

Is Turkey the next Argentina?
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Modernizing economies II

ANKARA Foreign money has been pouring into Turkey at a rapid pace, fueling an economic expansion that has many investors and analysts praising the country's policies and reforms. But those who remember a similar excitement about Argentina in the early 1990s, which was followed by one of the most disastrous collapses in Latin American history, should be wary.

The parallels are striking. Argentina's growth in the early 1990s was also spurred by foreign capital inflows, and it also led to an overvalued currency that helped destroy the country's manufacturing base. And even during the country's growth years, when it was the poster child of the International Monetary Fund, there was little job creation.

Turkey's economy actually shrank in the years 1998-2001, with a 9.5 percent plunge in the last year. In response to the crisis, the government borrowed heavily from the IMF - \$31.8 billion between 1999 and the present - and adopted a set of policies that the IMF advocated. These policies brought about very high real interest rates, reductions in the government's fiscal authority and spending, an increase in foreign borrowing, a floating exchange rate and a rise in the local currency. They also resulted in privatization of state-owned industries (and consequent unemployment), and a removal of agricultural and other subsidies.

Supporters of these policies point to the economic recovery since 2001. The Turkish economy grew by an average of 7 percent annually in 2002-3, and is expected to have grown at the same rate in 2004. Inflation, which was at 68.5 percent in 2001, has been brought to a projected 11.4 percent for 2004.

But beneath these numbers, a crisis looms. The expansion has been driven by a huge inflow of capital from abroad, \$10.9 billion in 2003 (4.6 percent of the economy) and \$12.5 billion in just the first eight months of 2004. These are overwhelmingly speculative, short-term inflows - not direct investment, for example, which would expand the country's productive capacity and create jobs. Foreign direct investment has in fact fallen since 2000. The country is very vulnerable to a serious economic downturn when the inflow of foreign money goes dry.

These kinds of massive speculative capital inflows have a habit of reversing themselves, as they did in Asia in 1997, setting off the Asian financial crisis and a regional depression. In such situations, investors eventually begin to worry about the sustainability of such borrowing and debt. Any number of external events could trigger such an exodus from Turkey: For example, if U.S. and world interest rates rise, as they undoubtedly will from their current historic lows, safe assets like U.S. Treasury securities will become much more attractive.

The influx of speculative money from abroad has also pushed the Turkish currency, the lira, to an overvalued level. This, too, is a bubble waiting to burst. In the meantime it has devastated traditional Turkish industries that are typically labor-intensive by making imports artificially cheap, thus aggravating the unemployment problem. The lira had risen 139 percent against the dollar between 2000-2003.

The country's public debt is unsustainable at 70 percent of the economy. In order to sustain it presently, the IMF has the government running a primary (excluding interest) budget surplus of 6.5

percent. This is extremely high (compare it with 3.0 percent for Argentina and 4.25 percent for Brazil), and prevents the government from making necessary investments in human capital and infrastructure.

Another devastating part of the IMF program is high interest rates: The Treasury's debt instruments that are the leading assets in the Turkish financial markets carry an interest rate of 26 percent, still very high at 15 percent in real, inflation-adjusted terms. Compare this with 2 percent in the United States - it is easy to understand why businesses in Turkey are reluctant to borrow and invest in productive capacity.

In short, the policy makers have created an economy that runs on a speculative bubble. It would be nice if a majority of the Turkish people at least got some of the benefits of bubble-driven growth for as long as it lasts. But unfortunately, this has not been the case. Since 2000, the unemployment rate has risen by almost 4 percentage points to 10.5 percent, and real wages have actually fallen.

As Turkey and the European Union continue talks on the possibility of EU accession, the Turkish government should re-examine its unsustainable economic policies of the last five years. Continuing these IMF-supported policies in hopes of garnering credibility with the EU may be dangerous. Ironically, such policies could lead to an economic failure that would actually doom Turkey's chances for membership.

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