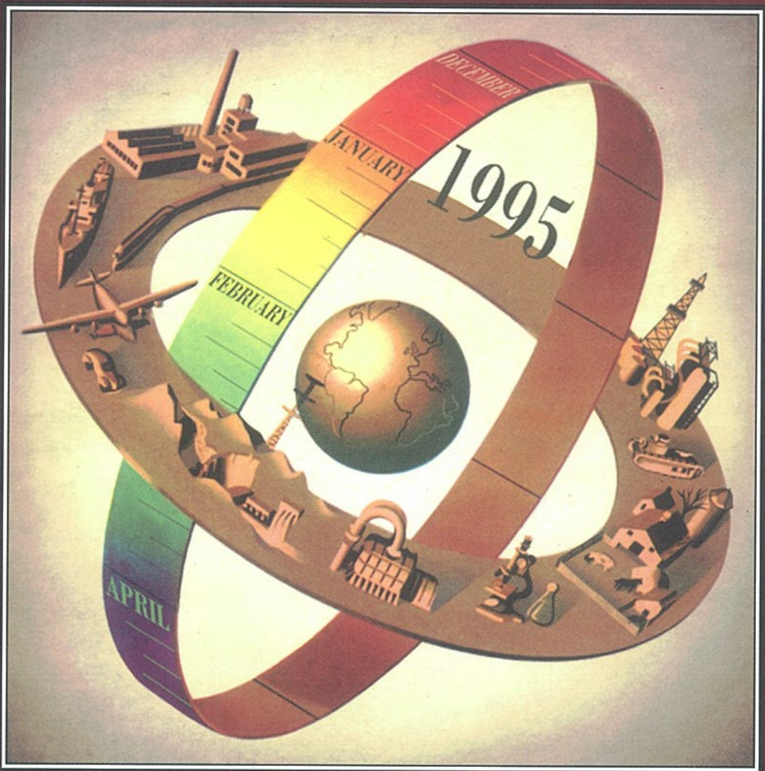
TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION



THE TURKISH ECONOMY AT THE BEGINNING OF 1995

(Executive Summary)

TÜSİAD

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FOREWORD

TÜSİAD stands for "Türk Sanayicileri ve İşadamları Derneği" ("The Turkish Industrialists' and Businessmen's Association") which was founded in 1971 by a group of leading names in Turkish industry and business. TÜSİAD is an independent, non-profit institution whose primary purpose is to promote public welfare. TÜSİAD is scientific and objective in its researches. It is emphasised that this study does not necessarily reflect the views of the TÜSİAD members nor, of course, is it to be considered in any way whatever to be an official publication.

This report which is the English translation of the executive summary of a 125 pages TÜSİAD report at the same title, was prepared by the TÜSİAD Research Department.

FEBRUARY 1995

MAIN ECONOMIC INDICATORS

Main Economic Indicators	Unit	1991	1992	1993	1994*	1995**
Growth Rate						
GNP (at 1987 prices, new series)	% change	0.4	6.4	7.6	-3.8	4.4
Agriculture		- 0.9	4.3	-2.2	-2.5	2.8
Industry		2.7	5.9	8.2	-1.9	4.9
Services		0.6	6.5	10.0	-3.2	4.3
Sectoral Distiribution	% share					
Agriculture		15.2	15.0	14.4	13.2	13.0
Industry		25.9	25.6	25.4	26.5	26.7
Services		58.8	59.4	60.2	60.3	60.3
Population 000 persons		57,326	58,584	59,869	61,183	62,526
GNP Percapita	$	2,675	2,786	2,933	2,761	2,821
Expenditures						
Fixed Capital Investments	% change	-1.0	1.3	4.9	-15.7	5.7
Public		3.2	1.1	-2.5	-28.4	5.8
Private		-4.1	1.4	10.7	-10.6	5.7
Total Consumption % change						
Public		2.1	9.5	13.3	-3.1	2.3
Private		1.5	1.9	7.6	-2.8	2.5
GNP Deflator	%	59.2	63.5	62.5	116.0	41.5
Unemployment Rate	%					
Total		7.4	8.0	7.3	8.3	
Urban		12.1	12.1	11.2	12.9	
Rural		3.9	4.7	4.1	4.6	
Inflation Rate	%					
Wholesale Price Index (12 months average percentage change)		55.3	62.1	58.4	116.0	41.5
Consumer Price Index (12 months average percentage change)		66.0	70.1	66.1	101.0	
Public Sector Balance (As a percentage of GNP)	%					
Public Sector Deficit		10.4	10.6	12.1	7.5	5.1
Budget Deficit		5.3	4.3	6.9	3.5	3.3
SEES' Deficit		3.1	3.3	2.5	2.1	1.6
Others		1.7	3.0	2.6	1.9	0.2
Consolidated Budget	TL, Trillion					
Budget Revenues		97	174	351	770	1,133
Budget Expenditures		130	222	485	909	1.331
Budget Deficit		34	48	134	139	198
Domestic Debt Stock	TL, Trillion					
Government Bonds		33	86	190	223	
Treasury Bills		18	42	65	272	
Public Sector Papers		52	129	254	495	
Central Bank Advances		16	31	70	106	
Exchange Rate Differences		32	35	32	125	
Total		99	195	357	726	

Main Economic Indicators	Unit	1991	1992	1993	1994*	1995**
Interest Rates (Simple average)	%					
Government Bonds		72.1	75.4	86.3	115.0	
3-months Treasury Bills		68.4	74.4	69.8	105.0	
Exchange Rates						
(12-months average percentage change)	%					
US Dollar		73.0	68.0	63.0	170.0	42.0
D.Mark		55.0	74.0	52.0	192.0	
Reel Exchange Rate	%					
(Dolar/WPI, 1987=100, 12 months average percentage change)		-4.3	-4.0	-0.6	-28.0	-2.6
Monetary Indicators	%					
(Changes with respect to the end of the previous year)						
				November		
Banknotes Issued		45	71	71	86	
M1		44	68	62	85	
M2		61	63	49	125	
M2Y		78	88	77	136	
Foreign Exchange Deposits/M2Y		29	37	47	49	
Total TL Deposits		67	65	46	131	
TL Credits of Deposit Banks		53	78	82	21	
Foreign Trade	$ Billion					
Exports		13.6	14.7	15.3	17.5	19.5
Imports		21.0	22.9	29.4	23.0	27.0
Trade Deficit		7.4	8.2	14.1	5.5	7.5
Balance of Payments	$ Billion					
Foreign Trade Balance		-7.3	-8.2	-14.2	-4.6	-6.5
Balance of Invisibles		7.6	7.3	7.8	6.7	6.9
Current Accont Balance		0.3	-0.9	-6.4	2.1	0.4
Current Account Balance						
(As a percentage of GNP)	%	0.2	-0.5	-3.6	1.6	0.2
Capital Movements	$ Billion	-2.4	3.6	8.9	-1.9	0.7
Direct Investments		0.8	0.8	0.6	0.4	0.8
Long-term Capital Movements		-0.2	1.4	5.2	1.3	1.3
Short-term Capital Movements		-3.0	1.4	3.1	-3.6	-1.4
International Reserves	$ Billion					
Central Bank Foreign Exchange Reserves		5	6	6	7	
Commercial Bank's Foreign Exchange Reserves		6	8	10	9	
Total		11	14	16	15	
Outstanding Foreign Debt Stock	$ Billion					
Long and medium term		41	43	49	53	
Short term		9	13	19	12	
Total		51	56	67	65	
Foreign debts (As a Percentage GNP)						
Long and medium term		27.0	26.3	27.8		
Short term		5.9	7.8	10.5		
Total		32.9	34.1	38.3		

* Provisional
** Programme

EXECUTIVE SUMMARY

1994 was an extraordinary period for the Turkish economy. The fluctuations in the money market affected all sectors with a special emphasis on the financial sector during the first quarter of 1994. The problems became more complicated due to the misconception and misinterpretation of the market reactions to the long-standing imbalances in the economy. As necessary measures were not taken on time, solutions became more challenging and led to an inevitable crisis. Thus, Turkey, that achieved significant structural changes and was in the process of harmonisation with the European Union, once again became a country in search of economic stability.

Macro economic imbalances transformed into a crisis in 1994

In 1980s a structural change programme supported by radical policies was put into force with an objective of improving the macro economic imbalances. Liberal policies were implemented with the objective of orienting the Turkish economy to international markets within the framework of market economy and free competition. These policies contributed to the integration of the Turkish economy with the international markets primarily through foreign trade and later on through capital movements.

The transformation process initiated in 80s was supported by radical implementations.

The important phases in structural change were: initiating the value added tax; supplying the funds needed for economic growth through reforms to facilitate the development of the financial sector; updating the law on capital markets; rendering the stock exchange market operational; amending the banking law for compatibility with international standards; and introducing new institutions in the money market. Thus, financial instruments became more diverse, the financial system grew and the scope of influence for economic policies broadened. Consequently, during the period between 1981-87, stable growth could be achieved, economic expectations became positive and the share of industry in national income increased through mostly private sector technological investments.

Stable growth during structural change was achieved in the period between 1981-87.

Economic stability could not be maintained due to the imbalances in the public sector although these positive developments in the financial and real sectors constituted the basis for the sustainability of economic growth in the following years. This situation was pronounced in frequent fluctuations

Economic growth tended to be high but unstable after 1987.

in growth rate- between 9 percent and 0.9 percent - with an average of 4.3 percent. There was a lack of political determination for the realisation of the fundamental phases in the structural change program such as decreasing the share of the public sector in the economy, adjusting the tax regulations and social security practices and reforming the agricultural sector. The latter policies had always been short-term and influenced by political expectations. The emphasis on populist policies lead to a rapid increase in public expenditures which was in contradiction with the transformation program that aimed at increasing the share of the private sector in the economy. Public revenues, however, could not be increased at the same rate and consequently, public sector deficit reached peak levels.

The pressure on the financial system caused by the increase in public sector borrowing requirement was easened by foreign borrowing.

The increase in the public sector borrowing requirement put a tremendous pressure on the financial sector which resulted in a rise in interest rates. In the third quarter of 1989, the pressure on interest rates was eased through the entry into force of the regulation liberalising capital movements, and thus the inflow of foreign funds accelerated. The liberalisation of capital movements initiated a new period in the Turkish economy. Nevertheless, political implementations remained unchanged despite significant modifications in the power of economic policies to influence macro balances as well as the economic decision making process. Thanks to the favourable position of Turkey's international credibility, a significant amount of foreign funds entered into the economy through capital movements. The pressure on the financial sector created by maintaining the increase in public expenditures at the expense of allowing the public deficit to grow could therefore be eased and economic growth continued.

The increase in total demand was maintained at the expense of disturbing domestic as well as foreign balances.

High level of real wage increases in the public sector and the positive impact of foreign borrowing on interest rates led to a rapid growth in total demand. This was translated into a gradual increase in financing economic activities through foreign loans. The Turkish currency gained value against other currencies and imports became even more attractive. Therefore, growing domestic demand was met by imports to a great extent. As a consequence of skyrocketing imports, foreign trade and current account deficits grew as no significant changes were experienced in the growth rate of exports and the invisibles balance. These developments did not only complicate the existing structural problems in the economy and disturbed domestic as well as foreign balances, but also made economic stability more sensitive to fluctuations in both national and international markets.

The developments in 1991 were serious warnings for the need for long term and comprehensive decisions.

Following an economic growth in 1990 realised at 9 percent - a rate unexpectedly higher than the long term average economic growth almost stagnated in 1991 due to the Gulf Crisis and the uncertainties caused by the early general elections. The ongoing instability did not fortunately result in a crisis since the availability of an adequate amount of foreign exchange reserves allowed the Central Bank to intervene in the markets on time.

Central Bank funds were mobilised to decrease the interest rates and improve the maturity structure of domestic borrowing.

The coalition government formed by the elections in 1991 contented with short term solutions instead of comprehensive decisions to solve the problems, probably because of the positive political environment that they were enjoying. The government took up the policy of increasing public expenditures once again to respond to the demands of the community. For the purpose of financing the growth in public expenditures, this time, Central Bank funds were used to a great extent as well as foreign loans. The government limited domestic borrowing in order to decrease the cost of Treasury borrowing and render domestic borrowing favourable for long term papers. Nonetheless, increasing liquidity accelerated inflationary expectations and the consequent regression in interest rates encouraged the leakage from Turkish Lira.

The increase in Central Bank's interest rates led to taking resort in foreign borrowing again.

The rise in foreign exchange demand and exchange rates in an environment of growing public expenditures created a significant amount of pressure on the foreign exchange reserves of the Central Bank. The Central Bank tried to control liquidity with open market transactions in order to ease the pressure on reserves and stabilise currency rates, which resulted in a rise in interest rates. The Treasury borrowed from international money markets with the aims of limiting the negative impact of the rising interest rates on the level of economic activity and of financing the public sector borrowing requirement. Thus, the real exchange rate appreciated once again, imports increased and foreign trade and current account deficits reached a peak level.

Decreasing interest rates on domestic borrowing became a priority policy in the second half of 1993 whereas policies should have aimed at controlling the public deficit which was the fundamental reason behind the problems that determined stability by turning domestic economic imbalances into foreign imbalances. Treasury tenders were canceled and following the arbitration law, an additional budget was formed to enable the utilisation of Central Bank advances for the redemption of domestic debts. Therefore, the increase in the liquidity volume triggered speculative expectations. In this case, the financial institutions experienced a high risk of exchange and interest rates due to their policies. and behaved in a way that encouraged such expectations in the market. The leakage from the Turkish Lira accelerated by the end of 1993 when the economic decision makers decided to speed up the devaluation with the idea of diminishing the gap between devaluation and inflation rates. This resulted in a rapid fall in the value of public papers followed by declarations from international rating companies announcing a downgrade on Turkey's credit rating. Meanwhile, the introduction of tax on revenues from repurchase and public paper interest rates aggravated this fall. The economy started facing a serious resource problem during the last quarter of 1993: whereby the public sector deficit continued to grow, domestic borrowing became more challenging and capital movements experienced an outflow as the current account deficit broadened. The markets responded to the situation in a meaningful manner that led to a fluctuating but still upward trend in interest and foreign exchange rates.

The resource problem in the economy was triggered by the practices in the second half of 1993.

At the beginning of 1994, the government postponed the necessary measures with the idea of investing in the local elections due March. They, instead, continued with policies to decrease interest rates despite the rising instability in money markets and referred to Central Bank funds for public financing. Although the Central Bank largely upgraded the level of short term interest rates, increasing liquidity caused depositors to change their portfolio choices in favour of foreign exchange resulting in a tremendous demand for foreign currencies and consequently, the devaluation of TL accelerated.

Turkey started to experience increasing imbalances in the economy which gradually transformed into a crisis in 1994.

In January 1994, the lack of serious steps to shrink the large public sector deficit caused domestic imbalances to turn into foreign imbalances and consequently Turkey's international credit rating was downgraded. This situation limited the possibility of foreign borrowing and aggravated the outflow of capital. Investors developed a large demand for foreign exchange and the banks initiated efforts to close their short positions in foreign currency causing expectations for a shock devaluation that resulted in a rise in the demand for imports. The pressure on the foreign exchange rates could not be eased even when the Central Bank sold foreign exchange in the market and thus, TL was devalued at a rate of 14 percent against the US dollar on January 26. Budgetary expenditures, however, continued to grow in the following months due to the upcoming elections. Central Bank advances were largely used to meet the booming fund demands of the Treasury caused by the growing budget deficits and redemptions. Meanwhile, tenders were canceled in face of increasing interest rates. The attempts by the Central Bank to control the liquidity in the market through open market transactions caused overnight interest rates to reach an average of 200 percent, fluctuating between 60 percent and 700 percent. The demand for foreign exchange continued to grow in spite of this intervention and the devaluation of TL in real terms accelerated.

Decisions to reduce the fluctuations in the markets were not taken on the eve of local elections.

The inflation rate followed an upward trend in relation to the booming domestic demand despite restricted price adjustments in public sector economic units. During the first quarter of 1994, current account deficit grew as imports continued to rise under the influence of increasing domestic demand and speculative expectations in spite of real devaluation. The interesting developments at this stage, were the withdrawal of foreign currency from the banking system and the acceleration in short term capital outflow. As a result of this development, Central Bank reserves melted so rapidly, that the foreign exchange reserves amounting to 6.2 billion US dollars by the end of 1993, reduced to 3.2 billion by the end of March 1994. The concentration on short term transactions as a choice due to pre-election uncertainties aggravated instability and the crisis that initiated in the financial sector gradually involved the manufacturing sector as well.

The crisis that initially started in the money markets gradually spread to all sectors.

Right after the elections on March 27, the government put the "Plan for the Implementation of Economic Measures" into practice on April 5, with the aims of preventing the growing crisis, of stabilizing the financial markets as a priority and of solving the structural problems which constitute the main reason for economic imbalances.

April 5 decisions were put in practice right after the local elections.

The initial phase of the implementation focused on controlling the growth in the budget deficit and disciplining monetary expansion. For this purpose, the budget deficit foreseen as 198 trillion TL for 1994 was reduced to 109 trillion TL, with the objective of decreasing the ratio of the budget deficit to GNP from 6.9 percent to 3.5 percent. In this context, several one time taxes were imposed to increase budget revenues. Moreover, expenditures excluding personnel were restricted in order to reduce budget expenditures. Personnel expenditures were also limited to fit the targets foreseen in the budget. Meanwhile, State Economic Enterprises readjusted prices for their goods and services at shocking levels.

Stabilization measures targeted at disciplining the financial sector as a priority.

Stabilization measures covered rearrangements for legislation and practices pertaining to monetary policy, in order to maintain financial discipline. The amount of Central Bank short term advances earmarked for the Treasury were restricted to 12 percent of the budgetary allocations for 1995. This ratio was established as 10 percent for 1996, 6 percent for 1997 and 3 percent for 1998 and the years to follow. It was also decided that the amount of rebates and advances to public institutions should not exceed half of the amount earmarked for the Treasury. The amendment to the law on Central Bank, however, enabled the Central Bank to forward loans to banks within the framework of a legislation aiming to overcome possible uncertainties and distrust in the banking system. The rearrangements also covered revisions for the liquidity rates in the banking system: required reserve and disponibility ratios were reduced and extended to cover a broader range of bank liabilities as well. The condition to deposit a security for repurchase agreements in the Central Bank was introduced in order to prevent the occurrence of uncovered repurchase agreements. Surrender requirement of the Central Bank were increased from 20 percent to 25 percent. Moreover, ten major banks were authorized to establish the foreign exchange rates.

Legislation and practices pertaining to monetary policy were rearranged.

As the Central Bank overnight interest rates fell from about 300 percent to 91 percent right after the announcement of the austerity measures, the US dollar rate increased by 39 percent on April 6, reaching 32,000 TL to a dollar on April 7 and 39,900TL to a dollar on April 8; meanwhile the currency rate for German Marks increased by 40.7 percent reaching 19,000 TL and 23,000 TL to a DM respectively. While the financial markets panicked in face of the dramatic increases in currency rates, this case also affected the banking system that kept tremendous open positions in TL and foreign currencies. During this period, foreign borrowing became impossible and the banks tried to meet, on one hand their foreign liabilities and on the other, the effective demand for the domestic currency in order to reinforce confidence in the financial system. The sector encountered a significant liquidity problem at this stage. The operations of three banks that failed to meet their obligations were stopped. The deposits in TL and other currencies were covered by the government guarantee in order to prevent another crisis in the sector. Deposits with seven days notice were allowed with the aim of preventing leakage from TL and encouraging savings in this environment of uncertainty.

All deposits were fully backed by government guarantee in order to prevent the crisis in the financial system.

Negotiations with the IMF yielded positive results while domestic discussions on the stabilization measures and their initial effects continued, and the government signed a stand-by agreement covering a program for loans and monetary targets for the period between July 1994 - September 1995. The IMF agreed to lend 750 million dollars according to the agreement.

The IMF supported the stabilization measures.

Monetary objectives in the program covered quarterly balance sheets of the Central Bank and monetary indicators. The measures limited the increases in the TL assets of the Central Bank and allowed the balance sheet to grow only in ratio of the increase in net foreign currency reserves. The program also stated targets for the inflation and foreign exchange rates. The targets foresaw approximately 20 percent increase in consumer prices for the second half of 1994. Accordingly, TL-the nominal anchor- was estimated to reach about 38,000 to a US dollar by the end of the year.

The increase in TL assets of the Central Bank was limited.

The panic at the beginning of April soothed down when overnight interest rates were reelevated to 200-400 percent. There were dramatic increases in the interest rates for deposits of all terms. Meanwhile, the Treasury started borrowing again in order to meet the financing need since advances from the Central Bank had already reached the legal limit. Despite the rising interest rates, the Treasury could not raise a demand for papers with terms exceeding three months and eventually started to issue treasury bonds with a maturity of one month and an interest rate of 145 percent as of the beginning of May. Although the interest rate for papers with a maturity of three months was elevated form 90 percent to 160 percent, the demand remained limited. In this case, the Treasury took a proper decision to issue treasury bonds with a maturity of three months and an interest rate of 300 percent by public offering and the market responded to these papers with a booming demand.

The Treasury again started very short term domestic borrowing with phenomenal interest rates.

In this way the escape from TL was reversed and foreign exchange rates began to drop after the second half of May, since the demand for foreign currencies had decreased relatively. This trend continued also in June and July. With the help of support from international markets to the stabilization programme, the portfolio choice of investors began to change in favour of TL. Since the Treasury was able to borrow at record-high real rates, the pressure on the Central Bank balance sheet mitigated; the use of short-term advances was reduced and foreign exchange reserves increased. As a result of the re-established confidence in the financial system, TL deposits increased, equilibrium in markets was restored and interest rates tended to fall in the period until September.

The Treasury's capability to borrow again reduced the pressure on foreign exchange rates and increased the demand for TL.

Besides the rise in public revenues, a decrease in public expenditures and the control of expansion in the budget deficit both contributed to the results achieved. The disposable income, purchasing power and therefore aggregate consumption of economic actors decreased due to additional taxes, soaring prices, the loss in the real value of TL and the fall in real wages. The rise in real interest rates caused fixed capital investments to decrease significantly. As a result of these, domestic demand declined rapidly. According to the State Planning Organization (SPO), in 1994, the fall in domestic demand, fixed capital investment and aggregate consumption will be 9 percent, 16 percent and 3.2 percent respectively.

Domestic demand decreased rapidly.

According to the estimates by SPO, economic growth will be a negative 4 percent in 1994. This rate stands for the biggest recession in the Turkish economy since 1949. It is estimated that the agriculture, industry and services sectors will contract by 3 percent, 2 percent and 3 percent respectively.

It is estimated that the economy has shrunk by 4 percent.

The additional taxes and high price increases to reduce the public deficit on the one hand and high real interest rates on the other, caused the financing and input costs to rise. Thus the private sector, in line with the decrease in aggregate demand, reduced its production. The capacity utilization ratio decreased significantly as compared to that of 1993. According to the Quarterly Production Index prepared by the State Institute of Statistics (SIS), output in the manufacturing industry decreased by 4.1 percent. While production in the private sector decreased by 11.3 percent, it increased by 5 percent in the public sector. The capacity utilization ratio in the manufacturing industry, decreased from 80.7 percent to 71.3 percent for the private sector and kept more or less the same level of 79 percent for the public sector. The most important development in 1994 is that the private sector contracted much more rapidly than the public sector. Therefore, the share of the public sector in the economy increased, as opposed to what was aimed.

Total output decreased rapidly in the private sector while increasing in the public sector.

Employment was also adversely affected by the economic recession. It is estimated that the unemployment rate, 7.6 percent in 1993, has risen to 10.5 percent and most of the workers who lost their jobs were employed in the private sector. The reason for this is the negative effect of the swiftly growing imbalance in the public sector had on the private sector.

Unemployment rate is expected to exceed 10 percent.

Although the additional tax revenues, expected to reach TL 65 trillion, made a significant contribution to the lessening of the budget deficit, it is expected that the 1994 deficit will reach TL 170 trillion, above the target level. The reason for this deviation is the rise in interest payments. Since the borrowing was made in relatively short terms like 3 or 6 months and the average real interest rates were at a very high level, there was a rapid increase in interest expenses. Thus the share of interest payments in the budget expenditure is expected to rise from 24 percent to 33 percent. On

Budget deficit could be improved in real terms by additional tax revenues.

the contrary, the share of personnel and investment expenditures has dropped. In spite of the deviation from the targets foreseen by the programme, the budget deficit could be reduced in real terms. The main factor contributing to this development is the fact that the deficit, which was TL 17 trillion in the 1993 non-interest budget, could be turned to a TL 160 trillion surplus at the end of 1994.

The ratio of public sector borrowing requirement to national income is expected to fall from 12 percent to 7.5 percent.

The decrease in the budget deficit, which has the greatest share in the public sector deficit, led to a relative improvement in the public sector borrowing requirement (PSBR). According to the SPO, the ratio of PSBR to GNP, based on the new national income series published by SIS, is expected to reach the level of 7.5 percent in 1994, while it was 12 percent in 1993. The other important component of the budget deficit, The State Economic Enterprise (SEE) deficit, experienced a slower improvement as compared to that of the budget deficit. The ratio of the SEE deficits to GNP is expected to fall from 2.5 percent to 2.1 percent. However, latest developments indicate that the ratio of public deficit to national income will exceed SPO estimates and will be above 10 percent. While very high level of expenditures in real terms influenced budget expenditures negatively, as a result of the positive effect of high price increases of the SEE's products on revenues, the public sector deficit could be kept limited. Nevertheless, it was this price increase, that caused the Turkish economy to enter into a process of 3-digit inflation, for the first time since 1980.

Inflation has reached 3-digit levels.

Inflation, which showed an upward trend after the last quarter of 1993, has accelerated, although the price increases in the public sector were kept at a limited level in the first quarter of 1994. Following the elections, the prices of SEE products and services were increased and the inflation rate exceeded 100 percent. In April the wholesale and consumer price indices increased by 38 percent and 25 percent respectively. As a result, annual inflation rates leaped to the levels of 125 percent for wholesale and 107 percent for consumer prices. The price indices, that experienced a limited increase during the summer, have tended to speed up again in September, due to the combined effect of the slowdown in the demand increase and seasonal factors. At the end of the year, the rate of inflation is expected to reach 140 percent and 120 percent as measured by wholesale and consumer prices respectively. These rates are above the targets of the stabilization programme. While, with its existing level and trend, inflation is still the most important problem of the Turkish economy, it also threatens short-run stability. Inflationary expectations cannot be eliminated and this certainly influences the confidence in TL negatively and also reduces the effectiveness of monetary policy.

After the April 5 Measures, the financial system expanded due to the increased demand for TL induced by high interest rates.

Inflationary expectations also had effects on the financial system. This occurred in such a way, that the share of foreign exchange savings went up, while the size of the financial system remained constant. This process accelerated after the last months of 1993, when real interest rates became negative and followed a remarkable trend in 1994. The share of foreign exchange deposits in M2Y, which was 48 percent at the end of 1993, increased up to 54 percent after the announcement of the stabilization program. Due to the increase in the real returns on government bonds and bills as well as deposits, the demand for TL deposits increased at the middle of the year. After stability in financial markets was restored, M2 increased rapidly and the share of foreign exchange deposits in M2Y declined to 43 percent. During this period, when the Central Bank credits to the public sector were restrained, the Central Bank money was created to a great extent through the foreign exchange transactions; the reserve money and foreign exchange reserves increased.

After the end of summer, foreign exchange rates increased while real interest rates decreased.

The increase in TL deposits helped the banking sector to surpass the liquidity crisis and to pay its foreign debts on time without any delay. As the foreign exchange rates were stable during this period, the pressure on interest rates was mitigated and interest rates began to fall in line with the rapid decrease in the demand for loans. However, the expansion of the financial system in real terms slowed down after July and the system started to shrink after August. Meanwhile; real interest rates were still positive, although the level continued to decrease. In spite of this fact, the share of foreign exchange deposits in M2Y rose again. With the rise in advances to the Treasury , the improvement in the Central Bank balance sheet and the rise in reserves stopped. The increase in foreign exchange rates speeded up, how-

ever remained below the inflation rate. As a result of the increase in PSBR, interest rates ceased falling and even started to rise after September.
The main reasons for this development are the trend of inflation to increase and continuing net capital outflow. In this environment, where interest rates are falling, the strengthening of inflationary expectations has forced the economic actors to escape from TL based financial assets in their portfolio choices. Net capital outflow, in spite of the rapid improvement in the current account balance, has created a severe pressure on the balance of payments.

The current accounts experienced a surplus in a rapidly contracting economy.

Another interesting development in 1994 concerns the balance of payments. During the first months of the year, imports decreased due to the devaluation of the TL. After the announcement of the April 5 programme, the contracting domestic demand caused imports to decrease dramatically. Exports however accelerated. This trend continued during the May-September period, where the TL was revalued in real terms. During the January-September period, imports diminished by 23 percent, whereas exports increased by 16 percent. Consequently, the trade deficit decreased by 64 percent and the current account displayed a surplus. The current account, which had displayed a $4.8 billion deficit in the first three quarters of 1993, experienced a $ 2.1 billion surplus in the corresponding period of 1994. This improvement could be achieved faster than it was expected and prevented a possible balance of payments crisis caused by net capital outflow.

The banking system paid out $ 7 billion short term foreign debt.

The fall in Turkey's international credit rating made long term borrowing difficult and as a result of the financial crisis, short-term capital movements became negative. Between January-September 1994, there was a net capital outflow of $ 4 billion as compared to a capital inflow of $ 7 billion during the corresponding period of 1993. In the period January-September 1994, short-term liabilities declined by $ 6.7 billion. The net errors and omissions item, which explains unrecorded transactions and which has to be considered together with capital flows, displayed an outflow of $ 2.7 billion in the first three months and an inflow of $ 3.9 billion in the period between April-September. As a result of these developments the decrease in the

Central Bank reserves in the first months of the year ,were compensated. The reserves, after hitting a minimum of $ 3 billion during the first week of April, went up to $ 6.7 billion at the end of September and $ 7.1 billion at the end of November. Meanwhile, commercial bank reserves decreased approximately by $ 2 billion, as compared to the end of 1993.

Total outstanding debts remained almost at the same level, while short-term foreign debts decreased rapidly.

Total short-term foreign debts dropped significantly from $ 18.5 billion to $12.2 billion at the end of September, due to a decline in short-term liabilities. At the same time, the volume of medium and long-term debts increased due to the changes in the exchange rate parities in the international markets. As a result, no significant changes were observed in the outstanding foreign debts and the total external debt stock maintained its level of $ 65 billion in September. Repayment of foreign debts on time has positively influenced Turkeyís credibility in international markets. However, permanent stability has to be maintained if this positive influence is to manifest itself in practice.

Recommendations

The basic structural problems in the Turkish economy should be solved in a decisive way, in order to obtain and maintain long-term economic stability. For this purpose, a medium-term stabilization programme, containing longer term targets, must be drafted shortly. Stabilization programme studies should be performed in a definitely organized and comprehensive debate environment, by keeping open all possible channels of information.

All relevant groups in the society should intensively exchange views towards a long-term economic stability.

The stabilization programme, should first of all be in compliance with the parliamentary-democratic system and the basic principles of a free market economy and should also be based on a free exchange regime: free exchange regime spreads the market adjustments to changes in economic policy over time, such that it might reduce the cost of the implementation of these policies to the economy. Free market economy should be established with all its institutions and rules and these rules must be followed completely and promptly by all segments of the society, including the government.

Free market economy should be established with all its rules and institutions.

The success of the programme is strictly dependent upon the elimination of inflationary expectations. For the implementation of a medium-term stabilization programme which targets an average growth rate of 2.5-3 percent and therefore does not have any inflationary effects by not stimulating demand, a definite discipline should be applied to the public expenditures. In this way, inflationary expectations will be reduced and it will become easy for the private sector to make decisions on future objectives in an environment of confidence.

Rate of inflation should be reduced to a controllable level in a reasonable period of time.

A medium-term stabilization programme should rely upon the following basic principles:

1) A definite attitude about the function, size and share of the public sector in the economy should be adopted and the revenues and expenditures of the budget should be determined in line with this principle. The public budget should be prepared as a dependable document with which the governments will definitely comply.

Administrative reforms should be realized without losing any time.

2) Reforms in the public sector, which are essential for an improvement in public deficits, should definitely be made.

3) An administrative reform ought to come first among the reforms necessary in the public sector. The framework of such a reform, also known as personnel reform, should contain the restructuring of all service units, considering each group in its own characteristics of resource utilization and size of staff.

The social security system should be reorganized with the participation of the private sector.

4) The second important reform is the integration of the social security system under a single law. Meanwhile, establishment of private retirement and social security funds should also be allowed. Necessary conditions for this social security reform are: managing the social security funds in a rational manner so as to ensure that they become income generating entities; dividing the pension funds and the health insurance systems for financial and administrative purposes, exempting the participation in government pension and health insurance system of those corporations who have their own pension funds and health insurance systems.

The tax reform should promote savings.

5) Increasing the burden on present tax-payers, for the purpose of increasing public revenues, should be avoided. The tax base should be broadened.

The role of local administration in public services should be increased.

6) Public services should be performed at the levels where they can be performed in the best possible way, rather than in a centralized system.

Privatization should be achieved in a broad sense and without any delay.

While these reforms are being implemented, privatization should be carried out without any hesitation so as to remove the burden of the SEE's on the economy. Privatization should be carried out together with a medium-term stabilization programme and industrialization strategy, if it is to be successful.

The most important key to success is to establish a consensus on the necessity of the privatization process and to create public support. Moreover, privatization should not be limited to the industrial sector and should be considered together with an agricultural subsidy policy and infrastructure investments. All measures should be taken against the rise in unemployment, which is an unavoidable consequence of privatization. Moreover, the public should be informed that unemployment would reach higher levels, if privatization is not carried out.

Structural adjustment for the Customs Union should be achieved.

The medium-term stabilization programme should comprise the precise studies on new social and economic conditions, that will arise from joining the Customs Union or even the EC. Targets should be established and studies should be carried out on topics such as the free movement of commodities, services, capital and labour; common tariffs and common free trade policy; common agricultural policy; legal adjustments for competition; participation in the European monetary system, contributions to be made to the EU budget and the financial benefits that might be gained from this contribution.

A medium-term stabilization programme, which relies upon the above mentioned conditions and principles, will have the ability to solve deep-rooted structural problems of the Turkish economy.

On the contrary, daily politicking, not relying on such a programme and far from integrity will only serve to postpone the solution of problems and exert a more serious burden on the economy.

QUESTIONNAIRE ON TÜSİAD MEMBERS' FUTURE EXPECTATIONS

Results of the Questionnaire on TÜSİAD Members' Future Expectations, December 1994

Since 1985, TÜSİAD has been preparing and distributing a questionnaire among its members in order to provide a thorough survey of economic developments in Turkey. The number of respondents show a rising trend year by year. In 1994, 95 members answered the questionnaire.

The results of this TÜSİAD initiative were indicative of the importance which is now placed on the forecasting of economic development. Sixty-four percent of the respondants have special sections or staff concerned with forecasting in their companies. These forecasting groups average about six persons each.

Number of Persons Dealing with Forecasts

Persons	%
*	35.8
1.9	51.6
10+	12.6

Of the respondents, 82 percent expect that the period 1995-99 will be more sucessful than the period 1990-94.

Expectations as Regards the Period 1995-99 in Compansion With 1990-94.

Evaluation	%
1995-99 period will be more succesfull	82.0
1990-94 period was more succesfull	18.0

According to TÜSİAD members, economic instability is the major factor negatively affecting fixed capital investments. High interes rates, political instability and insufficiency of credits are ranked as other important factors.

* *There exist no special staff concerned with forecasting*

Factors Negatively Effecting Fixed Capital Investments

Factors	%
Economic instability	47.8
High interest rates	22.2
Political instability	22.2
Insufficient Credit Facilities	5.6
Inadequate domestic demand	1.1
Others	1.1

According to 30 percent of TÜSİAD members, inflation was the major problem of the Turkish economy in 1994. Among others, 26.9 percent of the members cites public expenditures, 10,8 percent growth rate whereas 8,6 percent terror as the most important problem in 1994.

Education and health is ranked first among the major problems in the economy in 1999 by 19.6 percent of the respondents. On the other hand, 16,3 percent consider inflation as the major problem. Another 12 percent of the members anticipate that unemployment will be the most important problem of 1994, whilst 10.9 percent ranks public expenditures and 9.8 percent the income distribution as the major problem.

The Most Important Problems

	1994	1999
Inflation	30.1	16.3
Public expenditures	26.9	10.9
Growth rate	10.8	7.6
Terror	8.6	1.1
Education and health	6.5	19.6
Income distribution	3.2	9.8
Domestic debts	3.2	1.1
High interest rates	3.2	0.0
Unemployment	2.2	12.0
Lack of technology	1.1	6.5
Foreign debts	0.0	2.2
Foreign trade deficit	0.0	2.2

Among the three major problems in 1994, inflation is ranked first by 62 percent of the respondents. Another 50.5 percent ranks public expenditures and 51.6 percent terror as one of the three major problems of 1994. These are followed by domestic debts and growth rate by 28.4 percent and by 23.2 percent of TÜSİAD members, respectively.

The Three Major Problems

	1994
Inflation	62.0
Public expenditures	50.5
Terror	31.6
Domestic debts	28.4
Growth rate	23.2
Income distribution	21.0
Education-health	19.0
Unemployment	14.8
High interest rates	10.5
External debts	6.3
Bureaucray	6.3
Foreign trade deficit	5.3
Lack of technology	4.2
Short-term capital movements	2.1

Only the 2.2 percent of our members object to Turkey`s participation in the Customs Union with the European Community, while 81.5 percent of them approve it. The remaining 16,3 percent consider that 1995 is too early to achieve the necessary arrangements.

Joining the Customs Union with European Community (%)

Agree	81.5
Do not Agree	2.2
Early	16.3

Most of the respondents consider that Turkey`s participation in the Customs Union will lead to technological improvement, increase in foreign capital investments, an improvement in quality and an increase in research and development activities.

According to the 93.3 percent of our members, the profit margins will shrink but the Customs Union will have favorable effects on inflation rate, competitiveness, and fixed capital investments. A majority of our members (91.8 percent) expect that inflation rate will lower, 89,5 percent hope that fixed capital investments will rise and 81,1 percent believe that competitiveness of the economy will improve. According to most of our members, Customs Union will have adverse effects on foreign trade deficit. The ratio of members who expect an increase in trade deficit is 71.4 percent. While 71.8 percent of the members anticipate an increase in the growth rate, the remaining 28,2 percent predict the reverse.

The Effects of the Customs Union on the Turkish Economy

	Increase	Decrease
Inflation	8.2	91.8
Growth rate	71.8	28.2
Foreign trade deficit	71.4	28.6
Unemployment	44.9	55.1
Profit margins	6.7	93.3
Competitiveness	81.1	18.9
Foreign capital investments	96.7	3.3
Fixed capital investments	89.5	10.5
Improvement in technology	98.9	1.1
Research and development	92.0	8.0
Improvement in quality	96.7	3.3

Most of our members are optimistic about the competitiveness of their sectors. While the ratio of members who believe that the competitiveness of their sector is high or medium is 95.6 percent, the remaining 4,4 percent of the members consider that it is low.

The Evaluation of Sectoral Competitiveness (%)

High	47.8
Medium	47.8
Low	4.4

According to 39,2 percent of the respondents, the level of stocks in 1993 was lower than that of the previous year. On the other hand, 41.8 percent of the respondents expect that the level of stocks in 1994 would be much lower when compared with 1993.

Average Level of Stocks (%)

	1993	1994	1995
Higher than the previous year	27.0	30.4	6.8
Same	28.4	22.8	49.3
Lower than the previous year	39.2	41.8	34.2
No answer	5.4	5.1	9.6

Although total orders, when compared with the previous year, rose to a great extent in 1993, it is estimated that they will be much lower in 1994. The ratio of the respondents who report that their total orders increased is 21 percent whereas the ratio of those who declare an increase in their external orders is 54.1 percent. These ratios in 1995 is expected to be 45.5 percent and 58.9 percent, respectively.

Total Orders (%)

	1993	1994	1995
Higher than the previous year	70.5	21.0	45.5
Same	20.5	14.8	35.1
Lower than the previous year	7.7	63.0	13.0
No answer	1.3	1.2	6.5

External Orders (%)

	1993	1994	1995
Higher than the Previous Year	47.9	54.1	58.9
Same	29.6	20.3	24.7
Lower than the Previous Year	11.3	16.2	2.7
No answer	11.3	9.5	13.7

Most of the TÜSİAD members point out that the level of production is decreased in 1994 when compared with the previous year, but that this trend will be reversed in 1995.

Production (%)

	1993	1994	1995
Higher than the Previous Year	80.5	26.2	56.6
Same	15.9	10.7	30.1
Lower than the Previous Year	3.9	61.9	9.6
No answer	0.0	1.2	3.6

More than half of the respondents informed that the price of their products rose in 1994, and they expect this trend to continue in 1995.

Price Level (%)

	1993	1994	1995
Higher than the Previous Year	64.0	52.5	52.6
Same	20.0	11.3	26.3
Lower than the Previous Year	14.7	33.8	13.2
No answer	1.3	2.5	7.9

FORECASTS OF TÜSİAD MEMBERS REGARDING THE TURKISH ECONOMY

	1993	1994	1995	1996
1. Income/Production/Investment				
Real Growth Rate %				
GNP	7.3	-3.0	2.7	4.9
Manufacturing Sector	8.2	-2.5	4.0	5.5
Number of Building Permits	3.1	2.0	2.0	3.0
Fixed Capital Investment	21.7	3.0	10.0	15.0
2. Foreign Economy				
Export ($ Billion)	15.3	17.5	19.4	22.0
Imports ($ Billion)	29.4	23.0	26.0	30.0
Foreign Exchange Buying Rate (End of Year)				
TL/$	14.5	38.3	65.5	103.0
TL/DM	8.3	24.8	41.7	64.8
Workers` Remittances ($ Billion)	2.9	3.0	3.0	3.1
Foreign Debts ($ Billion)	67.4	67.1	68.0	70.0
3. Wages/Prices/Interest Rates				
Inflation (%)	71.1	120.4	75.0	60.0
Interest Rate on One-Year Deposits (%) (end of the year)	74.7	100.0	77.5	60.0
Interest Rate on Short-term Credits (%) (end of the year)	99.2	120.0	100.0	75.0
Gold Ingot (gr, end of the year)	176.4	460.0	775.8	1,126.5
Average Wage Increase (%) (June)	68.6	70.0	70.0	60.0
4. Public Finance/Money/Credits				
Increase in Tax Revenues (%)	87.3	120.0	76.3	71.2
Growth in Money Supply (M2) (%)	60.0	100.0	70.0	65.4
Budget Deficits (TL Billion)	122.0	150.0	210.0	260.0
Increase in Bank Credits (%)	91.2	75.0	77.5	70.0
Increase in Time Deposits (%)	42.1	98.0	60.0	60.0