THE EFFECTS OF RUSSIAN CRISIS ON TURKISH ECONOMY

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Turkish economy showed a strong growth performance during the last decade except the downswing of 1994 when the GNP contracted by more than 6 percent. The crisis of 1994 was fuelled from the financial sector and contaminated to the real sector in a short period of time.

Before 1994, high and chronic public deficits (a record high in 1993 with 12% of GNP) was the biggest problem of the economy and there were serious difficulties in rolling over the short term domestic debt stock and an upward pressure on interest rates. Under the managed float regime, the currency was misaligned due to the massive capital inflows mainly in short term nature as a result of high real interest rates. This led to a mild overvaluation of domestic currency.

A policy mistake of financing public deficits through the Central Bank resources triggered the crisis. A huge depreciation of currency due to a runaway from the Turkish Lira had to be put in place and the interest rates increased. As a result the inflation skyrocketed. Soon, a comprehensive program was introduced including mainly short term measures. Introduction of additional taxes and imposing discipline on fiscal policy resulted with an improvement public balance. Moreover, exports recovered quickly whereas import demand fell down dramatically. All the measures helped to increase national saving, decrease saving-investment gap and the current account balance turned to surplus by the end of 1994 after several years of deficit. The economy recovered quickly in the following year, and three consecutive years from 1995 to 1997, average growth rate reached to around 8 percent. During

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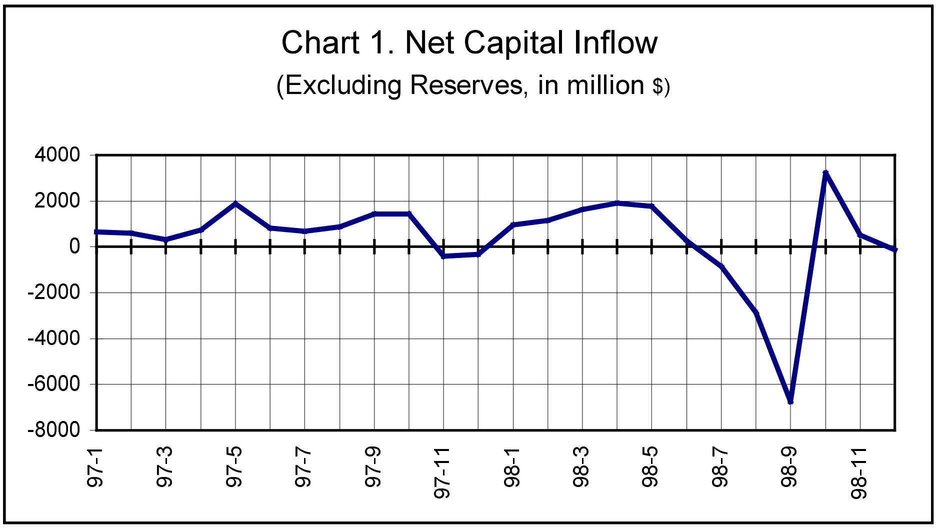
the years after the crisis, Turkey could achieve little in terms of solving her big problems like inflation and high public sector deficits. Despite short term improvements such as primary surplus in public balance, high and increasing interest payments due to high real interest rates continued to be a major problem. High interest rates together with a stable domestic currency again attracted foreign capital mainly in shorter term. Unfortunately, Turkey was late and not successful in the implementation of structural reforms, like privatization, social security reform, agricultural support price reform and banking sector reform. Due to mainly high backward indexations and high inflationary expectations together with highly deteriorated public balance, inflation had been a chronic problem. During a period when the fundamental problems have not yet been solved, the international financial crisis emerged.

Effects of the Crises

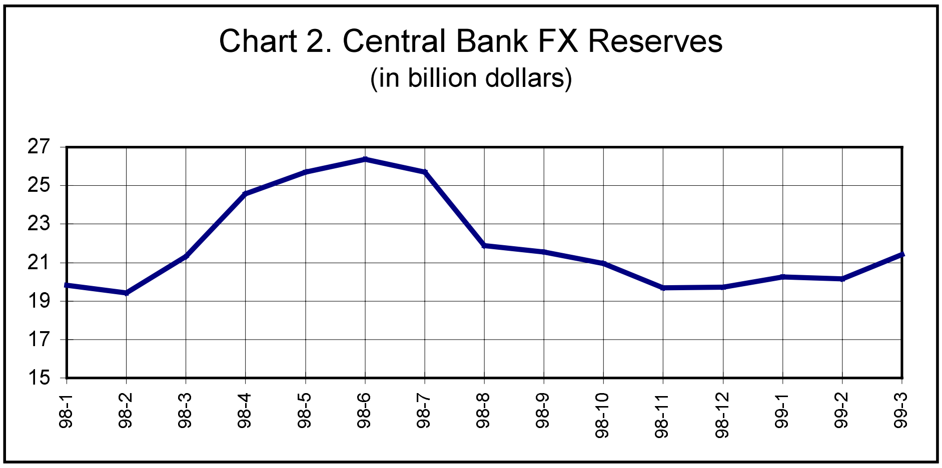
Turkey, like many other emerging market economies was exposed to serious amount of capital outflows as a result of the behaviour of cautious investors, especially after the Russian crisis. Since international investors accepted Turkey within the same category of portfolio investments as Russia, Turkey faced with an immediate capital flight right after the Russian crisis. The only impact of the international financial crisis on the Turkish economy was not through capital flight.

Together with the capital outflow, goods prices in international markets had fallen down after a series of devaluation of currencies of Asian countries and Russia, which means higher competition for Turkish export goods. Due to a decline of total income in Russia, demand for Turkish goods in Russian markets decreased dramatically as well. On the other hand, the tourism sector also recessed in 1998, due to smaller number of tourist arrivals especially from Russia and increased competition from other Mediterranean resorts.

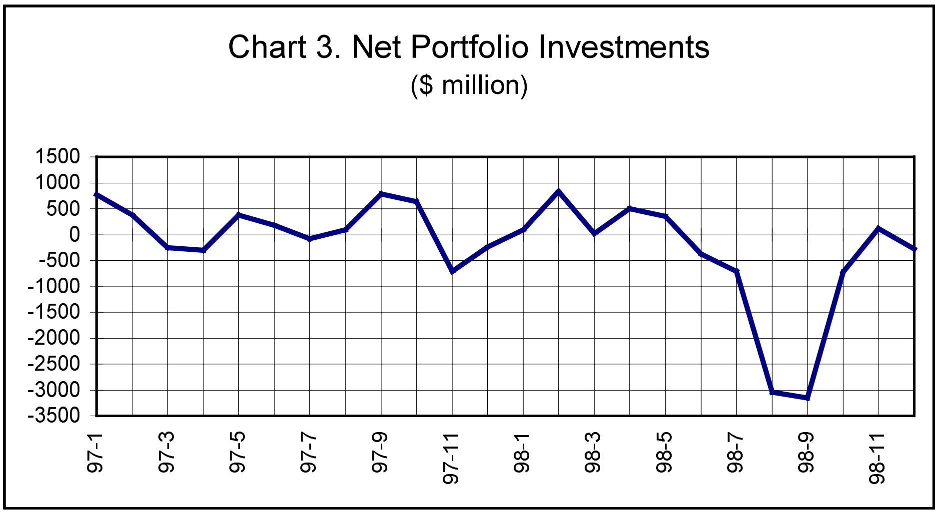
There was more or less stable net capital inflow on a monthly basis during 1997 and early 1998. However, Turkey experienced a net outflow of capital amounting to $ 10.5 billion during the period of July-September 1998 (see Chart 1). As a result, net capital inflows declined sharply to 905 million dollars during 1998 from 8700 million dollars in 1997.



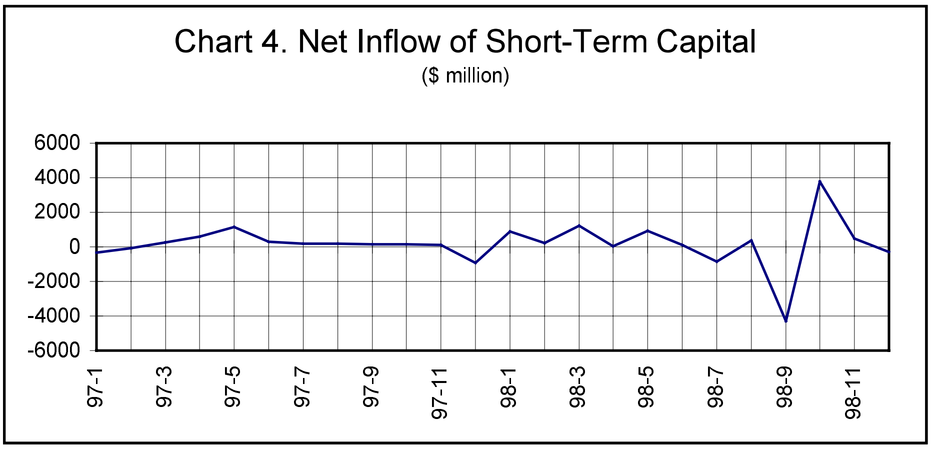
Such unfavourable developments led to a decline in foreign exchange reserves. The Central Bank FX reserves eroded by $ 3.8 billions in August 1998, and continued to decline gradually during the following months. However, there is a sign of accumulation starting by the end of 1998 (see Chart 2) .



Among the capital account items, net portfolio investment and net short term capital inflows were highly affected from the crisis. Portfolio investments which were volatile during 1997 and in the first half of 1998, declined strongly in August 1998. Literally, 6.4 billion dollars of portfolio investment was withdrawn in 1998 compared to a $ 1.6 billion of portfolio investment in 1997 (see Chart 3).

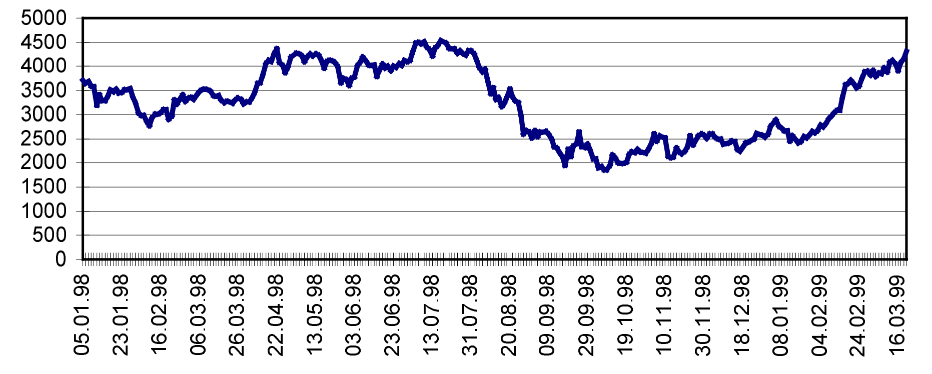


On the other hand, flow of net short term capital began to fluctuate largely after the Russian crisis. In September 1998 short term capital amounted to 4.3 billion dollars flew out. However, there was an inflow of $ 3.8 billion of net short term capital in the following month of the same year (see Chart 4).



Similar to the developments seen in stock exchange markets of the other emerging markets, the Istanbul Stock Exchange (ISE) 100 Index declined as a result of increasing uncertainty. It is possible to follow the footprints of consecutive crises on the stock market prices. Although the stock prices exhibited waves of decline after Southeast Asian crisis in October 1997 and Gulf Crisis in February 1998, the foremost impact was seen after the Russian crisis. As a result, the composite index of ISE dropped more than 57 percent during the July-October 1998 period (see Chart 5).

Chart 5. Istanbul Stock Exchange (ISE) Composite Index (Closing)

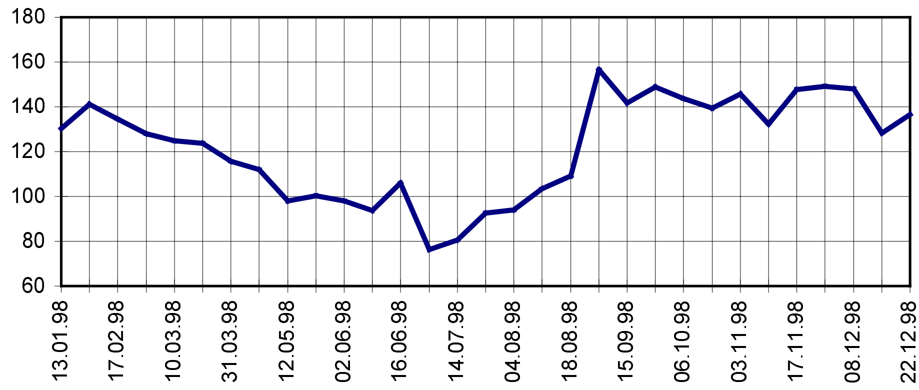


In the first half of 1998, there was a substantial inflow of foreign capital and as a result of that the official reserves increased by around 8 billion dollars. The Central Bank conducted a monetary policy in order to sterilize the excess liquidity created through foreign exchange transfers to and purchases by the Central Bank. The Central Bank, in the first half of the year, chose the change in the reserve money as a target of the monetary program. However, due to the rapid increase in the reserves this target cannot be achieved because the Central Bank faced with difficulties in sterilizing the increase in the reserve money. Thus the Central Bank changed the target aggregate of the monetary program in the second half of the year, and chose the level of the net domestic assets as a target. But due to the negative impact of the Russian crisis, there was an increased tendency of the foreign capital to flow out. This created an outflow of capital around $ 10.5 billion in the third quarter of 1998 and as a result, a fall in the official reserves by 6 billion dollars in the second half of the year.

The change in the international economic environment caused difficulties in achieving the targeted levels of net domestic assets in the balance sheet of the CB. During the period when the reserves were falling, the CB had to supply the market with foreign currency which led to a liquidity squeeze. In order to overcome the shortage of liquidity and facilitate the borrowing of the Treasury the CB funded the markets through OMO. These changes in the monetary policy made it difficult to achieve the monetary targets but made it possible not to plunge into the crisis.

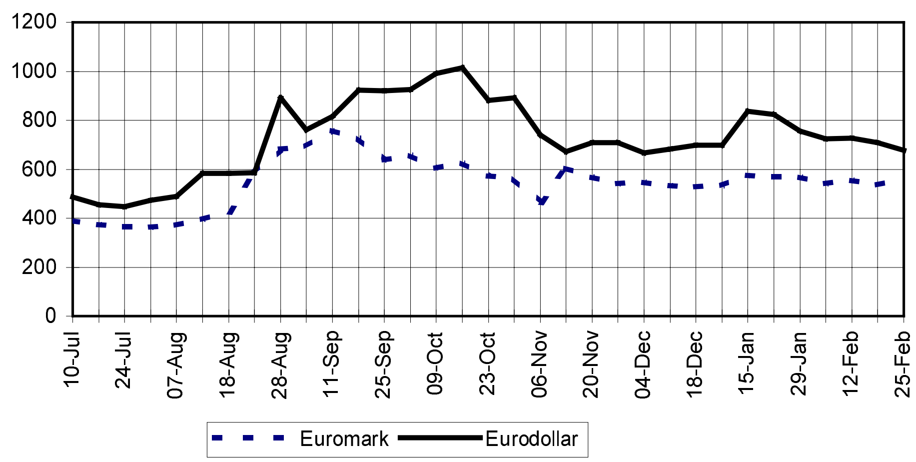
Capital flight in August 1998, as a result of the Russian Crisis created a liquidity shortage in the domestic market which led the interest rates to rise sharply. Overnight rates, Treasury auction rates (see Chart 6), secondary market rates as well as time deposit rates displayed parallel rises. High interest rates realised in Treasury auctions increased the interest burden of the budget which eventually led to a rise in the borrowing requirement. While inflation had a downward trend, such an upward pressure on interest rates increased real interest rates seriously.

Chart 6. Compound Interest Rates in Treasury Auctions
(annual, %)



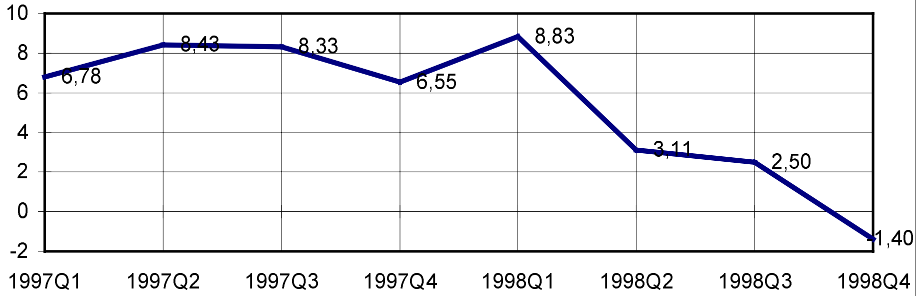
On the other hand, due to the widened uncertainty, spreads on Turkish government bonds issued in international markets increased like the other emerging markets' instruments (see Chart 7). The spread on Eurodollar bond with 10 years of maturity reached to 1014 basis points (bp) in October 10 from 474 bp at the end of July 1998. Likewise, the spread on the Euromark bond with the same maturity increased from 370 bp to 757 bp between July 31-September 11.

Chart 7. Spreads on Turkish Bonds
(basis points)



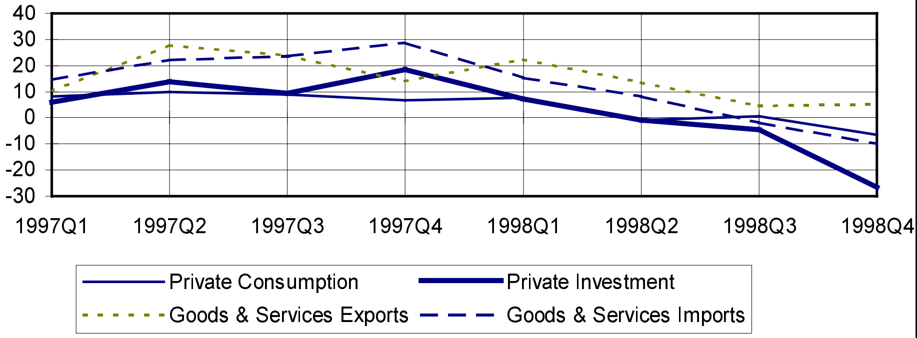
As a result of the contraction in external and internal demand, Turkish economy experienced a decline in economic activity. Real GDP growth which was 7.5 percent in 1997 fell down to 2.8 percent in 1998. 8.7 percent of growth rate in the first quarter of 1998 compared to the same quarter of the previous year, replaced by 3.1 percent in the second quarter and then 2.5 percent in the third quarter. Furthermore, in the last quarter of 1998, the economic activity contracted by 1.4 percent (see Chart 8). Although the data are not available yet, early indicators such as the industrial production index imply the continuation of contraction in the first quarter of 1999.

Chart 8. Quarterly GDP Growth Rate
(% change compared with the same period of previous year)



Among the components of GDP, private investment shows the biggest contraction with 26 percent during the last quarter of 1998, followed by a 10 percent decline in imports of goods and services and a 6.5 percent decline in private consumption in the last quarter of 1998 (see Chart 9).

Chart 9. Growth of GDP Components
(% change compared with the same period of previous year)



The most important and direct effect of Southeast Asian crisis on global economy was through changes in prices of traded goods. After a series of devaluation of the currencies of emerging market economies, export prices of these countries decreased dramatically. This was an important channel of contagion of the crisis to other parts of the world. Primary commodity prices went down, and those economies depended highly upon the exports of primary goods found themselves in trouble with declining revenues. Being one of those economies, crisis hit the Russian economy more than the others.

After the collapse of the Soviet Union, Russia has become one of the biggest trading partner of Turkey. In 1997, exports to Russia ranked as the second with an amount of $ 2.1 billion, following the exports to Germany. In addition, unofficial 'shuttle' trade, amounted to $5.8 billion in 1997 is quite important for Turkey's trade balance. Since most of this trade is conducted with the CIS (Commonwealth of Independent States) countries, the Russian crisis has caused a sharp decline in unofficial 'shuttle' trade. At the end of 1998, official exports to Russia declined by 35 percent compared to the year before, whereas total 'shuttle' trade was down by $2.1 billion in 1998.

Following the consecutive devaluations of many currencies, together with the fall in total demand in Russia, international markets became more competitive. This created two effects on Turkish exports. First, some of the exporters failed in competing and had to leave the market. Second, the survivers earned little because of low export prices As a result, total exports declined in nominal terms although it did not show a big decline in volume.

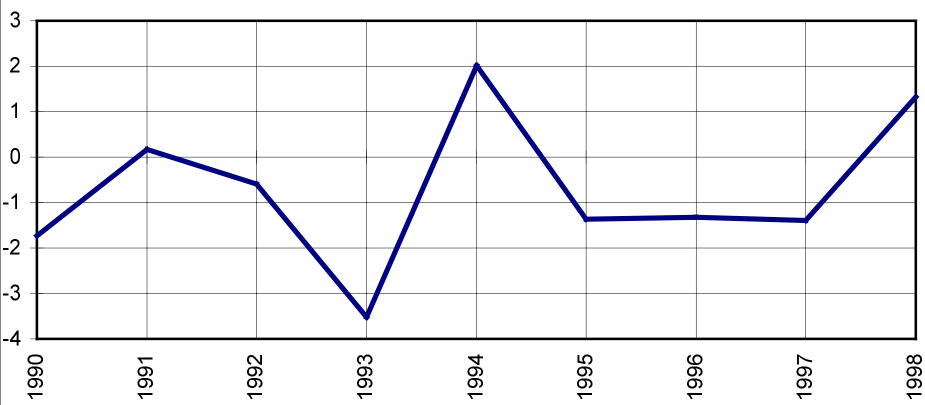
Terms of trade did not change too much as a result of firstly the parallel movement of export and import prices, and secondly highly diversified structure of Turkish foreign trade.

Despite a slowdown in exports in 1998, the trade deficit shrunk, as a result of a decline in imports exceeding the decline in exports (see Chart 10). This is mainly due to the domestic recession. Another conractionary effect on the trade deficit was coming from a decline in oil and raw material prices since they have an important part in Turkey's imports. The trade deficit reached to $ 22.3 billion in 1997, however it declined to $ 19.7 billion by the end of 1998.

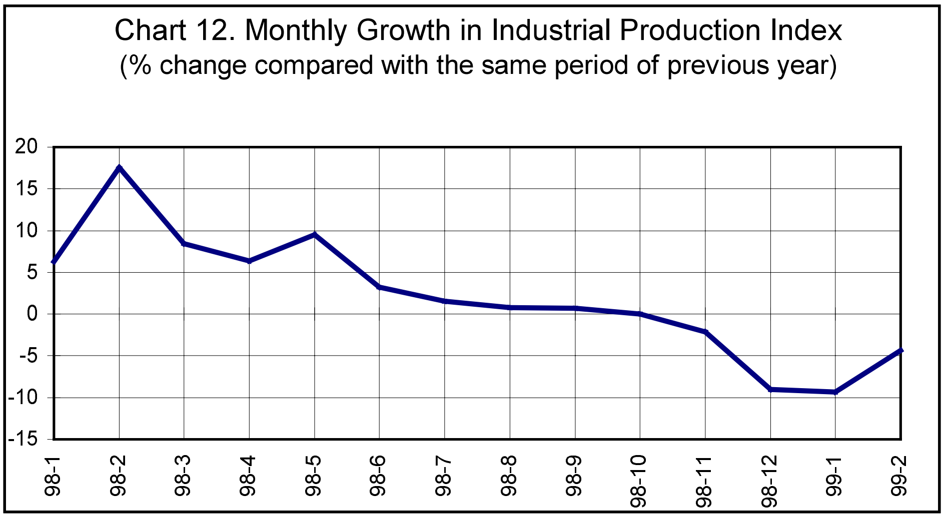
Chart 10. Merchandise Exports and Imports
(% change compared with the same period of previous year)

FX transfers from Turkish workers living abroad increased significantly in 1998, although the income of Turkish contractors in Russia was negatively affected due to a decline in total demand following the crisis and the delays in payments of finished contracts. Smaller trade deficit together with larger transfers from the workers abroad and an improvement in 'other invisible trade', led to a significant improvement in the current account balance. In 1998, the ratio of current account surplus to GNP reached to 1.3 percent, following a deficit of 1.4 percent in 1997.

Chart 11. Current Account Balance/GNP (%)



Uncertainty in external demand conditions and rising real interest rates due to credit shortage led to a fall in production, especially in the industrial sector. During the period May-October 1998, the growth rate of industrial production declined. Following that period, the industrial production fell below the level of previous year.



The downturn was especially seen in the manufacturing industry, notably in textiles, automotives, paper and publishing and fabricated metals. The textile industry is particularly exposed to competition from Asian countries. In recent years, Russia has become one of Turkey’s main export markets for textiles, clothing and leather goods. Thus, the fall in Russian demand has a direct impact on the demand for the Turkish textile products. As a result of that, textile production fell around 30 percent towards the end of 1998 compared to the same period of previous year on a monthly basis.

In the face of this deterioration in the real sector, the banking sector which is negatively influenced by the capital outflow in the third quarter has also been faced with growth in nonperforming loans portfolio.

Past and current experiences influenced the expectations in the business sector. It can easily be seen from the Business Survey results of the Central Bank. The expectations about the future of the economy and about export possibilities worsened dramatically in the last quarter of 1998 (see Charts 13 and 14).

Chart 13. Change in Expectations in the General Course of the Economy in Coming Month (Business Survey of the CB, % balance of better and worse responses)

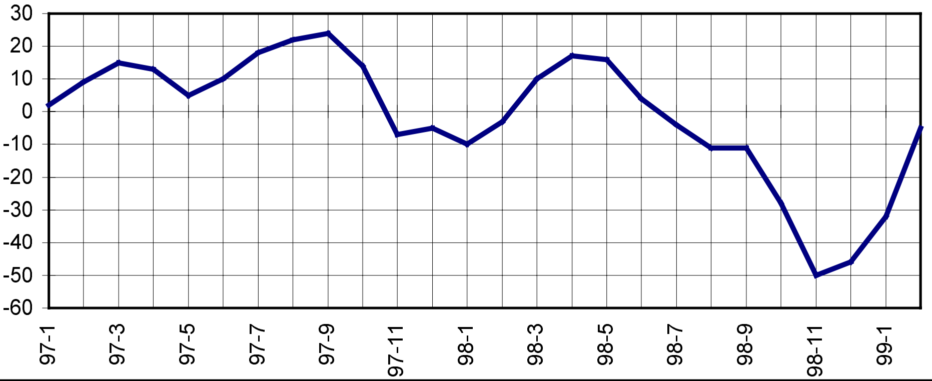
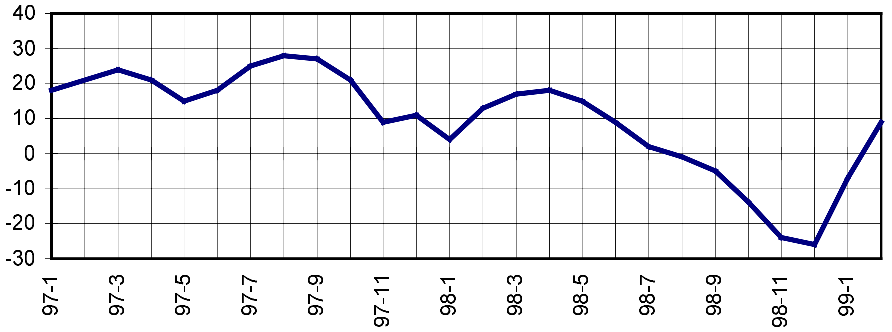
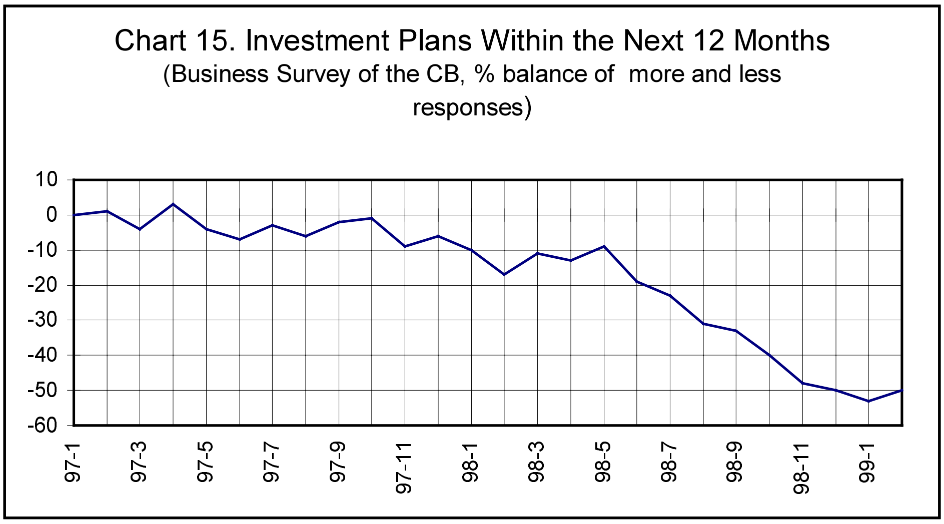


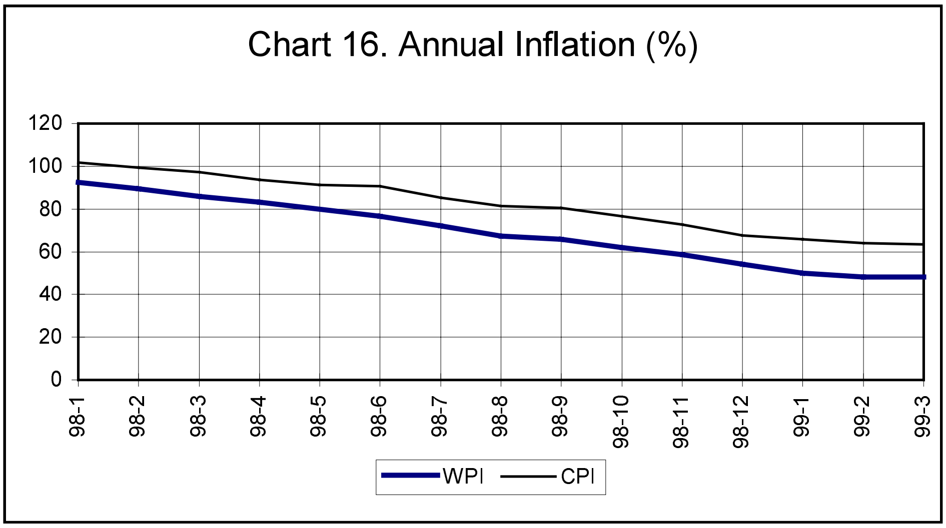
Chart 14. Export Possibilities in the Coming Month (Business Survey of the CB, % balance of better and worse responses)



The general course of the economy and the expectations together with the problems faced in financing also affected the investment decisions in Turkey. During the second half of 1998, increasing number of business people declared that they will reduce their investment in the following 12 months compared with the previous year.



Following the slowdown in demand factors of the economy, inflation has started to decline since the beginning of 1998. Consumer price inflation fell down from above 100 % to 63.5 % during the period of January 1998-March 1999 on an annual basis. Likewise, wholesale price inflation fell from 92.5 % to 48.2 % during the same period (see Chart 16). Other factors that cause the decline in inflation rate are the reduction in oil and commodity prices in dollar terms, slower growth in labor costs and moderate increases in prices of goods produced by the public sector.



Conclusion and Expectations

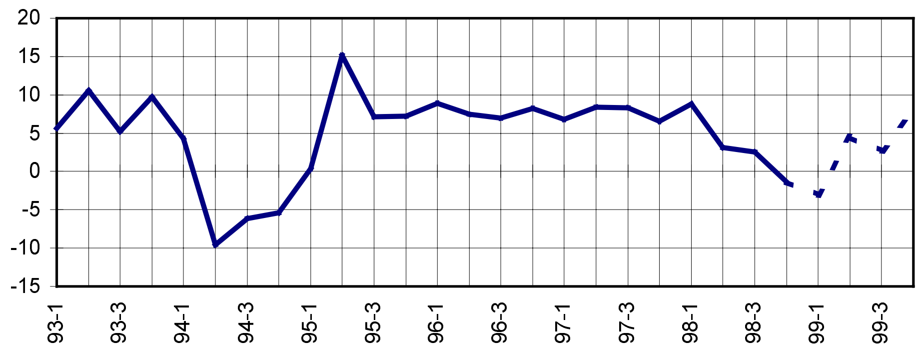
Even though the Turkish economy was not in the middle of them, consecutive crises in the world markets created big impact on the Turkish economy. After the Russian crisis, almost all of indicators except inflation and current account balance displayed deterioration. However, high flexibility of monetary and exchange rate policies prevented Turkey to fell deeper into the crisis. Moreover, the staff monitoring program of the IMF launched together with the high level of budgetary discipline imposed upon the government throughout 1998 have contributed positively to the strength of the country against the tide of financial instability culminating from the Russian crisis.

Economic agents expect that the economic activity as a whole will gain acceleration starting from the second quarter of 1999. Most of the indicators justify our expectations regarding an output recovery process.

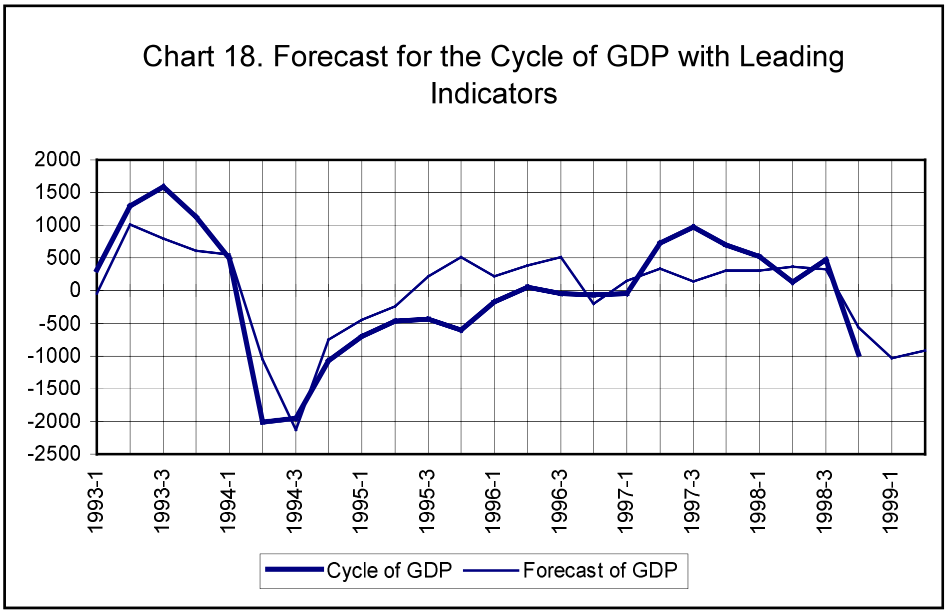
Moreover, the forecasts produced by the Treasury Macroeconometric Model of Turkey and the trends in leading indicators for production and demand factors of national accounts support the expectations about the recovery of the economy. The model results indicate increasing GDP growth rates starting from the second quarter of 1999, mainly due to the expected recovery in private consumption (see Chart 17).

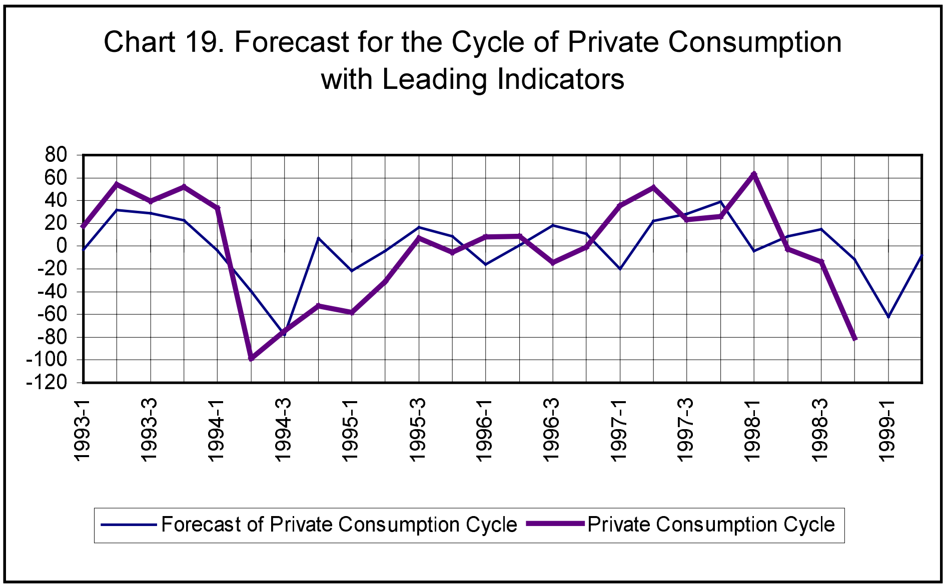
Chart 17. GDP Quarterly Growth Rates

(% change compared with the same period of previous year, Model forecast after 1998)



Similarly, a cycle analysis of leading indicators for the GDP and private consumption shows a slight turn in those indicators following the second quarter of 1999 (see Chart 18 and 19).





However, we believe that the economy will continue to be vulnerable, unless a policy package to solve the structural problems of Turkey decisively conducted. It has to be noted that to address various structural problems of the Turkish economy, a broad consensus was reached on the building blocks of such a policy package. In fact, starting from the banking reform bill, a series of bills are ready to be sent to the new Parliament.

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