarization. Bureaucrats know that an exchange rate and/or availability of foreign exchange problem will be very visible and that they will be held responsible by both the public and the politicians. Not only will it take longer to realize that a severe economic contraction is taking place, but the link between the recession and the monetary and exchange rate policies will not be visible to the naked eye. Therefore, it is much easier to put the blame on other factors (e.g.: the crisis in Asia, then in Russia, then the budget deficit and so on). This, in my opinion, along with the risk aversion mentioned above, goes a long way in explaining the

[13] The "Treasury-Central Bank complex" also has very close ties both with the industrial-financial establishment and politics: when they retire in their mid to late 40s, the mandarins of finance take executive or consultancy jobs in the larger institutions of the private sector or become members of Parliament and even Ministers.

bizarre monetary and exchange policy response to domestic and external disturbances after 1998.

Finally, we must introduce the last social actor into our analysis: the business community. Why did the business community, which should suffer the most from high interest rates and output volatility resulting from inflation, remain passive and not mobilize its remarkable lobbying power towards disinflation? I have two hypotheses. One is the divisions within the business community and lack of powerful central organizations, which represent them and project their vision in the public sphere. The other is the illusion, inherited from the days of the closed command economy, that inflation is not all that harmful to the interests of the bosses. Whatever the causes, the end result is the same: businessmen felt no strong urge to fight against inflation, but rather attempted to learn to live with it.

The aim is not to dissolve successive governments, who alone bear the final responsibility of the persistence of high inflation during the last two decades, but to show that there was no substantiated demand, either from the citizens, the bureaucracy or the business community, for a hard stance by the politicians against inflation. After all, politics is the art of knowing to do the right thing at the right time. When nobody really wanted them to fight against inflation, politicians simply followed the popular sentiment and did nothing.[14]

CONCLUDING REMARKS

This article, concentrating on the purely economic aspects of Turkish inflation and neglecting all other social and human damages caused by the absence of a sound and stable national currency, tells but one side of the story. Yet, these other costs are probably more important in the long run. Two decades of high inflation worsened the already bad distribution of income, increased urban and rural unemployment and underemployment, and thus contributed to the erosion of the ethical and moral values of the society during a period of difficult social transformation. For the economist, Turkish inflation is a case study; for everyone else, it is much more.

Can we seriously expect the disinflation program to deliver results? Can we imagine Turkey with single digit inflation in only a few years time? The severity of the crisis and the impotence of economic policy in 1998-99 have produced a new consensus to reduce inflation to reasonable levels. The answer is a qualified "yes."

[14] There is a catch: lower income groups might not have been satisfied with this turn of events. The three mainstream political parties that monopolized government during this period (Motherland, True Path and the Republican People's Party) have seen their combined share of the national vote fall from 70 percent in 1991 to 35 percent in 1999, most of the defections taking place are among the less affluent voters.