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**MANAGEMENT OF FOREIGN DEBT**  
**AND TURKISH APPLICATION**

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## **TEZ ONAY SAYFASI**

## ÖZ

1980’li yıllardan başlayarak tüm gelişmekte olan ülkeler ve yükselen piyasalar ciddi bir dış borçlanma sürecine girmiştir. Borç krizlerinde yaşanan deneyimlerin de etkisiyle, uluslararası örgütlerin, bu ülkelerdeki borç yönetim sistemlerinin modernize edilmesi ve iyi işleyen bir yapıya dönüştürülmesi konusundaki çabaları da bu sürecin şekillenmesinde önemli katkıda bulunmuştur. Türkiye’ye özgü yapısal ekonomik problemler, 1980’ler ve 1990’lar boyunca önemli dış borç birikim süreçleri yaratmıştır. Dış borç stoklarının ulaştığı bu boyutlar, ülkemizde etkili borç yönetim sisteminin oluşturulması konusundaki çabaları da yoğunlaşmıştır. Bu çalışmada bu çabalar incelenerek Türkiye’nin dış borç yönetim sistemi değerlendirilmektedir. 1980’li yılların ortalarından itibaren başlayan bu olumlu çabalar, ülkemiz dış borç yönetim sisteminde önemli gelişmelere neden olmuştur. Zira Türkiye bir kaç sorunlu alan dışında etkin dış borç yönetimin altyapısını oluşturan pasif dış borç yönetimi ile ilgili tüm süreçleri önemli ölçüde tamamlamış bulunmaktadır. Bundan sonraki süreç mevcut bu sistemin geliştirilmesi olacaktır. Güçlü ekonomiye geçişin ön koşulu olarak borç stoklarının piyasa kurallarına uygun olarak eritilmesi şarttır. Türkiye bunu başaracak güçtedir. Politik kararlılık, sıkı maliye politikası ve akılcıl ekonomik yönetim bizim borç problemimizi çözecektir.

## ABSTRACT

Starting from 1980s, all developing countries and emerging markets entered into a serious external borrowing period. In the light of the experiences gained during debt crises, international organizations’ efforts to modernize the debt management systems in these countries and to establish a well-operating structure contributed the most to this process. Structural economic problems special to Turkey led to significant external debt accumulation processes throughout the 1980s and 1990s. With these levels the external debt stock reached, efforts intensified in Turkey to form an effective foreign debt management system. In this study, by analyzing these efforts Turkey’s foreign debt management system is evaluated. These efforts that started in mid-1980s caused some very important changes in our external debt management system. Currently, except for some problematic areas, Turkey has completed almost all of the processes pertaining to the passive external debt management that make up the infrastructure of an effective external debt management system. The next step will be to improve this system. As a precondition for achieving a strong economy, the debt stock must be eroded in a manner that conforms to the rules of the market place. Turkey is capable of doing just that. Political determination, tight fiscal policy and wise economic management will solve our debt problem.

## PREFACE

Beginning from the 1980s, there has been a serious debt accumulation process in developing countries caused by their structural problem and global financial relations. In line with these developments these countries were obliged to establish foreign borrowing management systems in order to find solution to the size of external debt. Having recognized the importance of an effective debt management system, we currently observe intensified efforts in Turkey towards achievement of this objective.

The debt burden of the Turkish economy constitutes the fundamental cause of the problems with which we are confronted. If Turkey is to be a strong country politically, socially and economically, then we must attach priority to resolving the problem of debt. In our country, every new-born child is heavily-indebted from the moment of birth, simply on account of his or her Turkish citizenship. In the absence of a permanent solution to this issue, it will be impossible to construct a new future.

Taking into account of this basic reality, this study aims to focus on the efficiency and development level of foreign debt management in Turkey. I would like to thank Prof. Dr. Nihal Tuncer for her guidance, helpful comments and suggestions on the course of achieving this aim.

Eyüp Önder Erdem

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## ABBREVIATIONS

- BIS:** Bank of International Settlements
- BOP:** Balance of Payments
- CB:** Central Bank
- CMB:** Capital Market Board
- CML:** Capital Market Law
- CBT:** Central Bank of Turkey
- EU:** European Union
- FDI:** Foreign Direct Investment
- FX:** Foreign Exchange
- GDP:** Gross Domestic Product
- GDIs:** Government Debt Instruments
- GNP:** Gross National Product
- HIPCs:** Highly Indebted Poor Countries
- IIF:** International Institute of Finance
- IMF:** International Monetary Fund
- LDCs:** Less Developed Countries
- OECD:** Organization for Economic Cooperation and Development
- PEE:** Public Economic Enterprises
- PSBR:** Public Sector Borrowing Requirement
- SEEs:** State Economic Enterprises
- TSEP:** Transition to Strong Economy Program
- TURKSTAT:** Turkish Statistical Institute
- UNCTAD:** United Nations Conference on Trade and Development

## INTRODUCTION

If we are to analyze Turkey's borrowing dynamics, beginning from mid-1980s, we can talk about an accelerating process. Especially, in 1990s after the new actors entered into this process, domestic and external borrowings gained new momentums in Turkey. Since our foreign debt stock has reached critical high values in terms of international criterions, Turkey can be named as an excessive debtor country. With the existence of both high level of foreign debts and actors who supply debt sources to our country, Turkey were obliged to establish an effective and active foreign debt management as soon as possible. These developments in foreign borrowing make foreign debts to be evaluated more carefully in the scope of foreign debt management.

Based on high importance of foreign debt, this study summarizes the overall process of foreign borrowing, and also tries to offer some suggestions in order to remove deficient points inherited in the borrowing system.

This thesis primarily bears three aims; Firstly, it tries to determine the theoretical framework for external borrowing and foreign debt management concept. Secondly; by analyzing borrowing dynamics and its level it tries to demonstrate how foreign debt management became crucial and vital for Turkey, especially after the 1980s. By observing Turkey's foreign debt management applications, the third and most important aim of this thesis is to determine the steps had been taken so far, and evaluating the characteristics of foreign debt management of Turkey. Subsequent to such an evaluation, inefficient points that pending solutions for a better debt management will be taken into consideration.

Accordingly, this study mainly consists of four sections. In the first section, theoretical framework of external borrowing and foreign debt management are tried to be drawn. In this regard, the following issues are dealt with; basic general information about foreign borrowing, international borrowing problems that primarily raised after the 1980s and mechanisms developed in relation with their solution, growing foreign debt stocks of emerging markets and how vital is the well-established foreign debt management for them, what is the meaning of foreign debt management in general, what are the functions, tools, and contents of foreign debt management.

In the second section, Turkey's foreign debt processes that accelerated as of the 1980s and leading factors caused the existence of these consequences are dealt with. Macroeconomic policies that had influence on growing debt stocks had also been considered. Nevertheless, in the light of latest information, the general framework of Turkey's foreign debt stock is demonstrated, thereby, the importance of an effective foreign debt management is emphasized.

In the third section, developments in Turkey's foreign debt management applications are analyzed. As a result of increasing importance of foreign debt, latest efforts about foreign debt management are evaluated.

In the last section, by making general evaluation for infrastructure of foreign debt management, Turkey's level of progress and adequacy are tried to be demonstrated. In this context, the problematic areas of the system are taken into consideration as much as possible and required steps on the way of overcoming of them are tried to be designated.

## CHAPTER 1

### MAIN CONCEPTS ON FOREIGN DEBT AND FOREIGN DEBT MANAGEMENT

The aim of this section is to provide some basic information regarding foreign debts and examine international debt problems that originated from the early stages of the 1980's. Debt problems in developing countries starting from those years and their reasons also will be mentioned. Because, the international debt crises have been the main motivation behind structuring for the effective debt management systems especially in developing countries.

Based on the growing importance of foreign debt issue, in this section, the meaning of foreign debt management system, its scope, dimensions, functions, and techniques will be dealt with.

#### 1.1. FOREIGN DEBT

##### 1.1.1. Definition

International debt problem and excessive indebtedness concepts which have started to share significant place in the agenda after 1980's and in turn led to a need for analyzing foreign debt in the standard manner throughout the world economies. In this framework, international institutions like, The World Bank, BIS, IMF, OECD launched an associate working team to standardize data regarding foreign debt in 1984.

Foreign debt definition which have been suggested by this working team in 1988 and accepted by Turkish Treasury is such that; "within a specific time period gross foreign debt for a country is the summation of its short, mid and long term liabilities all of which were provided by the non-resident individuals" (Bal, 2001, p.14). In other words, it is a concept of providing external credit by residents of a country and institutions from the foreign non-resident individuals and institutions.

##### 1.1.2. Reasons for Foreign Borrowing

Foreign borrowing, in general, is known as providing external sources from developed countries to less developed countries. However, in reality foreign borrowing is not only a concern for the developing countries; but also for the developed countries, since they have some degree of foreign debt as well. But, the developed countries' foreign debts are not at the serious dimensions as the developing countries' foreign debts and do not create any problems. Accompanied by present globalization process we observe accelerated industrialization and improving financial markets which necessitate more external financing sources than before.

Developing countries resort to external borrowing to fill the gap between desired expenditure and domestically available resources and also to obtain required sources for development. Developing countries necessitates investments in order to reach a certain economic growth and development level. Savings are the sources of investments. Because of low level of national income in the developing countries, they lack in domestic savings which in turn oblige themselves to turn foreign sources. Accordingly, foreign borrowing takes an important place in financing required development for emerging markets.

If foreign debts are used in compliance with their utilization aim, it would eventually bring foreign exchange revenues to the country, and generate funds for investments in line with development strategies and it would re-finance itself. Otherwise, in repayment time of the debt the needed funds may not be generated and the country may choose the way of re-financing for repayment. If we assume that the foreign debts are used in the desired manner like investments and development projects, demanded debt amount would be bound to various factors such as; investment volume, amount of domestic saving, marginal capital/national income ratio, import goods and export volume. If borrowed resources are not used productively, external borrowing can result in severe debt servicing difficulties. Debt management authorities therefore need to focus on efficient allocations of capital in sectors generating proper returns, and should effect monitoring to determine whether the borrowed resources are being used to improve the country's production capacity so that future obligations are serviced.

As a result, for the less developed countries and developing countries reasons for engaging in foreign borrowing can be summarized as; (Evgin, 2000, p.3)

- Lack of investment sources and savings,
- Foreign trade or balance of payment deficit,

Furthermore, level of economic development or under-development may lead to many different factors for a country falling into indebtedness. Countries may borrow for below listed various reasons;

- To overcome budget deficit problem,
- Providing financial sources for military spending,
- To create and maintain economical stabilization,
- To finance big investments and reforms,
- To maintain efficiency in resource allocation and its usage,
- Aiming at channeling the savings towards specific investments,
- Creating financial sources for the matured liabilities,
- To meet a need for an extraordinary expenditure like natural disaster, war etc.
- Economic openness to short term capital flow.

Alongside all these reasons, a country can borrow to increase national income, expand employment, maintain equilibrium in balance of payments, sustain

price stability, rearrange income distribution, provide balanced regional development. (Önertürk, 1979, p.11)

Especially in formal borrowing, we can observe a linkage between external borrowing and foreign politics. While foreign borrowing is mostly realized for the economic difficulties by the debtor country, it can also serve for the creditor country's political and strategic purposes.

### 1.1.3. The Operation Stages of Foreign Debt

The operation stages of foreign debt may vary in special credits<sup>1</sup>, but in general the process from the date of obtaining credits to completion date of repayment can be depicted as follows;

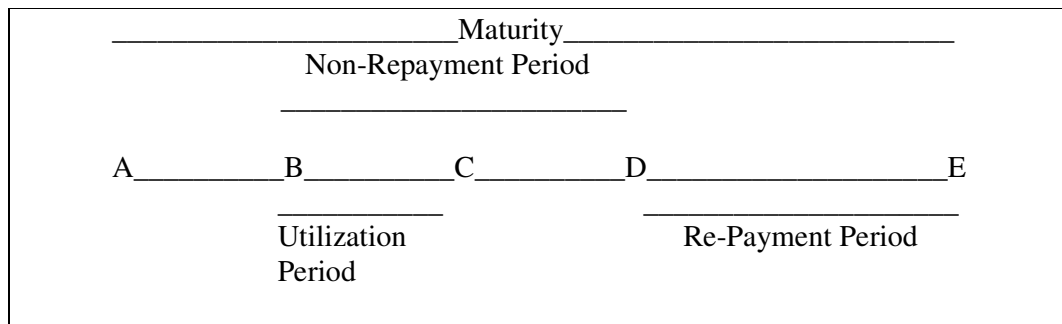


Table 1.1 The Diagram of General Operation Stages of Foreign Debt (Akçay, 1988, p.42)

Point (A) at the Table 1.1 indicates signing date of the credit agreement. In many cases this date can vary from the effective usage date of the credit. In other words, there can be a time interval between signing the credit agreement and the date of first utilization of the credit. For instance, in Turkey, some credit agreements could become effective only after the approval of Grand National Assembly of Turkey and president of republic and then, publication in the official journal. In this regard, although there may be no decision about the date of the credit agreement, utilization and agreement date of the credit can diversify.

In general, utilization does not occur for one time instead it can be gradually used. Hence, between the points (B) and (C) is the utilization period. In credit agreements, parties usually specify a non-repayment period, in general. This period which follows the date of last utilization depicted between the points (B) and (D) in the diagram.

Repayment of the credit is usually made partially too. We can depict this repayment process between the points (D) and (E) in the diagram. Maturity of the credit starts from the point (A) and continues up to the point (E).

<sup>1</sup> For instance syndicated loan and bond issue

#### 1.1.4. Types of Foreign Debt

Foreign debt can be classified by many ways, however among all classifications the most preferable one is the maturity based classification according to debtor and creditor. This classification complies with the standard classification that the World Bank uses as well.

The maturity of foreign debt is the time interval between the date of credit agreement and repayment of principal of the credit. If this period is equal or less than one year, it can be classified as short-term credit. If it is between one and five years, then it can be classified as mid-term credit, or if it has more than five years maturity, then we mention about a long-term credit.

According to its debtors, credits can be classified as special debt without guarantee public borrowings, and the debt with public guarantee. Especially in the third case in which a public institution is in the position of debtor and in the same time, Treasury is in the position of guarantor, Treasury undertakes a hidden liability. This liability is called 'Contingent Liability' for which there should be a correct and complete determination in order to reach effectively working debt management system (Sarı, 2004, p.5).

According to its creditor, credits can be classified as, formal-source and special-source debts. A formal-source debt can be multilateral and two-sided. Whereas, a special-source debt is the debt provided from the commercial banks and other kinds of debts.

According to usage method, foreign debt can be classified as, project and program credits, free and bound credits, debt postponement and refinancing credits. Furthermore, according to unit of currency (Dollar, Euro, Yen etc.) or according to legal status of borrowing (military, political, economical, fiscal, technical etc.) credits can be differently classified.

#### 1.1.5. Limitation to Foreign Borrowing

Foreign borrowing has some degree of natural limit above which brings undesirable costs to a country. Debt sustainability analysis has a crucial place in determining the limitation to foreign borrowing since it has to be taken into consideration when making plans on debt sustainability. For an accurate projection on debt sustainability, several indicators should be assessed simultaneously, in a forward-looking way. It should be noted, also, that debt sustainability analysis has to be country-specific, with consideration of the country's debt history, the level of sovereign ratings and the degree of development in the financial sector and capital markets.

Necessity of foreign borrowing can be determined by comparing two facts; social utility and social cost to the country. Like a consumer, the government tries to maximize its utility, accepts foreign borrowing until the point at which marginal

utility of borrowing is equal to its social cost. After the point at which costs exceed the utility, borrowing becomes unbearable burden for the government. These utilities and costs depend on the ability of the debtor country in achieving advancement in social welfare. Cost concept used here contains some non-monetary factors other than nominal interest rates and financing interest rates (Evgin, 1996, p.16).

It is a common belief that there is an upper limit for productively using foreign sources that provided to the developing countries. According to this argument as long as there is an increase in economic efficiency, foreign borrowing should be maintained. However, rising trend that supported by foreign borrowing in investment may subject to 'Law of Diminishing Returns'. For this reason the more investment provides the less contribution to production volume so that, after a certain point this increase may fall below the total amount of capital and interest necessitated in repayment. Nevertheless, behind this point, borrowing means a net loss for a country. In other words, borrowing above the 'Absorption Capacity<sup>2</sup>' means transfer of the country's internal sources to the foreign countries (Evgin, 2000).

Main factors that determine the absorption capacity are;

- Existence of database regarding the country's natural resources,
- Existence of technical administrative labor force and its use degree of mobility,
- Tolerance degree of national economy in importing foreign sources,
- Internal balance of investments program,
- Adequacy of political staff (Evgin, 2000).

Foreign borrowing enables a country to increase its usable sources for a specific period of time. In spite of this opportunity, it necessitates increase in export volume to overcome repayment of capital and interest proceeds at the maturity of the credit. As the other positive effects on the economy, foreign debt also provides revenue to the government and helps in closing foreign trade deficits as well.

When a country obtains foreign debt, the GNP (Gross National Product) increases, but in the time of repayment of capital and interest amount of the debt, GNP decreases because of transfer of internal sources to abroad. Foreign borrowing gives incentives for the economy to enlarge beyond its domestic limits; it also causes high degree of unsteadiness into the system. If foreign loans were converted into capital and other necessary inputs, development would occur. On the other hand, if the borrower countries misallocate resources or waste them on consumption, then economic development is negatively effected.

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<sup>2</sup> Absorption Capacity, which means ability to absorb sources provided from abroad, is related with the ability in efficiently using the capital (Evgin, 2000).



### 1.1.6. Some Ratios Used in Measuring Foreign Indebtedness

Foreign indebtedness ratios provide us very useful database for forward-looking project regarding foreign borrowing. Although ratios do not bear the same weights and importance among themselves, when all of them considered thoroughly, they do provide fairly comprehensive information on foreign debt profile of the country in question.

Following the Asia Crisis, intensified efforts on classification of crises and establishment of an early warning system, foreign indebtedness ratios started to gain more and more importance as the time passed. According to Kaminsky, Asian Crisis was significantly different from the other crises and capital movement, high level of short term foreign debt had shared a great role herein. Because, countries having high level of foreign debt were facing more severe balance of payment problems. They were also accompanying with increasing vulnerability. Hence, quantity of foreign debt of countries and especially short-term foreign debt was becoming more and more important leading indicator as the time passed (Kaminsky, 1999).

The ratio of short term debts to foreign exchange reserves is accepted as an important indicator in measuring vulnerability. First of all, this ratio gives information about the country's liquidity that affects the country's vulnerability.

Secondly, the magnitude of this ratio is vital for tracking the country's macroeconomic problems as well. Because, the greater ratio probably indicates that the country finances its long-term requirements by short-term borrowing instruments. This probability is a very important matter for foreign investors who closely pursuing the economic environment for their investment decisions. Thirdly, high level of short-term debt increases the probability of foreigner's immediate drawings of their investments which in turn damages economic stability. Lastly, the greater level of this ratio also spreads a negative impression on the quality of the balance of payments financing. (Furman, J., S., E. Joseph, 1998)

By using of data of IIF (International Institute of Finance) Rodrik examined thirty two emerging market economies and has established a model through which he reached a conclusion that high level of short-term debt within the reserves causes a potential liquidity problem which increases vulnerability of the economy, and triggers the crisis. This process has been deeply felt during the Asia Crisis. (Rodrik and Valesco, 1999, p.16-17)

Some other widely used ratios regarding foreign indebtedness are as follows<sup>3</sup>;

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<sup>3</sup>These ratios which are stated herein are the ratios used by the important international institutions like The World Bank and IMF in determining the country's level of excessive indebtedness (Sari, 2004, p.9)

#### 1.1.6.1. Total Foreign Debt /GNP

This ratio is used in measuring the general credibility of a country's economy, and has some defined degrees. For instance, if this ratio is between % 30 - %50, then the country is named as mid-level debtor, if it is above the % 50, the country is named as an excessive debtor country.

#### 1.1.6.2. Total Foreign Debt / Export

This ratio, which indicates the country's capacity in repaying of the debt, gives us some clues regarding long-term effects of export revenues over the total debt stock. In the case of this ratio is between % 165-275, the country is said to be mid-level debtor, if it exceeds %275, then the country is accepted to be an excessive debtor country.

#### 1.1.6.3. Total Foreign Debt Servicing / Export

This ratio is named as debt servicing ratio which indicates in what degree the country's export revenues are allocated to foreign borrowing expenses and it is widely used in measuring debt burden. This is an important criterion for both analyzing foreign debt, and analyzing the country's international liquidity problems. In the case of this ratio reaches to high values, the debtor country falls in a difficult situation in fulfilling its liabilities regarding foreign debts. If this ratio is between % 18-30, the country is said to be mid-level debtor. When this ratio exceeds % 30, the country is called excessive debtor country.

#### 1.1.6.4 Foreign Debt Interest Servicing / Export

This ratio is mostly used in calculating the cost of foreign borrowing. While this ratio fluctuates among % 12-20, the country is said to be mid-level debtor, when it reaches to above % 20, the country is said excessive debtor country.

These ratios started to be applied on the analysis of emerging market's debt sustainability. Nevertheless, foreign debt concept began to take a great place in the agenda throughout the 1980s in the international literature. The main reason for that was the international debt crises started from Latin Americas and also observed in almost all emerging market.

#### 1.1.6.5. Effects of Excessive Borrowing

Increasing state debts have various effects on the economy. The heavier effect can be observed on the interest rates. In order to close budget deficits, state is obliged to increase the interest rate on the government bond. This tendency increases the ratio of interest repayment in budget expenses which in turn causes increase in budget deficits. Increases in interest rates create a negative effect on investment and consumption expenditures. Increasing budget deficits accompanying with growing

state debts have an impact on foreign exchange rates, foreign trade equilibrium and the flow of funds. All these developments undoubtedly have a negative impact on inflation as well.

#### 1.1.6.5.1. Economic Effects of Excessive Borrowing

The government applies public borrowing as a tool of reducing budget deficit. This attempt brings some restriction on the private sector borrowing capacity. The important point here is that what kind of borrowing is being restricted. If the restriction is about the private sector's consumption expenditures, then it does not create any concern. However, it should not be forgotten that consumption expenditures is less sensitive to the interest rates in comparison with the investment expenditures. Whereas, investment expenditures are very sensitive to interest rates and the most beneficial expenditures in terms of employment and economic development. In such instance, slow down in economic growth and falling real income would inevitably occur. In the case of no borrowing from abroad, private sector borrowing would be bound to level of country's savings.

#### 1.1.6.5.2. International Consequences of Excessive Borrowing

In an excessively indebted developing country, an increase in interest rates cause foreign debt servicing burden to increase. There is one point here that should be taken into account. While, internal debt repayment allocates revenues from one group to another foreign debt repayment brings about decrease in the total real income of a country. However, this should not be forgotten that when foreign borrowing is efficiently used, it provides increase in production and revenues of the country, whereas internal borrowing is just an allocation of resources from private sector to the state.

### 1.2. The International Debt Problem and History of Foreign Indebtedness of Developing Countries

Worldwide external debt problems began during the 1970s, when international banks began lending in earnest to developing countries in the mistaken belief that sovereign governments would always pay their debts, while apparently ignoring the fact that several countries had defaulted on their debts in the past. A number of developing countries faced debt-servicing problems and an international debt crisis began to unfold in the 1980s. Several international factors contributed to the debt crisis in the 1970s and 1980s, when there was a surge in oil prices, recession in industrialized countries, high interest rates and weak commodity prices. Internal shocks also contributed to the debt crisis in developing countries, for example, high budget deficits, poor performance of debt-financed investment projects, low saving rates, and massive capital flight (Nigel Healey M., 1995). The inability of some countries to meet their debt-servicing requirements put pressure on the international banking sector and threatened to become an international banking crisis. For example, 24 countries defaulted on loan payments in 1982. However, schemes to

combat the problem were devised, including the 1985 Baker Plan, which incorporated debt rescheduling and new loans to prevent such an international banking crisis. However, despite the fact that the international banking sector was able to recover, indebted countries were faced with rising debt and debt servicing obligations (Nigel Healey M., 1995 p.139).

### 1.2.1. Debt Crisis of the 1980's

We can classify reasons of the 1980's debt crisis as; external cyclical reasons, and internal reasons that emanating from structure of the debtor countries.

#### 1.2.1.1. External Reasons

##### i) Changes in International Circumstances

After the Second World War, Marshall Aids and credit provided by the World Bank for the reconstruction of West European countries have both started resurgence, and development process accelerated especially in the countries benefited from these aids. Moreover, Bretton Woods Agreement has also provided a relative stability in convertible currencies. Tendency in foreign trade liberalization was another observed feature of this period. Developing countries had benefited from this expansion and prosperity period that lasted until the mid-1970s. Parallel to those developments in the world trade, export volume of developing countries increased and they also found a chance for financing their development needs with a relatively lower cost funds. According to Balkan,

“Productive capital in the central countries starts to shift to the finance sector. Corporations avoid to shift their accumulated capital to the new investment in case of there are relatively low profit opportunities. Having decreasing profit ratios, many companies can survive with the aids of borrowing which in turn leads to an upward tendency for the credit demand. In conclusion, financial sector makes a peak in the emerging market economies. Thereby, intensive capital flow starts from central countries to other countries. For indebtedness literature, this development is called ‘credit push’ to the less-developed countries” (Balkan, 1996, p.6)

However, this positive circumstance started to reverse as of mid-1970s. While fixed exchange rate system brought by the Bretton Woods System was becoming to end, petrol prices increased by four fold which caused a significant cost push to upward direction for the countries. Through the end of the year second petrol crisis occurred which pushed the petrol-importer countries falling into the difficulties in repaying their debt servicing. In the period 1973-1982, additional costs that emanating from increase in petrol prices had reached to significant points. After these circumstances, developing petrol-importer countries were obliged to pay higher petrol bills. Contraction in western market accompanied with regression in foreign trade rates, had all caused decrease in import capacity for these countries (Sarı, 2004, p.12).

## ii) Changes in International Credit Markets

After the 1975s, changes started to be experienced in the structure of international credits. While loanable funds were shifting from official development credits to private credits, on the other hand, interest and maturity structure of these credits were changing adversely on behalf of developing countries' interests. Official credits, provided from international institutions like the World Bank, were more advantageous credits comparing with the private credits since they were having low interest ratios, longer maturity with constant interest ratio (Sarı, 2004, p.13).

Parallel to the increase in private credits, international credits' cost had also increased and their maturity had shortened as well. These structural changes in the international credits started to create some troubles and difficulties for the credit-user countries in debt servicing at the end of the 1970s.

Starting from the 1980's, seeing the potential risk of an international debt problem, creditors started to shift interest rates from stable to floating to take themselves under guarantee. Moreover, they started to impose additional interest which was called 'spread' on their lending so that they were taking into account of potential risks of debtor countries. All these developments had created higher cost of foreign borrowing to the developing countries. This process which feeding itself within the vicious circle, via creating new burdens on the financial balance of the debtor countries laid the groundwork for the emergence of international debt trouble (Sarı, 2004, p.14).

Increases in international interest rates are transmitted to the debtors in developing countries on an expanded scale as other related charges pile up, mainly on the ground of protection of the intermediary institutions against developing country risk. In 1983 in Latin America, where devaluations were much larger, "the effect on the individual private sector, which in some cases had been encouraged by the policies of the authorities to borrow, has been devastating the amount needed in local currency to service external debt has increased three or four times" in one year. In the estimates of the Institute of International Finance Inc., Washington, D.C., each one percentage point change in the international interest rate used to change the amount of interest payments of developing countries by 3-4 billion US dollars per year in the late 1980s. The effect is now smaller as a part of the debt has been shifted from a floating rate to a fixed rate basis. Nonetheless, the effect is still formidable (Dragoslav Avramovic, 1998).

As developing country export prices have been generally falling in the postwar period, the real interest rates they have been paying have been higher than the nominal rates stipulated in their debt contracts. During the commodity price slump in the first half of the 1980s, the average real rate these countries were paying amounted to close to 17 percent per year (Table 1.2)

**Table 1.2 Real interest rates paid by selected major debtors, 1980-1985**

	1982	1983	1984	1985	Average
Argentina	26.3	23.8	11.3	11.6	18.25
Brazil	22.2	19.6	12.6	12.0	16.00
Chile	33.8	8.9	21.6	8.4	18.20
Mexico	27.4	16.9	9.9	15.0	17.30
Nigeria	25.9	25.4	11.5	18.2	20.25
South Korea	14.0	12.5	5.8	7.1	9.90
Average	24.9	17.8	12.3	12.3	16.73

Note: Real rates are nominal (money) rates adjusted by the country's export price index. Source: Dragoslav Avramovic, *Developing Country Debts in the Mid-1980s: Facts, Theory and Policy*, in *Policies for Development*, ed. by Sidney Dell, Macmillan Press, 1988.

These rates are more than three times higher than the rates experienced by developed countries in the same period.

### iii) Fluctuations in the Foreign Exchange Rates

As of the 1970s, after the replacement from fixed exchange rate regime to floating exchange rate regime, there have been observed some negative affects of cross exchange rate on the foreign debt stocks of developing countries. Developments in the value of dollar were becoming important since the funds supplied by the petrol producer countries and developing countries' debt instruments were both in dollars term. After the 1979s, dollar started to gain value relative to other currencies, which in turn led to a negative effect on the debt stocks of the developing countries.

#### 1.2.1.2. Internal Reasons

In the emergence of foreign debt problem, internal reasons had borne as much share as the external factors. While sharing the same cyclical fluctuations, some countries have fallen into deep recessions, but others have not effected. This diversity among countries could be described as the internal dissimilarity of them.

As of the 1970s, developing countries started to compensate their financial requirements for their development process from the foreign credits and aids. Inadequacy in their internal savings emanating from present low income level, inability to create an effectively working tax collection system and low level of export were the reasons behind borrowing from abroad.<sup>4</sup>

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<sup>4</sup> Debt dynamics had worked in two ways. On the one hand, public authorities by themselves had directly gone into borrowing, and on the other hand in order to remedy their deficits, public sector stimulated the private sector for foreign borrowing. High interest rates created by public deficit made foreign borrowing more attractive for the private sector and banking sector. Meanwhile foreign capital tried to evaluate its short-term funds in those countries which in turn played a key role in the increase of debt volumes. This similar mechanism was seen in our country's applications as well (Sari, 2004 p.15).

### i) Internal Reasons In relation With the External Reasons

The growth rates of the developed countries began to decreasing while inflation rates accelerated. The developed countries introduced some contractionary economic policies.

As regards to the LDCs (Less Developed Countries), the important repercussion of these policies was the decline in the import demand for their exports. Beside that in US, growing budget deficits and tight monetary policy pulled the interest rates upwards which caused the appreciation of the US dollar in comparison to the other major currencies. Increasing interest rates and appreciation of the US dollar have caused increase in the debt servicing burden of the LDCs. Since LDCs loans were at floating interest rates, their debt burden was increasing as the interest rates moved up and since foreign debts were serviced particularly in US dollar currency terms, the governments of the debtor countries had to generate more of domestic resources to service a given amount of the debt.

As soon as the debt difficulties in debt servicing emerged, the international banks ceased to extend loans which in turn exacerbated the debt problem. The debtor countries which have not found fresh foreign finance, could not service their debts appropriately. Uncertainty prevailed in international financial markets. Finally, the debt crisis officially came with the declaration of moratorium by the government of Mexico in August 1982 (Candemir, January 1994).

Most of the debtor countries negotiated with their lenders. A few managed to postpone some part of their debt service, while most of them could not. Some attained a type of second best options like Peru who attempted to tie its debt servicing to its export earnings (Candemir, January 1994).

### 1.2.2. Various Approaches to Solve Debt Problem

As a combination of above mentioned reasons, developing countries started to face a debt crisis at the beginning of 1980s. In economic literature this process named as 'Debt Decade' which originated from August 1982 Mexico's moratorium. Mexico was followed by Brazil, Chile, Argentina, and a few African countries. At another corner of the problem there were developed creditor countries. These countries tended to deal with the international debt problem which would potentially affect their economies negatively in the coming days. Nevertheless, for solving these problems, some suggestions came into the agenda (Sari, 2004, p.16).

#### i) Baker Plan

It was a plan designed by US Treasury Secretary James Baker under which 15 principal middle-income debtor countries (the Baker 15) would undertake growth-oriented structural reforms.

The general framework of the plan was to liberalization of the trade, privatization of the public institutions, enhance transfer of direct foreign investment to the countries under this plan.<sup>5</sup>

After three years to announcement of this plan, commercial banks' delay in their commitment on giving credits and insufficiency in meeting the demand of the debtor countries have all played part in restricting the success of the plan and the plan finally lost its functions on the way of solving the problems (Çalışkan, 2003, p.234).

## ii) Brady Plan

The Brady Plan, the principles of which were first articulated by US Treasury Secretary Nicholas F. Brady in March 1989, was designed to address the so-called LDCs debt crisis of the 1980's. The debt crisis began in 1982, when a number of countries, primarily, Latin America, confronted by high interest rates and low commodities prices, admitted their inability to service hundreds of billions of dollars of their commercial bank loans. Because many of these countries' economies were then dependent on commercial bank financing, continued debt rescheduling and resulting perception of uncreditworthiness led to a 'lost decade' of economic stagnation, during which voluntary international credit and capital flows to these nations and their private sectors were severely interrupted.(The CATO Journal, 2006, Vol.16 No:2 )

Mexico, was the first nation to begin negotiating with its commercial bank creditors (August 1982), was also the first nation to restructure under the Brady Plan (1989-90).

The Brady Plan was very successful in several important respects. First, it allowed the participating countries to negotiate substantial reductions in their overall levels of debt service. Second, it succeeded in diversifying sovereign risk away from commercial bank portfolios more widely throughout the financial and investment communities. Third, it encouraged many emerging markets countries to adopt and pursue ambitious economic reform programs. Finally, the Brady Plan has enabled many international capital markets for their financing needs.

This is not to say, of course, that the Brady Plan succeeded in solving all economic problems throughout the emerging markets. The road to greater economic development and democratization has been a bumpy one for some countries. But the Brady Plan did facilitate a return from the rescheduling mode of the LDCs debt crisis to a more normalized, market-oriented relationship between Emerging Markets countries and their creditors.

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<sup>5</sup> Although at that time, Turkey had 20 billion US dollar foreign debt, Turkey was not included in the scope of Baker Plan.



### iii) Paris Club

The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor nations. In the scope of Paris Club the creditors agreed on rescheduling the debts. Rescheduling is a means of providing a country with debt relief through a postponement and, in the case of special rescheduling, a reduction in debt service obligations.

The first meeting with a debtor country was in 1956 when Argentina agreed to meet its public creditor in Paris. Since then, the Paris Club has reached 406 agreements concerning 84 debtor countries. In spite of such activity, the Paris Club has remained strictly informal. It is the voluntary gathering of creditor countries willing to treat in a coordinated way the debt due to them by the developing countries.

In the 1990s, the Club began to treat the HIPCs (Highly Indebted Poor Countries) and non-HIPCs differently. The club began to grant increasingly larger debt reductions for the HIPCs.

In 2004, the Club decided to write-off the debts of Iraq. After 2004 Indian Ocean earthquake, the Paris Club decided to suspend temporarily some of the repayment obligations of the affected countries.

The permanent member-nations of the Club are, Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Russia, Spain, Sweden, Switzerland, The United Kingdom, and the United States. (Xavier, 2004).

### iv) London Club

A committee of bankers representing a debtor country's commercial bank lenders-often called the 'London Club' was typically set up in parallel with the Paris Club when countries faced debt service problems. The aim of the London Club was to ensure equal treatment provided to all bank lenders while providing rescheduling terms to help the country return to creditworthiness.

Rescheduling was a remedy that proved effective for some distressed middle-income debtors. However, this was not enough, and as countries applied for repeated rescheduling, creditors began to look for ways of reducing the amounts owed to manageable levels (IMF Staff, September 2000).

### 1.2.2.1. The Logic of the Debt Relief for the Poorest Countries

Worldwide events in the 1970s, and 1980s, particularly the oil price shocks, high interest rates, recessions in industrial countries, and then weak commodity prices were major contributors to the debt build-up in the HIPC countries.

Beginning of the late 1980s, creditor countries have worked together to provide easier repayment terms for poor countries that struggling with their debts and implementing policies to increase growth. Special relief increasingly was provided on countries' existing debt. Nevertheless, many countries continued to have problems. In time, it became clear that countries' debt problems were not just temporary and that a more comprehensive solution was needed (Calvo, 2001, p.7).

Domestic factors, however, also played a large role in the debt build-up. Many countries were already living beyond their means, with high trade and budget deficits and low savings rates, and had no way to cushion themselves from external shocks. Instead, they borrowed more heavily, often without any change in policies to reduce their dependence on loans. Protracted civil wars, weak economic policies and poor governance all played a part in the build-up (IMF Staff, September 2000).

Some poor countries increasingly resorted to new borrowing simply to service debt. Funds for new investments became more scarce, economic growth slowed and debt dynamics were set off that became unsustainable in many case. Developing (including middle-income) countries' debt rose from 500 billion dollars in 1980 to 1 trillion dollars in 1985 and around 2 trillion dollars in 2000. The 41 HIPC countries, among the poorest of the poor, saw their total indebtedness increase from 60 billion dollars in 1980 to 105 billion dollars in 1985 and 190 billion dollars in 1990. (IMF Staff, September, 2000).

In October 1996, the IMF and the World Bank jointly announced the HIPC Initiative to provide a comprehensive solution to the problems of poor country indebtedness. The initiative aimed for countries to make debt service burdens manageable, through a mixture of sound policies, generous debt relief, and new inflows of aid.

One of the ground-breaking features of the HIPC Initiative was that it was based on the full participation of multilateral creditors, including the IMF, the World Bank, and the regional development banks.

Once countries have demonstrated their commitment to reduce macroeconomic imbalances and sustain growth-oriented policies, normally over a three-year period, they reach the 'decision point'. At this stage, an assessment of the needed assistance is made and appropriate relief is committed, including reductions in the stock of debt. The full stock of debt reduction was implemented following a further period of sound economic policies, at what is the called 'the completion period'.

The IMF and the World Bank, of course, have special roles to play in the implementation of the HIPC Initiative. It is their duty to help governments formulate the economic policy programs that ensure that the resources of the HIPC Initiative will be properly used, and to form an assessment that countries' poverty reduction strategies are up to the job. To reach this goal, the IMF and the World Bank undertook further steps to accelerate the process of granting debt relief by;

- Focusing pre-relief policy requirements on those that are essential to the success of countries' poverty reduction and growth strategies.
- Adopting a more flexible approach to 'track record' requirements, to allow relief to countries whose economic performance is broadly on track (IMF Staff, September 2000).

#### 1.2.2.2. Guidelines for Public Debt Management

In April 2001, IMF and the World Bank have criticized the long-term sustainability of debts of poor LDCs and argued that one of the biggest reason of debt accumulation process of these countries was their insufficient foreign debt management and their inability in establishment of an efficiently working debt management system accompanied by tight fiscal policy.

In March 2001, IMF and the World Bank have jointly published 'Guidelines for Public Debt Management' aiming at constructing of an effective debt management system and reducing country's fragility<sup>6</sup> against international financial shocks. This publication includes some significant recommendations on the aims of debt management, coordination, transparency, debt management strategy, risk management mechanisms. (IMF and the World Bank, 2001)

In 2003, the Guide updated in line with the intensified debates on the sustainability of the debts. This new updated Guidelines was containing 'Collective Action Clauses' (IMF and the World Bank, 2001)

One conclusion is that Collective Action Clauses could allow efficient debt renegotiation while unanimity rules offer incentives for opportunistic behavior by bondholders that leads to inefficient outcomes. With Collective Action Clauses, the mutual gains from renegotiation can be internalized by bondholders so that the holders of each bond issue have incentives to participate in a collective debt restructuring.

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<sup>6</sup> Fragility is especially widespread in developing countries. Fragility arises from tightness economic variety, insufficiency in international savings, less-developed financial system, high sensitivity of economic situation to the high volume capital flows emanating from abroad (IMF and the World Bank, 2001).

## 1.3. Public Debt Management

### 1.3.1. Definition and the Importance of Public Debt Management

Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, pursue its cost and risk objectives, and to meet any other public debt management goals the government may have set such as developing and maintaining an efficient and liquid market for government securities. (IMF and the World Bank, 2001, Guidelines for Public Debt Management, Washington, D.C).

Government debt managers share fiscal and monetary policy advisors' concerns that public sector indebtedness remains on a sustainable path and that a credible strategy is in place to reduce excessive levels of debt. Debt managers should ensure that the fiscal authorities are aware of the impact of government financing requirements and debt levels on borrowing cost.<sup>7</sup>

Every government faces policy choices concerning debt management objectives, its preferred risk tolerance, which part of the government balance sheet those managing debt should be responsible for, how to manage contingent debt, and how to establish sound governance for public debt management.

On many of these issues, there is increasing convergence in the global debt management community on what are considered prudent sovereign debt management practices that can also reduce vulnerability to contagion and financial shocks. Those include: (i) recognition of the benefits of objectives for debt management, (ii) weighting risk against cost considerations, (iii) the separation and coordination of debt and monetary management objectives and accountabilities, (iv) a limit on debt expansion, (v) the need to carefully manage refinancing and market risks and the interest costs of debt burdens, (vi) the necessity of developing a sound institutional structure and policies for reducing operational risk, including clear delegation of responsibilities and associated accountabilities among government agencies involved in debt management; and (vii) the need to carefully identify and manage the risks associated with contingent liabilities (IMF and the World Bank, 2001, Guidelines for Public Debt Management, Washington, D.C).

Public debt management problems often find their origins in the lack of attention paid by policy makers to the benefits of having a prudent debt management strategy and the costs of weak macroeconomic management and excessive debt levels. In the first case, authorities should pay greater attention to the benefits of having a prudent debt management strategy, framework, and policies that are coordinated with a sound macro policy framework. In the second, inappropriate fiscal, monetary, or exchange rate policies generate uncertainty in financial markets

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<sup>7</sup> Excessive levels of debt result in higher interest rates can have adverse effects on real output.

regarding the future returns available on local currency-denominated investments, thereby inducing investors to demand higher risk premiums. Particularly in developing and emerging markets, borrowers and lenders alike may refrain from entering into long-term commitments, which can stifle the development of domestic financial markets, and severely hinder debt managers' effort to protect the government from excessive rollover and foreign exchange risk. A good track record of implementing sound macroeconomic policies can help to alleviate this uncertainty. This should be supplemented with appropriate technical infrastructure such as central registry and payments and settlement systems to facilitate the development of domestic financial markets (IMF and the World Bank, 2001, Guidelines for Public Debt Management, Washington, D.C).

In addition, poorly structured debt in terms of maturity, currency, or interest rate composition and large and unfunded contingent liabilities have been important factors in inducing or propagating economic crisis in many countries throughout history. For example, irrespective of the exchange rate regime, or whether domestic or foreign currency debt is involved, crises have often arisen because of an excessive focus by governments on possible cost savings associated with large volumes of short-term or floating rate debt. This has left government budgets seriously exposed to changing financial market conditions, including changes in the country's creditworthiness, when this debt has not been rolled over.

Foreign currency debt also poses particular risks, and excessive reliance on foreign currency debt can lead to exchange rate and/or monetary pressures if investors become reluctant to refinance the government's foreign currency debt. By reducing the risk that the government's own portfolio management will become a source of instability for the private sector, prudent government debt management, along with sound policies for managing contingent liabilities, can make countries less susceptible to contagion and financial risk.

The size and complexity of a government's debt portfolio often can generate substantial risk to the government's balance sheet and to the country's financial stability. As noted by the Financial Stability Forum's Working Group on Capital Flows,

"Recent experience has highlighted the need for governments to limit the build-up of liquidity exposures and other risks that make their economies especially vulnerable to external shocks. Therefore, sound risk management by the public sector is also essential for risk management by other sectors of the economy, because individual entities within the private sector typically are faced with enormous problems when inadequate sovereign risk management generates vulnerability to a liquidity crisis"  
(Andrew Cornford, Financial Stability Forum, Report of the Working Group on Capital Flows, April, 5, 2000 p.2)

Sound debt structures help governments reduce their exposure to interest rate, currency and other risks. Sometimes these risks can be readily addressed by relatively straightforward measures, such as lengthening the maturities of borrowings and paying the associate higher debt servicing costs (assuming upward sloping yield curve), adjusting the amount, maturity, and composition of foreign exchange reserves,

and reviewing criteria and governance arrangements for contingent liabilities (IMF and the World Bank, 2001, Guidelines for Public Debt Management, Washington, D.C).

There are, however, limits to what sound debt management policies can deliver in and of themselves. Sound debt management policies are no substitute for sound fiscal and monetary management. If macroeconomic policy settings are poor, sound sovereign debt management may not by itself prevent any crisis. Even so, sound debt management policies can reduce susceptibility to contagion and financial risk by playing a catalytic role for broader financial market development and financial deepening.

### 1.3.2. Debt Management Objectives and Coordination

#### i) Objectives

The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Prudent risk management to avoid dangerous debt structures and strategies is crucial, given the severe macroeconomic consequences of sovereign debt default, and magnitude of the ensuing output losses. These costs include business and banking insolvencies as well as the diminishing long-term credibility and capability of the government to mobilize domestic and foreign savings (Guidelines for Public Debt Management, IMF and the World Bank, April, 2001).

#### ii) Scope

Debt management should encompass the main financial obligations over which the central government exercises control. These obligations typically include both marketable debt and non-market debt, such as concessional financing obtained bilateral and multilateral official sources. In a number of countries, the scope of debt management operations has broadened in recent years. Nevertheless, the public sector debt, which is included or excluded from the central government's mandate over debt management, will vary from country to country, depending on the nature of the political and institutional frameworks (Guidelines for Public Debt Management, IMF and the World Bank, April, 2001).

#### iii) Coordination with Monetary and Fiscal Policies

Debt managers, fiscal policy advisors, and central bankers should share an understanding of the objectives of debt management, fiscal and monetary policies given the interdependencies between their different policy instruments. Debt managers should convey to fiscal authorities their views on the costs and risk associated with government financing requirements and debt levels. Policymakers should understand the ways in which the different policy instruments operate their

potential to reinforce one another, and how policy tensions can arise. Prudent debt management, fiscal and monetary policies can reinforce one another in helping to lower the risk level in the structure of long-term interest rates. Monetary authorities should inform the fiscal authorities of the effects of government debt level on the achievement of their monetary objectives. Borrowing limits and sound risk management practices can help to protect the government's balance sheet from debt servicing shocks.

Debt management, fiscal, and monetary authorities should share information on the government's current and future liquidity needs. Since monetary operations are often conducted using government debt instruments and markets, the choice of monetary instruments and operating procedures can have an impact on the functioning of government debt markets, and potentially on the financial condition of dealers in these markets. The efficient conduct of monetary policy requires a solid understanding of the government's short-term and long-term financial flows. As a result, debt management, fiscal and monetary officials often meet to discuss a wide range of policy issues. They often coordinate their market operations so as to ensure that they are not both operating in the same market segment at the same time. Nevertheless, achieving separation between debt management and monetary policy might be more difficult in countries with less-developed financial markets, since debt management operations may have correspondingly larger effects on the level of interest rates and the functioning of the local capital market. Consideration needs to be given to the sequencing of reforms to achieve this separation (Guidelines for Public Debt Management, IMF and the World Bank, April, 2001).

### 1.3.3. Institutional Framework of Debt Management

#### i) Governance

The legal framework should clarify the authority to borrow and to issue new debt, invest, and undertake transactions on the government's behalf. The authority to borrow should be clearly defined in legislation. Sound governance practices are an important component of sovereign debt management, given the size of government debt portfolios.

The organizational framework for debt management should be well specified, and ensure that mandates and roles are well articulated. Legal arrangements should be supported by delegation of appropriate authority to debt managers. There is a range of institutional alternatives for locating the sovereign debt management functions across one or more agencies, including in one or more of the following: the Ministry of Finance, Central Bank Autonomous Debt Management Agency, and Central Depository.<sup>8</sup>

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<sup>8</sup> A few countries have privatized elements of debt management within clearly defined limits including, for example, some back-office and the management of the foreign currency debt stock.

Regardless of which approach is chosen, the key requirement is to ensure that the organizational framework surrounding debt management is clearly specified, there is coordination and sharing of information, and that the mandates of the respective players are clear.<sup>9</sup>

Many debt managers file an annual debt management report, which reviews the previous year's activities, and provides abroad overview of borrowing plans for the current year based on the annual budget projections. These reports increase the accountability of the government debt managers. They also assist financial markets by disclosing the criteria used to guide the debt program, the assumptions and trade-offs underlying these criteria, and the manager's performance in meeting them.

### 1.3.4. Foreign Debt Management Techniques

By collapse of Bretton Woods System in 1970, measurement and management of risk in financial markets started to gain importance. Several developments like; transformation to floating exchange rate system, emergence of various new financial instruments, globalization in international markets, development of derivative markets, increase in investable funds, and huge increase in volatility have all contributed to this process (Serdengeçti, 1999. p.83).

In recent years, spread of risk concept at international scale made it necessary to have effective foreign debt management techniques for countries. This necessity caused emergence of modern foreign debt management techniques.

#### 1.3.4.1. Traditional Foreign Debt Management Techniques

By these techniques the main aim was to get a parallel-run among the country's foreign currency expenses and revenues so that negative or positive fluctuations in one side would automatically result with the same direction developments in other side and equilibrium would be ensured.

Keeping reserves amount at high level, trying to diversify foreign exchange composition of the reserves, implementing policies towards having current account surplus, rising export revenues are all can be counted among traditional techniques. Other frequent application is to involve in such credit agreement which is bilateral and multilateral, having high donation, and having long-term maturity facilities. For all these purposes they apply to legal and institutional restrictions (Geribeyoğlu, 2001, p.18).

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<sup>9</sup> If the central bank is charged with the primary responsibility for debt management, the clarity and separation between debt management and monetary policy objectives especially needs to be maintained.



Having inadequate elasticity with respect to obtaining foreign exchange revenues, it is not easy for an underdeveloped country trying to have a parallel-run among foreign exchange expenses and revenues by using such traditional techniques.

Having a limited alternative foreign debt resources, developing countries usually get along with only present credits in the markets and their initiatives on determining credit interest rate and currency type interrupted.

In view of the market risk associated with fluctuations of the foreign exchange rates in foreign borrowing, policy makers in developing countries preferred to give more attention to them. However, they could not create any traditional instrument to the risk associated interest rates (Bal, 2001, p.135).

#### 1.3.4.2. Modern Foreign Debt Management Techniques

Inadequacy of traditional techniques for a well-operating debt management brought up application of modern debt management techniques for developing countries. Regarding modern foreign debt management, at least some of developing countries started to concern with it at the beginning of 1990's. These developing countries started to search applicability of financial risk management techniques used by the firms on their foreign debt management as well. IMF's and the World Bank's efforts were significant factors in this process too.

Modern foreign debt management implies application of modern risk management techniques on foreign debt management. The core of these approaches is to implement those techniques effectively on the foreign debt management process of developing countries. In other words, this approach aims at controlling future cash flow changes so that current management would be available.

Some prospected benefits of using modern foreign debt management techniques can be counted as follows; by using these instruments, saving in debt servicing would be probably realized. Countries using financial techniques are rated with higher credibility. With the aid of this high credibility they could easily enter into financial markets. Protection strategies have an important role on the economic stability programs. Nevertheless, countries which are intensively using these protection strategies are less likely affected from the negative circumstances emanating from external shocks. In the mean time, if they can decrease uncertainty, they will lead to emergence of a better operating public finance system in the market. These instruments also accelerate integration process of developing countries to international financial system (Ayaş, 1993, pp.9-10).

Within the assets-liabilities framework, some market-based instruments created in order to provide protection against potential risks in the market. These instruments are named as 'Hedging Instruments' and the most frequently used are; Swap, Futures, and Options agreements.

### i) Swap

Debt Swaps are exchange of debt, such as loans or securities, for a new debt contract (debt-to-debt swaps), or exchanges of debt-for-equity, debt-for-exports, or debt-for-domestic currency, such as to be used for projects in the debtor country also known as the debt conversion).<sup>11</sup> This definition is intended to include debt-for-development swaps where economic value is provided by the debtor to the creditor for use in development projects in the debtor's economy.

There are mainly two types of swap; interest and foreign currency swap. These swap transactions as a result lead to transfer of comparative advantage in goods and services markets to the capital markets (Tuncel, 1994, p.28).

### ii) Forward Transactions

In relation with any assets like, goods, foreign exchange, interest, it is a transaction in which maturity and price of the asset is predetermined today with connection to an agreement (Geribeyoğlu, 2001 p.22). Forward transactions embody the obligation to accept or deliver a certain quantity of a certain underlying investment on a certain date in the future (expiry date) at a price agreed upon when concluding the contract. The following may serve as an underlying instruments; Physical assets (equities, warrants, options, commodities, precious metals), benchmarks (currencies, interest rates, indices).

Unlike swap transactions, forward transactions are not implemented in spot markets. In forward transactions, there is no obligation for any prior payment at first step. Because, physical delivery is carried out according to predetermined maturity and terms of agreement. Payment would be effected at agreed maturity and the initially accepted price regardless of the price level in spot market at maturity.

The main purpose of forward transactions is to get protection against unexpected price fluctuations in the markets. In this regard, forward transaction has a special place as an instrument for risk management.

### iii) Future Transactions

Future transaction, like in forward agreements, is a type of agreement ensuring of an asset to be sold or bought by a certain price in the specific time of future. (Bal, 2001 p.159). Since future agreements are in the form of standard agreements, they are topic of stock market. In this regard, they diverge from forward transactions.

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<sup>11</sup> A debt swap should be distinguished from a financial derivative swap. The financial derivative swap involves two parties agreeing to swap future cash flows, while a debt swap involves the exchange of the debt instrument itself for economic value (Statistics Department of IMF, March, 2000).

As a risk management instrument, the main function of future markets is to create mechanism for managing the risks generated by price fluctuations.

#### iv) Option Agreements

With an option the purchaser acquires the right, against immediate payment of the option premium, to purchase (call option) or sell (put option) a certain quantity of the underlying instrument at a price stipulated in advance, either at any time during the life of the contract or on expiry date.

By contrast, the writer of an option undertakes to deliver (call option) or accept (put option) the corresponding underlying instrument at the agreed price if the option is exercised. Depending on the contract specifications, cash settlement can also be accepted in lieu of physical delivery. The following may serve as underlying instruments;

- physical assets (equities, futures, bonds, commodities, precious metals),
- benchmarks (currencies, interest rates, indices)

Contracts can be closed out at any time prior to expiry date. Depending on the type of contract and customary practice on the exchange in question, contracts are closed out either by means of an identical counter-transaction or by concluding an offsetting transaction in respect of the obligation, with otherwise identical specifications. In the latter case the delivery and acceptance obligations resulting from the two open contracts cancel each other out (Cantolan Bank of Berne, June 2000).

#### 1.3.5. Functions of Debt Management

Effective debt management involves primarily seven basic functions: policy, regulatory, resourcing, recording, analytical, controlling and operating functions. The first three functions are part of what can be called Executive Debt Management. The other four functions may be considered to be part of Operational Debt Management. Executive Debt Management might be viewed as the establishment of the “rules of the game” by the highest levels of government. It thus gives direction and organization to the whole which might be called the Debt Management System (UNCTAD, June 2005).

Operational Debt Management is the day-to-day management of debt in accordance with executive direction and organization. Operational debt management may in turn be viewed as being composed of passive and active debt management. Although the dividing line is not always clear, the former involves functions which do not include actions (interactions and transactions) on the debt front, while the latter does. Passive management will strongly influence active management through the provision of information and analysis, and is of equal importance.

Each function of effective debt management has a major output. The various basic functions of effective debt management can briefly be described as follows;

#### 1.3.5.1. Executive Management

The Policy Function involves the formulation of national debt policies and strategies in coordination with the agencies with prime responsibility for the economic management of a country. Broad policy considerations determine a country's sustainable level of external borrowing. This, in turn, is affected by the flows that the country can use efficiently, and how it can generate the additional foreign exchange earnings needed to meet service charges without risking external payments difficulties. These ramifications of foreign borrowing mean that external debt policy affects national planning, balance of payments and budget management, and all government agencies that determine that type of investment undertaken in a country. The major output of this function is a well-defined and feasible national indebtedness and external debt Strategy (UNCTAD, June 2005).

The Regulator Function of debt management involves the legal, institutional and administrative arrangements for external debt management. It involves the establishment of a well-defined regulatory environment to provide for the well-coordinated, and where necessary, centralized, administration of external indebtedness, at the recording, analytical, controlling and operating levels, supported by efficient information flows. The major output of this function is the establishment and continuous review of the administrative and legal framework of organizational responsibilities, rules and procedures among units involved, legal reporting requirements, etc., the organization Structure. The framework will in large measure define the Degree of Control exercised and the data which can be recorded.

The Resourcing Function ensures that the recording, analytical, controlling and operating functions pertaining to external debt management are performed by qualified staff. It involves recruiting, hiring, motivating, training and retaining staff. At times, it might involve the hiring and supervising of outside consultants to provide specialized technical expertise in the area of external debt management (i.e. computerization, debt audits, preparation for rescheduling negotiations, etc.). This function must also very broadly be understood as the provision of adequate material resources (office space, communication equipment, etc.). The main output might be termed Staffing and Means (UNCTAD, June 2005).

#### 1.3.5.2. Operational Management

The functions pertaining to operational debt management, particularly the recording, analytical and controlling functions, are performed on two levels: the Aggregate Level and the Single Transactions (or disaggregated level). This distinction is not always easy to make, but is necessary for a better understanding of debt management (UNCTAD, June 2005).

### i) Passive Management

The Recording Function requires collecting detailed information on debt on a loan-by-loan basis. The fundamental decision to make in elaborating a recording framework for external debt is to decide what constitutes an external debt and subsequently which data will be collected. The data collected on a loan-by-loan basis will be aggregated to provide statistics for analytic purposes. The major result of this function is to provide information, both on an aggregated and disaggregated level.

Very closely related to the recording function is the Analytical Function which utilizes the information provided by the former. At the aggregate level, it involves macroeconomic analysis to explore the various options available given economic and market conditions, and the future structure of the external debt. It is necessary in order to constantly review the impact of various debt management options on the balance-of-payments and the national budget and to help judge such matters as the appropriate terms for new borrowing. At the more disaggregated level, the analytical function would look at the various borrowing instruments, the choice of maturities, etc. and could also assist in the analysis of new financial techniques such as conversion schemes. The output here of course is Analysis (UNCTAD, June 2005).

Classifying foreign debt management as passive and active is a new concepts in evaluating foreign debt. Passive foreign debt management can be described as country's full knowledge about its foreign debt. The following issues need to be addressed for an assessment of passive foreign debt management. These are; (i) types of debt instrument, credit institution, creditor country, feature of the credit (bilateral, multilateral, or is it an commercial credit?), (ii) debtor of the credit(is it central government or local administration, is it guaranteed by the central government?), (iii) amount of the credit, monetary unit, interest rate, sort of interest, charges, grace period, pay-back period, (iv) agreement date, effective date of credit, usage amount, periods of usage, and usage mechanisms. (Bangura, S., Damoni, K, Poweel,R , 2001). From this point of view, passive debt management is the decision making process with respect to debt scheduling, and its instruments by relying on the present statistical debt servicing data.

### ii) Active Management

The Operating Function involves the whole range of activities related to borrowing and other agreements or arrangements which imply some kind of action (interactions and transactions). This function might be divided into three different phases: negotiating, utilization of loan proceeds and servicing. The activities or actions involved in each phase will be different depending on the type of borrowing involved (bilateral and multilateral concessional loans, Eurocredits, etc.). It thus deals with techniques, among which must be included those providing for some form of debt reorganization (such as restructuring, refinancing) and debt

conversion (debt-for-equity swaps, debt-for-goods swaps, 'debt-for-nature' swaps, etc.). The outputs of the operating function are thus actual Debt Operations: Negotiation, Utilization and Service. (These terms must be understood as broad categories. Actual interactions and transactions taking place will depend on the type of borrowing (UNCTAD, June 2005).

The Controlling Function is the function of debt management which is the most difficult to define separately. Indeed, control is intrinsic to a debt management system. While the recording, analytical and operating functions are described here in their 'pure form', it might be argued that control is embedded in those functions. Notwithstanding this, and at the risk of becoming too abstract, separating the controlling function enriches the conceptual approach undertaken here and underlines better the central role of this function.

At the aggregate level, the Controlling/Coordinating function is essential to ensure that operational debt management is in accordance with executive debt management. A strategy may, for instance, impose statutory limits or overall guidelines on how much borrowing can be done by the public sector and/or by the country as a whole. In this case, controlling/coordinating must ensure that borrowing is kept within the imposed limits.

At the transaction or disaggregated level, the Controlling/Monitoring function is more concerned with specific operations, i.e. negotiations, utilization and service. It must ensure, among other things that the terms of new borrowings fall within current guidelines, that funds are being utilized on time and appropriately, and that repayments are made according to schedule.

In practice, the degree of Control can vary widely (according to the different classes or types of debt and debt operations the different public or private borrowing entities involved) and can range from close control to coordination and monitoring.

By considering above information regarding active management, active foreign debt management can be described as utilizing present information for restructuring and re-negotiating the debts. Active debt management involves; usage of risk management techniques that provides reduction in interest and foreign exchange risks by restructuring the debt stock. In this regard, active management implies the process that contributes debt stock and new borrowings to be done with more favorable fiscal conditions. (Bal, 2001, p.80).

Currently, passive external debt management and its related applications fall short in meeting and solving the new foreign debt management problems. This situation revealed the problem concerning effective management of foreign debt stock against financial risks into the agenda. Foreign exchange rates, interest rates, agricultural and metallurgical product prices, fluctuations in petroleum prices and problems arisen in relation with them, have gained new dimensions to foreign debt

management. It is pretty obvious that the new dimension is about risk management which meant evolution of foreign debt management process from passive to active.

## CHAPTER 2

### THE EVOLUTION OF FOREIGN DEBT IN TURKEY

In constructing a well-operating debt management system, determination of the reasons behind foreign debt dynamics are vitally important. Nevertheless, macroeconomic policies have great influence on the foreign debt stocks and their magnitude. For this reason, these policies have to be analyzed very closely.

From this point of view, in this section, policies that have been implemented starting from the 1980s - up to now would be dealt with period by period so that we arrive at a general profile of our country's foreign debt stocks.

#### 2.1. Policies Influencing Foreign Debt Accumulation

Foreign debt accumulation periods of Turkey can be divided into three sub-periods starting from 1980. During the first sub-period, which is between 1980-1989, the financial liberalization process in Turkey was taken as a stage in the stabilization program suggested by the IMF and the so-called 'Washington Consensus'. During the second sub-period, which is between 1990-1999 full capital account liberalization launched. And the third sub-period, which is between 2000-up to now. In December 1999 the Turkish government launched an exchange-rate-based stabilization program in order to bring down inflation. In this regard, it is necessary to analyze these periods with more details in order to see how policies have an impact on the accumulation of foreign debt of Turkey.

##### i) Phases of Macroeconomic Adjustment in Turkey

The years covering 1972 to 1979 is identified as the deepening of the industrialization strategy based on import substitution (ISI). This period, often called the second phase of import substitution, extends the evolution of the inward-looking, domestic demand-led industrialization which dates as early as the 1950s. The late 1970s were characterized by the implementation of a vigorous public investment program which aimed at expanding the domestic production capacity in heavy manufacturing and capital goods, such as machinery, petrochemicals, and basic intermediates. The foreign trade regime was under heavy protection via quantitative restrictions along with a fixed exchange rate regime which, on the average, was overvalued in purchasing parity terms. The state was both an investing and a producing agent with State Economic Enterprises (SEEs) serving as the major tools for fostering the industrialization targets (Boratav and Yeldan, 2001, p.4).

The ISI reached its limits beginning 1976 when keeping up the investment drive and financing the consequent current deficits became increasingly difficult. The foreign exchange crisis of 1977-1980 accompanied by civil unrest and political instability ended with an orthodox stabilization package (1980) and a right-wing military regime (1980-1983).



The post-1980 Turkish adjustment path started with an orthodox stabilization policy which also incorporated the first structural steps toward a market-based mode of regulation. The shock treatment of 1980, facilitated by the military coup of September and generously supported by international donors was, to a large degree, successful in terms of its own policy goals. The rate of inflation which had almost reached three digit figures in 1980 was reduced to an average of 33.2 % in the following two years. The recession was brief and a relatively mild one. Liberalization of domestic markets eliminated the painful shortages in basic commodities, and the major realignment in relative prices took place relatively smoothly. However, the whole operation was, to a large extent, dependent on a drastic regression in labor incomes which was realized by means of the suppressive control of relations of distribution by the military regime. The first phase of reforms was followed by a gradual move into trade liberalization in 1984 (which culminated in a Customs Union With the EU eleven years later) and liberalization of the capital account in 1989 (Boratav and Yeldan, 2001, p.4).

Particularly during the early phases of its inception, Turkish adjustment program was hailed as a 'model' by the orthodox international community, and was supported by generous structural adjustment loans, debt relief, and technical aid. Currently Turkish economy can be said to be operating under conditions of a truly 'open economy' a macroeconomic environment where both the current and capital accounts are completely liberalized. In this setting, many of the instruments of macro and fiscal control have been transformed, and the constraints of macro equilibrium have undergone a major structural change (Boratav and Yeldan, 2001, p.4).

### 2.1.1. 1980-1989 Period

The main characteristics of the period 1980-1989 were export promotion with strong subsidy components and gradually phased import liberalization, together with the managed floating exchange rate and regulated capital movements. Gradual, but significant depreciation of the Turkish lira (TL) was one of the pillars of the policy orientation.

Turkey entered the 1980s with a negative growth rate, a high rate of unemployment, a three digit inflation rate, and huge budget and current account deficits worse was that Turkey had fallen into a payment crisis i.e. Turkey could not make the repayments of its debt which led the loss of creditworthiness in the international financial markets.

Under these circumstances, 'January 24 Decisions' were introduced in January, 24 1980. Decisions were based on the standard prescriptions of the World Bank and the IMF. Liberalization, contraction of the public sector and financial reformation constituted the spirit of the program. Turkey would experience structural change in the economy. Turkey would replace import substitution growth strategy with export promotion strategy. Trade liberalization would accommodate. And finally, this would be followed by financial reforms those aimed to flow savings back into the economy via efficiently working financial institutions.

“Turkish stabilization effort was orthodox and gradualist, and utilized the ‘trade account financial system-capital account’ sequence” (Gökçe, 1993).

In order to reduce the public deficit and offset inflationary impact of this deficit, the public sector needed financial markets in which it could borrow at competitive rates (Atiyas and Ersel, 1992). Hence, the liberalization of capital account was not the main aim per se, but a tool for macroeconomic purposes.

In Table 2.1 Turkey’s external debt stock is seen as 15.7 billion dollar as of 1980. By the January 24 Decisions, earlier periods’ main economic programs were released and above mentioned macroeconomic adjustments had taken place in order to overcome external debt problem. In this regard, the biggest change among others was the opening of Turkish economy to abroad via subsidizing export. Together with export, other subsidies have been provided for generating more revenues from tourism and worker’s remittance. However, in spite of these cautions taken in this period, foreign trade imbalances could not be removed and after 1983 external debt started to trace rising trend, by the 1984 acceleration mounted to above 20%. With the application of variable interest rates on external borrowing, Turkey’s external debt started to accumulate more and more.

Table 2.1 Foreign Debt Stock of Turkey, 1980-1990

Years	Foreign Debt Stock (Billion \$)	Increase (%)	Years	Foreign Debt Stock (Billion \$)	Increase (%)
1980	15,7	-	1986	34,3	24,73
1981	16,6	5,73	1987	43,1	25,66
1982	17,6	5,90	1988	42,7	-0,95
1983	18,8	6,94	1989	43,7	2,34
1984	22,6	20,21	1990	52,3	19,75
1985	27,5	21,68			

Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, [www.hazine.gov.tr](http://www.hazine.gov.tr)

One of the biggest reasons for rising foreign debt stock in this period was the depreciation of US dollars against other currencies. Because of the fact that the currencies other than US dollars were having a certain degree of weight in the composition of Turkey’s foreign debt and their relatively appreciation against US dollars, Turkey’s foreign debt increased in terms of US dollars. Only in the period 1984-1988, Turkey’s foreign debt doubled. Beginning from 1989 foreign debt stock started to be pulled back from its risky level, and Foreign Debt/GNP ratio could have been pulled down. In this period, this positive consequence was generated through Treasury’s determination in implementing a special policy, by which foreign borrowing usage restricted by the amount of foreign debt servicing. Since this similar precaution has not been taken for internal balance, internal economic stability problems came into the agenda (Tandırcıoğlu, 2000, pp.3-4).

The ratio of Foreign Debt to GNP has demonstrated a fluctuating movement in period of 1980-1990. While the ratio was 21.5% in 1980, it rose to 49.2% in 1987, and finally it was dropped to 34.3% in 1990 by Treasury's interventions.

Financial burden of export incentives and foreign debt servicing imposed high costs to state budget and public sector deficits started to increase in this period. Tax policy which focused especially on increasing export volume had prevented establishment of well-operating, conjuncture-oriented financing politics. Instead of establishing a healthy working tax policies, governing party have preferred the way of borrowing from domestic and external markets. (Ünsal, 2004, p.97).

In line with the increasing public deficits, domestic borrowing started to be frequently applied instrument in this period as well.<sup>1</sup> In 1985 where the ratio of domestic debt stocks to GDP was 3 %, by the year 1989 this ratio gradually has risen to 18.2 %.

As parallel movement to rising foreign debt stocks, increasing foreign debt servicing started from mid-1980s, began to exert significant pressures on the budget. These events made domestic borrowing to be frequently applied way of financing option and real interest rates having increasing pattern.

Turkey's tendency from traditional financing sources to new financing sources firstly demonstrated itself in the commercial banks credits' increasing shares. Turkey's first experience in stock market coincidence with this period as well.<sup>2</sup>

Towards the end of the period, increasing foreign debt stocks caused the emergence of some debates in the agenda for the foreign debt management and its related suggestions for the first time. Even in those years, the World Bank recommended the countries concerning the parallel run of liabilities and revenues and for the new borrowings this point should has been taken into consideration. This sort of recommendation can be combined with the traditional foreign debt management techniques. Nevertheless, the World Bank also asserted modern foreign debt management techniques like swap transactions in those years as well (The World Bank, 1990).

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<sup>1</sup> In Turkey, first debt bidding was held in 1985.

<sup>2</sup> In 1985, first exported bonds were the bonds which exported by the Turkey Industrial Development Bank to Japanese Shibosai (Private Placement) market (Sarı, 2004, p.52).

The export-led growth path, which was dependent on wage suppression, depreciation of domestic currency, and extremely generous export subsidies reached its economic and political limits by 1988. While export volume of Turkey was increasing steadily, import volume was increasing as well. This undesired increase in import volume can be attributed to dependence of Turkish industry to importation of intermediary products. So, in this period, with growing current account deficit Turkish economy could grow by the help of foreign borrowing (Boratav, 2003 pp.160-161).

### 2.1.2. 1990-1999 Period

At the beginning of this period, important regulation affecting the functioning of the capital markets was Decree No. 32 regarding the Protection of the Value of Turkish Currency. This Decree enacted in August 1989, aimed at further liberalization of the financial system and allowed not only non-residents to invest in the Turkish securities, but also permitted the outflow of domestic capital into foreign securities through the financial intermediaries authorized by the CMB (Capital Market Board of Turkey). In addition, under Decree No. 32, foreign investment funds may freely purchase and sell stocks that are traded on stock exchanges and other securities representing partnerships via banks and intermediary institutions authorized by CML (Capital Market Law). No requirement exists for either pre/post permission or notification (PricewaterhouseCoppers, 2004).

By-product of capital account liberalization has been a consistent overvaluation of TL. Apparently, after 1989 the real exchange rate of TL against major currencies moved to a lower plateau and except the depreciations in the crises years, stayed there. The overvaluation has perverse effects on exports and growth. In addition, overvaluation had a significantly positive effect on imports. Moreover, as debt stock was augmented, the interest paid for it rose too. Through those two channels, debt flows once used to finance basic balance deficits before liberalization, became a stimulating factor for those deficits.

However, when Özal government took the liberalization decision in 1989, it was most probably an attempt to cope with the macroeconomic imbalance reappearing after the export-led growth boom of 1980s (Akyüz and Boratav, 2002, p.3). The motive behind liberalization was to restore growth and stability by raising savings and improving economic efficiency. A major consequence, however, has been the exposure of the economy to short term capital movements (hot money) which have increased financial instability and have resulted in a series of financial crisis. With full liberalization of the capital account and the recognition of full convertibility of the lira in 1989, there has been a massive inflow of short term capital into the domestic economy. This, in turn, caused the emergence of 'hot money policy' implementation practices in Turkey. Foreign exchange rates were allowed to move parallel to the inflation. This policy furthermore aimed at financing public deficit with the real interest rates above the increase in foreign exchange rates (by allowing appreciation of TL), so that both the private and public sector borrowing had been encouraged.

Four years succeeding the 1989, these incentive policies caused foreign debt stock to increase by 61.3%. We can see in Table 2.2. that Turkey's debt stock reached to 70.5 billion US in 1993 (While it was only 43.7 billion US dollars in 1989 as depicted in Table 2.1.). In this four years period, increase in short-term borrowing was 223%. This occurrence brought the share of short-term borrowing within total debt stock from 13.8 to such a risky level of 27.5%. Commercial banks have played key role in deterioration of this balance. Ekinçi (1996) notes that of the 7.2 billion dollars of external debt accumulation in 1990, 3.8 billion was short term, and 60% of that amount was in the form of short-term foreign liabilities of the commercial banking sectors.

'Hot money policy' was based on the perception that the short-term liabilities would eventually lower the domestic interest rates. However, this did not occur in fact. Interest rate movement towards desired direction has been interrupted because of Treasury's need for funds, high level of foreign debt servicing, the need for foreign exchange in closing current account deficits, and devaluation risk (Bağcı, 2001, p.118).

Table 2.2 Foreign Debt Stock of Turkey, 1990-2005

Years	Foreign debt stock (Billion \$)	Increase (%)	Years	Foreign debt stock (Billion \$)	Increase (%)
1991	53,6	2,40	1999	103,0	6,85
1992	58,6	9,36	2000	118,6	15,12
1993	70,5	20,31	2001	113,7	- 4,13
1994	68,6	-2,62	2002	130,2	14,51
1995	75,7	10,31	2003	145,4	11,67
1996	79,4	4,80	2004	161,7	11,21
1997	84,2	6,12	2005	170,6	5,5
1998	96,4	14,49	2006**	185	8,4
As of first quarter of *2006.					
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>					

The policy of high interest rate and low-rate of exchange has become effective in shaping public sector financing policies after 1990. While increasing domestic interest rates were making internal borrowing more costly, rising inflation rate have restricted the application of emission possibilities. However, cost of foreign borrowing was lower compared to the domestic borrowing thanks to the low-rate of exchange policy. This situation caused the government frequently prefer foreign borrowing as a tool for financing. While in financing consolidated budget deficit contribution of net external borrowing was only 0.34% in 1990, it has mounted to 15% in 1993. Lower cost of external borrowing in comparison with the internal borrowing played a significant role in this consequence to occur (Uluğbay, 1994, p.34).

Although debt-financing was an easy way to finance public deficits, it was soon understood that it was a never-ending process. As continuity of capital inflows depended on high arbitrage levels for non-resident investors, while borrowing in high interest rates, government repressed depreciation of TL. As a result, arbitrage levels have generally been higher than 20 % and rose occasionally to rates over 60 %. However, when investor expectations were reversed, it had been impossible to access to international financial capital even at high arbitrage levels. The swing in debt inflows reached 25 billion US dollars in the major debt flow reversal of 2001 crisis (Boratav, 2001, pp.7-17).

Meanwhile, high arbitrage levels did not result in long-term borrowing. In the second half of 1993, to prevent a further rise in the cost of servicing the domestic debt, the government cancelled various domestic debt auctions or accepted a small percentage of short maturity offers and reversing the investor expectations. This attempt resulted in a run on foreign currency and consequently 1994 financial crisis. (Özatay, 1999, pp.1-26). After 1994, the government did not have any attempt to solve the short-termism in debt financing. Rather, continuing in managed float regime repressing depreciation to attain high arbitrage levels.

Public Sector Borrowing Requirement (PSBR) had been consistently on rise and government had chosen for the easy debt-financing way to sustain these high levels by the help of abundant capital inflows. The debt-financing was indirect form: government mostly borrowed in domestic markets, while domestic financial agents borrowed from abroad, increasing the foreign debt stock eventually. Indirect financing did not make a difference about solvency: Had the government became insolvent, its domestic lenders would be insolvent too. In addition, as Ziya Öniş and A. Aysan (2000) put forward,

“Government had been reluctant to take necessary measures to increase its revenues (such as tax reform) as it was presumed that the debt-finance would be never-ending”.

As Table 2.2 depicts, we see lower increase in Turkey’s debt stock in 1994. This was mainly due to difficult position of Treasury in making debt servicing. Treasury could not able to get required funds from abroad due to 1994 currency crisis by which Turkey has lost its confidence and credit standing in the eyes of lenders in international markets. However we observe an accelerated foreign debt accumulation prior to 1994 crisis which was 58.6 billion dollars in 1992 and 70.50 billion dollars in 1993. We also observe an increasing trend in foreign debt accumulation just after the 1994 crisis; while foreign debt stock was 68.6 billion dollars in 1994, it mounted to 75.7 billion dollars in 1995.

According to Treasury, total external debt stood at 84.2 billion dollars (43.3% of GNP) in 1997 and climbed to 103 billion dollars (55% of GNP) by the end of 1999. The private sector was responsible for all of the increase over this period as the public sector portion of the foreign debt remained constant at around 52 billion dollars during that period. Commercial banks held about half (13 billion dollars) of the total private sector short-term debt, which stood at 23.4 billion dollars in 1999.

The cumulative current account deficits for this period, 1996-1999, was only 4.4 billion dollars and thus capital inflows were financing positions in domestic debt instruments through the private sector, mainly, private banks. Private banks have been the main buyers of public debt instruments and developed a fragile financial position in the process. In 1999, the Treasury had to rollover an average amount of five billion dollars each month at an average maturity of twelve months in the first half of the year.<sup>3</sup> The average monthly interest rate was around 6%, which compounds to over 100% annually, compared to a rate of depreciation of around 60% over the year (Ekinçi and Ertürk, 2004, p.6).

The explosive increase in domestic public debt was one of the main problems the failed IMF-backed stabilization program meant to address. The Russian crisis only increased the urgency of the debt problem as it had led to an outflow of seven billion dollars in the last quarter of 1998 from Turkey. At the time, CB avoided a liquidity squeeze as it had partially sterilized the outflow, but the interest rates had soared. To stabilize the debt to GDP ratio, it was clear that interest rates had to decrease.

By 1999, it became evident that public debt was at unsustainable levels. Meanwhile, PSBR already reached 15 % and fragility indicators relating to short-term debt were at all-time high levels. A last attempt to control the debt stock by the IMF-led stabilization program of 1999 resulted in the financial crisis in February 2001.

### 2.1.3. Aftermath of the Currency Crisis of 2000

After going through a series of short-term cycles of instability, crisis, unsustainable growth, throughout the 1990's, it was understood by the political elites that the ongoing economic policies could not be continued, the main economic problems of Turkey were high PSBR to GNP ratio, weak banking system, high inflation and no prospect for sustainable GNP growth. As a matter of fact, solving these problems was the main motive behind the IMF supported 2000 Disinflation program.

Following the conclusion of a three-year stand-by agreement with the IMF in December 1999, Turkey began implementing a program in January 2000 that aimed at reducing consumer price inflation to 25 % in 2000, and to single digits by the end of 2002. The other main objective was to first stabilize and then reduce the debt to GDP ratio.<sup>4</sup>

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<sup>3</sup> The increase in average maturity towards the end of the year is attributable to announcement effects of the IMF-sponsored stabilization policy that became operational in the very beginning of 2000.

<sup>4</sup> The total debt to GDP ratio, which stood at 61 % at the start of the program, was expected to fall to 55 % by its completion at the end of 2002.

In addition to its tight fiscal stance<sup>5</sup> and promise of structural reform, Turkey's stabilization program was characterized by a firm exchange rate commitment (a soft peg regime implemented) and a quasi-currency board arrangement that set limits on the net domestic assets of the Central Bank.

The monetary policy setting meant that the Bank was not allowed to sterilize capital inflows or outflows and could no longer control interest rates. CBT, thereafter, gave up its control on the interest rates and focused on controlling the exchange rates.

Although the program started from a point where TL was already appreciated, soft peg regime affected the exchange rate expectations dramatically. The expected depreciation of TL declined dramatically which caused an inward shift on the expected return on foreign currency denominated assets given the foreign interest rates. This shift led to a capital inflow. These inflows were short-term capital in the form of portfolio investment and inter-bank lending.<sup>6</sup> This capital inflow led to a monetary expansion because of the monetary policy framework. As a result, interest rates declined while TL continued to appreciate in real terms since the inflation did not decline as fast as it should have been. As expected, real appreciation of TL led to a rise in current deficit.

The rise of the current account deficit was the first bad sign for the sustainability of the soft peg regime. But the real risk for the system was the weakness of the banking system which was exacerbated by the soft peg regime. During the soft peg regime, the banking system raised their Foreign Exchange position due to the elimination of the uncertainties in the future level of foreign exchange. On the other hand, they mainly focused on managing their interest rate risk which was hard to manage for some of banks because of the maturity mismatch in their balance sheet. The main reason for this maturity mismatch was the financing of the government securities with very short liabilities. Because of the lack of lender of last resort function of CBT in the soft peg regime, the operation of the interbank system was on a knife edge situation given this maturity mismatch since the volatility of the inter-bank interest rates increased with the soft peg system (Ekinçi and Ertürk, 2004, p.7)

In fact, the first shock to the system occurred when one of the banks could not be able to rollover its debt. This fact first raised the interest rates in interbank TL market and then in the secondary bond market. In addition, the rise of sudden capital outflow, liquidity contraction became more severe which pushed interest rates even higher. CBT had lack of instruments to prevent this contraction because of the soft peg regime. Therefore, the first shock could only be handled with taken over the insolvent bank by the government, receiving additional funds for 7.5 billion dollars

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<sup>5</sup> The fiscal adjustment envisaged a primary surplus of 2.2 % in 2000 and 5.5 % in the remaining two years (Ekinçi and Ertürk, 2004, p.7).

<sup>6</sup> The total of the portfolio investment and inter-bank lending was amounted 6.4 % of GNP in 2000 (Ekinçi and Ertürk, 2004, p.7).



from the IMF's Supplemental Reserve Facility and a firm government commitment that guaranteeing all the liabilities of the banking system to help avoiding the further capital outflow. Yet, the harm of the shock for banking system could not be reversed. As a matter of fact, it took only 3 months for another speculative attack which ended the soft peg regime lasted only 14 months. The process was similar to that of November. As the capital outflow contracted the money supply, interest rate rose to incredibly high level which hit the banking system second time in a very short time. CBT tried to defend the exchange rates for three days. Nonetheless, the credibility of the soft peg regime was completely lost and there remained no reason to continue to the system. Thereafter, TL was allowed to float which caused a sharp increase in exchange rates (Ekinci and Ertürk, 2004, p.8)

The soft peg regime, which was designed in coordination with the IMF, seems to be the worst possible choice for Turkey. In order to get the expected results of the exchange rate control in a free capital movement environment, the economy in general and banking system in particular, should be sound enough to resist sudden capital movements. Given the structural weaknesses in the banking system, it seems that this condition was not valid for Turkey. Therefore, the soft peg regime itself contributed to the severity of the problems in Turkey rather than solving them.

After the collapse of the soft peg in February 22, 2001, the stability program redesigned. As a matter of fact, the new set of policies which were introduced formally on April 14, 2001 under titles such as 'national program', and then 'transition to the strong economy program' (TSEP) asserted that; the main aim of the program was to eliminate the instability due to lack of trust and to construct the necessary legal infrastructure so as to re-organize the public administration and the economic decision making process. In the scope of this new program 10.2 billion dollars funds were utilized from IMF (Sari, 2004, p.59).

After the TSEP, banking restructuring became the top priority of the economic policy in the very short run, while the tight fiscal policy sustained.<sup>7</sup> In addition, inflation targeting has been decided as the monetary policy framework in the medium run. Thanks to free floating regime, CBT regained its power on monetary control.<sup>8</sup> This helped the CBT to build up accountability which would be necessary for the success of the inflation targeting.

In this period we see an accumulation of foreign debt stocks in order to recover the economy from crisis. In addition to these negative developments, the banking restructuring costs also worsened the fiscal conditions.

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<sup>7</sup> The banking restructuring costs, however, worsened the fiscal conditions. The cost of the banking restructuring has been reported around 40 billion US dollars. Total debt to GNP ratio increased 60 percentage points in 2001 mainly due to the banking restructuring costs (Sari, 2004, p.60).

<sup>8</sup> The institutional independence of CBT was enhanced with an amendment on the CBT Law. This was also a factor that contributed to the power of CBT (Sari, 2004, p.60).

## 2.2. Macroeconomics of Post-Crisis Adjustments and the Current Situation

Turkey experienced a severe economic and political crisis in November 2000 and again in February 2001. These crises erupted when Turkey was following an exchange rate-based disinflation program led and engineered by IMF. Over 2001 the GDP contracted by 74 % in real terms, whole sale price inflation soared to 61.6 %, and the national currency lost 51 % of its value against the major foreign currencies.

The IMF has been involved with the macro management of the Turkish economy both prior and after the crisis, and provided financial assistance of 20.4 billions dollars, net, between 1999 and 2003. Following the crisis, Turkey has implemented an orthodox strategy of raising interest rates and maintaining an overvalued exchange rate. The government was forced to follow a contractionary fiscal policy, and promised to satisfy the customary IMF demands, reduce subsidies to agriculture, privatize, and reduce public sector in economic activity (Yeldan, 2006).

With the new stand-by on which the government reached consensus with the IMF in 2004, the international system was assured that the process would continue up to 2007 along the same lines. The program was officially declared as a bundle of policies aimed at checking increases in both domestic and foreign debt and channeling the country again to the path of 'stable' growth.

### 2.2.1. Post-Crisis Characteristics of Growth

The current IMF program in Turkey relies mainly on two pillars: (i) fiscal austerity that targets a 6.5 percent surplus for the public sector in its primary budget<sup>9</sup> as a ratio to the gross domestic product; and (ii) a contractionary monetary policy (through an independent central bank) that exclusively aims at price stability (via inflation targeting). Thus, in a nutshell the Turkish government is charged to maintain dual targets: a primary surplus target in fiscal balances (at 6.5% to the GDP); and an inflation-targeting central bank whose sole mandate is to maintain price stability and is divorced from all other concerns of macroeconomic aggregates (Yeldan, 2006).

According to the logic of the program, successful achievement of the fiscal and monetary targets would enhance 'credibility' of the Turkish government ensuring reduction in the country risk perception. This would enable reductions in the rate of interest that would then stimulate private consumption and fixed investments, paving the way to sustained growth. Thus, it is alleged that what is being implemented is actually an expansionary program of fiscal contraction.

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<sup>9</sup> i.e., balance on non-interest expenditures and aggregate public revenues. The primary surplus target of the central government budget was set 5 % to the GNP.

The post-2001 growth had indeed been high. Annual rate of growth of real GNP averaged 7.8 % over 2002-2006's second quarter. Growth, while rapid, had very unique characteristics. It was mainly driven by a massive inflow of foreign finance capital which in turn was lured by significantly high rates of return offered domestically; hence, it was speculative-led in nature (Yeldan, 2006, p.4).

Disinflation has been another area of success for the government. CBT has started to follow an open inflation targeting framework since January 2006. The Bank's current mandate is to set a 'point' target of 5 percent inflation of the consumer prices. Inflation rate, both in consumer and producer prices, has, in fact been brought under control by 2004. Producer price inflation reduced to less than 3 % in late 2005. After the brief turbulence in the asset markets in May-July 2006, inflation again accelerated to above 10 % and as of third quarter of 2006, the rate of inflation stands at 12.6 % for producer prices, and 10.8 % for consumer prices (Yeldan, 2006, p.4).

Despite this positive achievements on the disinflation front, rates of interest remained slow to adjust. The real rate of interest on the government debt instruments (GDIs) for instance remained above 10 % over most of the post-crisis period and generated heavy pressures against the fiscal authority in meeting its debt obligations. (See figure 2.1).

**Table 2.3 Key Macroeconomic Indicators**

	IMF-Led Post-Crisis Adjustments						
	IMF-Led Dis-inflation Programme	Crisis	Under 3-party Coalition Government				2006.Q3
			2002	2003	2004	2005	
	2000	2001	2002	2003	2004	2005	2006.Q3
GNP Growth Rate	6.3	-9.5	7.9	5.9	9.9	7.6	7.8 <sup>1</sup>
Inflation (CPI, 12 months averages)	54.9	54.4	44.9	25.3	10.6	8.2	10.5
Real Wage Growth (%) <sup>2</sup>	2.1	-20.1	1.1	5.1	3.9	-0.1	1.3 <sup>1</sup>
Unemployment Rate (%)	6.5	8.4	10.3	10.5	10.3	10.2	8.8 <sup>1</sup>
Budget balance / GNP (%)	-10.9	-16.2	-14.3	-11.2	-7.1	-2.0	n.a.
Non-interest Primary Budget Balance / GNP (%)	5.7	6.8	4.3	5.2	6.1	7.4	n.a.
Central Adm. Domestic Debt (Billions \$)	58.0	84.9	91.7	139.3	167.3	182.4	155.4 <sup>1</sup>
Central Adm. Domestic Debt / GNP (%)	29.0	69.2	54.5	54.5	52.3	50.3	n.a.
Total External Debt Stock (Billions \$)	118.5	113.6	130.1	144.9	162.2	171.1	193.6 <sup>1</sup>
External Debt / GNP (%)	59.3	78.0	71.9	60.6	54.2	47.4	n.a.
Foreign Trade Balance (Billions \$)	-23.8	-7.1	-11.4	-18.2	-30.6	-39.8	-32.0
Exports (fob, billions \$)	30.7	34.3	40.1	51.1	66.9	76.7	63.9
Imports (cif, billions \$)	54.5	41.4	51.5	69.3	97.5	116.5	95.9
Current Account Balance (Billions \$)	-9.8	3.4	-1.5	-8.1	-15.6	-23.1	-25.3
Current Account Balance / GNP (%)	-4.9	2.3	-0.8	-2.8	-5.3	-6.4	n.a.

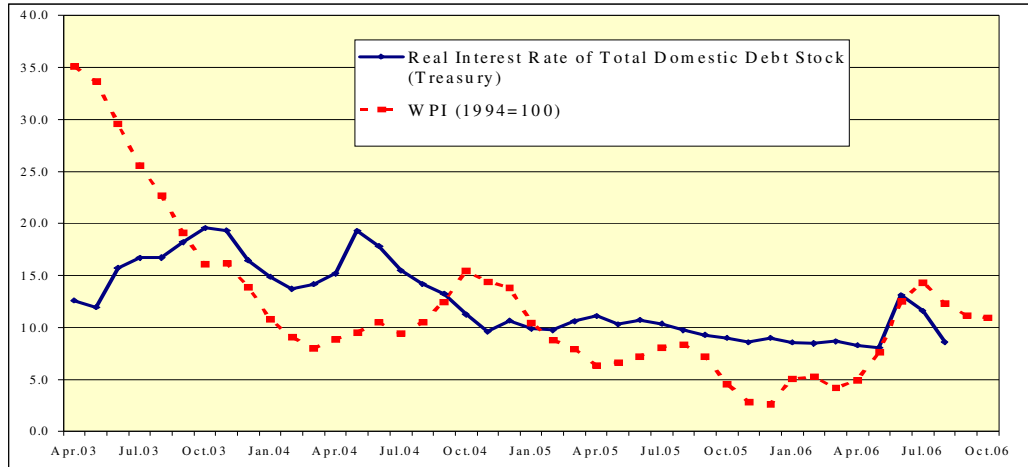
Source: TR Central Bank ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)); Undersecretariat of Treasury ([www.treasury.gov.tr](http://www.treasury.gov.tr))

1. As of Second quarter of 2006.

2. Real hourly wages growth in private manufacturing

Inertia of the real rate of interest is enigmatic from the successful macroeconomic performance achieved thus far on the fiscal front. Even though one traces a decline in the general plateau of the real interest rates, the Turkish interest charges are observed to remain significantly higher than those prevailing in most emerging market economies. The credit interest rate, in particular, has been stagnant at the rate 16% despite the deceleration of price inflation until the May-July turbulence. Since then the credit interest rates accelerated to 23.5% (Turkstat, 2006).

**Figure 2.1 Inflation (WPI, 1994=100) and Real Interest Rates**



Source: TURKSTAT

High rates of interest were conducive in generating a high inflow of hot money finance to the Turkish financial markets. The most direct effect of the surge in foreign finance capital over this period was felt in the foreign exchange market. The over-abundance of foreign exchange supplied by the foreign financial arbitrageurs seeking positive yields led significant pressures for the Turkish Lira to appreciate. As the Turkish Central Bank has restricted its monetary policies only to the control of price inflation, and left the value of the domestic currency to the speculative decisions of the market forces, the Lira appreciated by as much as 40% in real terms against the US dollars and by 25% against Euro (in producer price parity conditions).

**Figure 2.2 Index of the Real Exchange Rate (TL / US\$)**



Source: Central Bank of Turkey and TURKSTAT.

Figure 2.2 portrays the path of the real exchange rate (in PPP terms, with producer prices as the deflator) over 2000-2006. The currency crises of November 2000 through February 2001 are clearly visible in the figure. The recent blip in May-July 2006, on the other hand, has had a minimal effect on the real value of the real exchange rate and did not suffice to change the direction of the course towards appreciation.

## 2.2.2. Components of Balance of Payments and External Debt

The structural overvaluation of the TL, not surprisingly, manifests itself in ever-expanding deficits on the commodity trade and current account balances. As traditional Turkish exports lose their competitiveness, new export lines emerge. Yet, these are mostly import-dependent, assembly-line industries, such as automotive parts and consumer durables. They use the advantage of cheap import materials, get assembled in Turkey at low value added and then are re-directed for export. Thus, being mostly import-dependent, they have a low capacity to generate value added and employment. As traditional exports dwindle, the newly emerging export industries are not vigorous enough to close the trade gap (Yeldan, 2006).

Consequently, starting in 2003 Turkey has witnessed expanding current account deficits, with the figure in 2004 reaching a record-breaking magnitude of 23.1 billion dollars, or 6.4% as a ratio to the aggregate GNP. The latest data indicate that by the third quarter of 2006, the cumulative current account deficit has already reached 25.8 billion dollars, and calculated as the total of last twelve months, exceeds 7% as a ratio to the GNP. Thus, the strong pressures towards deterioration of the current account balance continued to persist over 2006 onwards.

**Table 2.4 Selected Indicators on Balance of Payments and Foreign Debt (Millions US\$)**

	2001	2002	2003	2004	2005	2006Q3	Total over 2006Q3-2003
Exports (fob)	34,373	40,124	51,206	67,047	76,595	63,916	258,764
Imports (fob)	-38,106	-47,407	-65,216	-90,925	-109,171	-95,922	-361,234
Trade Balance	-3,733	-7,283	-14,010	-23,878	-32,576	-32,006	-102,470
<b>Current Account Balance</b>	3,392	-1,524	-8,037	-15,604	-22,852	-25,334	<b>-71,827</b>
<b>Finance Account Balance</b>	-14,643	1,161	7,098	17,679	44,069	34,462	<b>103,308</b>
Foreign Direct Investment by Residents Abroad	-497	-175	-499	-859	-1,047	-361	-2,766
Foreign Direct Investment by Non-Residents	3,352	1,137	1,752	2,847	9,650	12,804	27,053
Non-Residents' Portfolio Investments in Turkey	-3,727	1,503	3,851	9,411	14,670	4,849	32,781
Residents' Portfolio Investments Abroad	-788	-2,096	-1,386	-1,388	-961	-1,284	-5,019
Other Investment, Net	-12,983	792	3,380	7,668	21,757	18,454	51,259
<b>Net Errors and Emissions</b>	-1,759	118	4,941	2,267	1,983	-659	<b>8,532</b>
<b>Change in Reserves (-: Increase)</b>	12,924	212	-4,097	-4,342	-23,200	-8,469	<b>-40,108</b>
Foreign Debt Stock	113,592	130,093	144,915	162,202	171,078	193,617 <sup>1</sup>	63,524 <sup>1</sup>
Short Term Foreign Debt Stock	16,403	16,424	23,013	32,569	38,247	43,727 <sup>1</sup>	27,303 <sup>1</sup>
Ratio of Short Term Foreign Debt Stock to Central Bank Reserves (%)	0.87	0.61	0.68	0.90	0.76	0.77 <sup>1</sup>	..

Source: TR Central Bank (www.tcmb.gov.tr)  
Note 1. As of second quarter of 2006.

In fact, the mechanics behind the culminating current account deficit can only be understood in the context of the speculative transactions embedded in the Finance account of the BOP. Table 2.4 summarizes the relevant data.

Data in Table 2.4 indicate that the finance account has depicted a net surplus of 103.3 billion over the period, 2003 through 2006 (September). About half of this sum (151.2 billion dollars) was due to credit financing of the banking sector and the non-bank enterprises, while a third (32.8 billion dollars) originated from non-residents' portfolio investments in Turkey. Residents have exported financial capital at the magnitude of 5.4 billion dollars, and if one interprets the net errors and omissions term of the BOP accounts as an indicator of domestic hot money flows (Boratav and Akyuz, 2004; Boratav and Yeldan, 2006), the total sum of net speculative finance capital inflows reach to 36.2 billion dollars over the three years of the post-crisis adjustments.

The foreign direct investment (FDI) is taken as an important source of financing the current account deficit especially after 2005. It is true that the BOP data reveal a sudden increase in the flow of FDI monies totaling 22.4 billion dollars in the last two years. However, looking at the FDI more closely, it would be revealed that the bulk of the aforementioned flow had been due to privatization receipts plus real estate and land purchases by foreigners. Neither of these items are sustainable sources of foreign exchange, and they were driven by speculative arbitrage opportunities rather than enhancing the real physical capital stock of the domestic economy. In fact as reported by the ANKA researchers, the stock of "hot money" has reached to 52.3 billion dollars as of August 2006. This stock is fed upon three sources: (i) foreigners' holdings of government debt instruments (17.9 billion Euro) and (ii) of securities at the Istanbul Stock Exchange Market (30.6 billion dollars); and (iii) foreign exchange deposits at the banking sector (3.7 billion dollars). The aggregate stock of hot money reaches to two-thirds of the cumulative current account deficit over the post-2001 crisis period (Yeldan, 2006, p.8).

A significant detrimental nature of hot money led balance of payments financing is its foreign debt intensity. As reported in Table 2.4, the stock of external debt has increased by a total of 63.5 billion dollars over the end of 2002 to the second quarter of 2006 (the most recent data available at the time of writing). This indicates a cumulative increase at a rate of 48.8% in US dollar terms over a period of 3.5 years. Despite this rapid increase, the burden of external debt as a ratio to the GNP has fallen from 71.9 % (2002) to 47.4 % (2005). This fall is due to both the rapid expansion of the GNP and the unprecedented appreciation of the Lira over the period. The appreciation of TL disguises much of the fragility associated with both the level and the external debt induced financing of the current account deficits. A simple purchasing power parity "correction" of the real exchange rate, for instance, would increase the burden of external debt to 76.8 % as a ratio to the GNP in 2005.<sup>10</sup>

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<sup>10</sup> Measured in 2002 producer prices. If the PPP-correction is calculated in 2000 prices, the revised debt to GNP ratio reaches to 82.3 % (Yeldan, 2006, p.8).

This would bring the debt burden ratio to the 2001 pre-crisis level. Under conditions of the floating foreign exchange regime, this observation reveals a persistent fragility for the Turkish external markets, as a possible depreciation of the Lira in the days to come may severely worsen the current account financing possibilities. This persistent external fragility is actually one of the main reasons why Turkey had been hit the hardest among the emerging market economies in the May-June 2006 turbulence (IMF, 2006).

Another facet of the external fragility of the Turkish balance of payments regards the composition of debt. As far as the post-2001 era is concerned, two critical features of external debt driven current account financing have been that, (i) the foreign debt accumulation was mostly of short term duration; and (ii) it was mostly driven by the non-financial private sector, rather than the public sector.

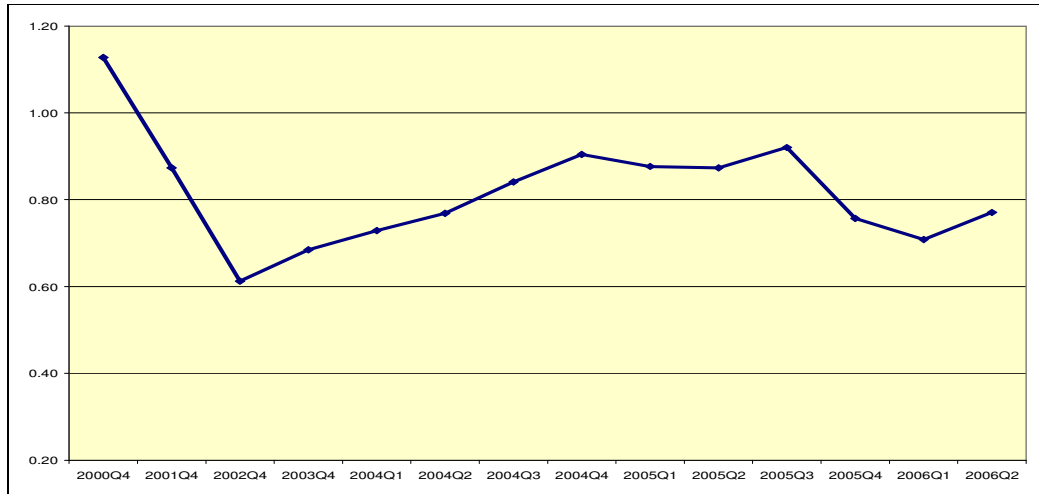
**Table 2.5 Composition of External Debt Stock (Millions US\$)**

	2000Q4	2001Q4	2002Q4	2003Q4	2004Q4	2005Q4	2006Q2	2006Q2 - 2002Q4 Increase
<i>External Debt Stock (1 + 2)</i>	118,504	113,592	130,093	144,915	162,202	171,078	193,617	63,524
<i>(1) Short Term Foreign Debt</i>	28,301	16,403	16,424	23,013	32,569	38,247	43,727	27,303
Banks	16,900	7,997	6,344	9,692	14,529	17,740	20,799	14,455
Other Sectors	9,748	7,654	8,425	10,461	14,753	17,744	20,154	11,729
TR Central Bank	653	752	1,655	2,860	3,287	2,763	2,774	1,119
<i>(2) Medium-Long Term Debt</i>	90,203	97,189	113,669	121,902	129,633	132,831	149,890	36,221
(2.1) Public Sector	47,621	46,110	63,618	69,503	73,825	68,114	66,899	3,281
(2.2) TR Central Bank	13,429	23,591	20,340	21,504	18,114	12,654	12,989	-7,351
(2.3) Private Sector	29,153	27,488	29,711	30,895	37,694	52,063	70,002	40,291
(2.3.1) Financial Enterprises	7,581	4,789	4,637	5,060	8,284	15,316	20,331	15,694
Banks	4,550	3,211	3,026	3,140	5,750	12,231	16,563	13,537
Non-Bank Financial	3,032	1,578	1,611	1,920	2,534	3,085	3,768	2,157
(2.3.2) Non-Financial Enterprises	21,571	22,699	25,074	25,835	29,410	36,747	49,671	24,597

Source: Undersecretariat of Treasury ([www.hazine.gov.tr](http://www.hazine.gov.tr))

As Table 2.5 depicts, of the accumulated foreign debt of 63.2 billion dollars over the current government era, 47 % was short term in maturity. Turkey's external short term debt stock, which had reached to 28.3 billion dollars just before the eruption of the February 2001 crisis, was reduced to as low as 13.7 billion dollars in the first quarter of 2002. The stock of short term debt has increased rapidly, especially after 2003, to reach 43.7 billion dollars as of the second quarter of 2006. A critical account of this episode pertain the ratio of short term debt to Central bank's international reserves. This ratio is regarded as one of the crucial leading indicators of external fragility (Kaminsky, 1999), and has been interpreted as the "most robust predictor of a currency crisis" in Rodrik and Velasco (1999). The path of this indicator over the post-2001 period is portrayed in Figure 2.3 below.

**Figure 2.3 Ratio of Short term External Debt to Central Bank Foreign Reserves (Gross)**



Source: Central Bank of Turkey

As the ratio of short term external debt to CB international reserves rise, it signals a “fall” in the capability of the CB to meet the external liabilities of the domestic economy, and is interpreted as worsening of external fragility. This ratio stood at 0.87 by the end of 2001<sup>11</sup>, and after receding to 0.61 in early 2002, rose up to 0.92 by the third quarter of 2005. It is brought back to 0.77 by the second quarter of 2006, thanks mainly to very rapid build-up of foreign exchange reserves by the Turkish Central bank in the past year. By way of comparison, the aforementioned “fragility ratio” was 0.60 in Malaysia, 0.91 in the Philippines, and 1.50 in Thailand just before the break down of the 1997 Asian crisis, and thus can be argued that 0.60 is regarded as a critical threshold from an international speculation point of view (Kamisky, 1999).

Despite the brief deceleration of the turbulence of May-June, Turkish economy increased its intensity of external debt accumulation in 2006. Available data of the first nine months of 2006 is a manifest of this as summarized in Table 2.6 below.

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<sup>11</sup> The ratio of short term foreign debt to CB international reserves was 1.47 just before the eruption of the February 2001 crisis.



**Table 2.6 Main Components of the Balance of Payments in 2006 (Millions US\$)**

	Jan - Sept 2005	Jan - Sept 2006	Difference
Current Account Balance	-15,870	-25,334	-9,464
Capital Originating from Foreign Sources	25,821	38,108	12,287
Capital Originating from Domestic Sources	-4,052	-7,188	-3,136
Change in Reserves ("- " indicates increase)	-8,561	-4,927	n.a.
Net Errors and Omissions	2,662	-659	-3,321
Net Capital Inflow	24,431	30,261	5,830
Foreign Debt Inducing Capital Inflows	17,291	23,705	6,414
Net Hot Money Flows	11,959	-1,869	-13,828

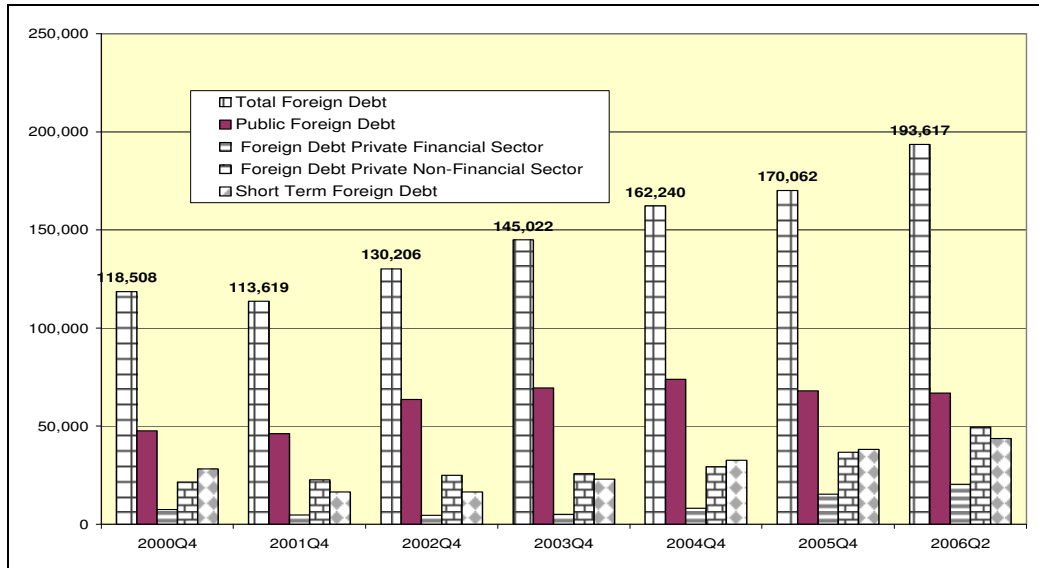
Sources : Boratav, 2006; TR Central Bank.

In Table 2.6, BPO data of January-September 2006 is distinguished over two axes: first is the decomposition of the in/out-flows of foreign capital into two sources: by the foreign non-residents versus domestic residents. Capital inflows originating from the foreign sources are observed to increase by 48 % over the comparable period of 2005, and reached to 38.1 billion dollars. The domestic source, on the other hand, displayed an out-flowing tendency and had been on the order of 7.2 billion dollars. This figure comprises outflows due to operations of the banking sector and the enterprises, as well as the domestic rentiers' decisions. Taking account of the net errors and omissions figure of 0.7 billion dollars, the overall net foreign capital inflow into Turkey reached to 30.3 billion dollars, a 24 % increase over the same period of 2005.

Data reveal that a significant deceleration of the hot money component of this transfer (1.9 billion dollars), as the domestic outflows of hot money had outpaced the speculative inflows of non-residents. Consequently, the role of hot money financing of the balance of payments is reduced in the first nine months of 2006. With a second axis of characterization of the same period, however, we witness a 37.7 % increase in net foreign indebtedness to reach 23.7 billion dollars. Given that the public sector is currently following a strict austerity program, and has generated a sizable primary surplus, this increase in foreign debt has originated mainly from the private sector and mainly by the non-banking, private enterprise sector. The external debt obligations of the private sector (70.1 billion dollars) now exceeds aggregate public foreign debt (66.9 billion dollars) as of second quarter of 2006.

Within the private sector, non-financial enterprises explain 60 % of the aggregate increase of private external debt over the post-2002 government period and accounts for 70.9 % of the total stock of private debt by 2006 second quarter (See Figure 2.4).

**Figure 2.4 External Debt By Sectors**



Source: Central Bank of Turkey

### 2.3. Turkey's Indebtedness in Comparison with Neighbouring Countries

What is the current situation of Turkish foreign debt level in terms of other neighbouring countries? Is it in such a level that we should worry about?

Below table 2.7 indicates various fragility and weight indicators for Turkey and neighbouring countries regarding foreign debts. Relying on the IMF's data; below table contains neighbouring countries and old socialist block countries. (Boratav, 2006).

**Table 2.7 Foreign Debt Indicators 2005, Percentages**

	Neighbour Countries	Turkey
Foreign Debts/National Income	30.9	47.0
Foreign Debt/Export	82.1	166.1
Foreign Debt Services/Export	14.8	35.7
Short Term/Total Foreign Debt	17.5	22.3*
Short Term Debt/Reserves	26.3	77.0**
Share of Debt Creating Foreign Capital	42.1	62.1***
Annual Rate of Increase of Debts: 1989-2005	5.4	9.2

\*: March 2006; \*\*: June 2006; \*\*\*: January-June 2006 (Source: Boratav, 2006).

In the above all indications we see Turkey as “heavily indebted” and “more risky” country according to neighbouring countries’ average ratios.

Is Turkey’s foreign debt considerably big? Our total foreign debt stock reached 171 billion dollars as of 2005 and 194 billion dollars as of June 2006; but for a meaningful evaluation we should compare Foreign debt/National Income ratio which was 47 % for Turkey and compared to other neighbouring countries’ averages it was fairly higher.

Another important indicator is Foreign debt/Export ratio which was twice as much higher in Turkey in comparison with other countries’ averages.

Foreign Debt Servicing, which composed of foreign debt capital and interest payments, can impose significant burden on the balance of payments. This can be computed by rationing foreign debt servicing to export revenues. This ratio is also higher for Turkey as compared to other countries. Accompanied with latest stated ratio and all other ratios on the table indicate us that when considering Turkey in the scope of other developing countries, Turkey’s location in terms of fragility and risk potential stand in the front lines.

“Plainly, in any case, foreign debt would bring Turkey into trouble sooner or later” (Boratav, 2006).

All these indicators show that, Turkey is a heavily indebted country and for this reason establishing for an effectively working foreign debt management system became a compulsory need for Turkey. In this regard, evaluation of Turkey’s foreign debt management and its inefficient points became extremely important. In line with this importance, in the next section, Turkey’s foreign debt management system will be evaluated, and in the last section some suggestions will be presented.

## 2.4. General Evaluation on Turkey’s Foreign Debt Structure

Here I want to focus on Turkey’s foreign debt indicators for the period 2000-2006 and outcomes can be depicted as follows;

### 2.4.1. Turkey and Foreign Indebtedness Ratios

Foreign indebtedness ratios provide us very useful database for forward-looking project regarding foreign borrowing. Although ratios do not bear the same weights and importance among themselves, when all of them considered thoroughly, they do provide fairly comprehensive information on foreign debt profile of the country in question.

The evaluation of Turkey’s foreign indebtedness performance for the period 2000-2006(as of first quarter) can be demonstrated as follows;

### i) Foreign Debt Stock / GNP Ratio

This ratio is used in measuring the general credibility and debt burden of a country's economy, and has some defined degrees. For instance, if this ratio is between % 30 - %50, then the country is named as mid-level debtor, if it is above the % 50, the country is named as an excessive debtor country. As Table 2.8 depicts this ratio was 59.3% by the end of the 2000, accompanied with 2001 crisis this ratio mounted to 77.9% in 2001, and dropped to 72% in 2002. In the following years by the growth of GNP, this ratio traced a decreasing trend and by the end of 2005 it decreased to 47.3%. According to this ratio, although Turkey was an excessive debtor country for years, it promoted to mid-level debtor country with the growing GNP in 2004 and 2005.

**Table 2.8 Turkey's Foreign Indebtedness Ratios for the period 2000-2006**

Years	GNP (Million \$)	Foreign Debt Stock (Million \$)	Export (FOB) (Million \$)	Foreign Debt Servicing (Million \$)	Foreign Debt Interest Servicing (Million \$)	Foreign Debt Stock/ GNP (%)	Foreign Debt Stock/ Export (%)	Foreign Debt Servicing /Export (%)	Foreign Debt Interest Servicing/ Export (%)
2000	200.002	118.503	27.775	21.939	6.301	59,3	426,7	79,0	22,7
2001	145.693	113.560	31.334	24.623	7.134	77,9	362,4	78,6	22,8
2002	180.892	130.164	36.059	28.852	6.402	72,0	361,0	80,0	17,8
2003	239.235	145.000	47.253	27.808	6.987	60,6	306,9	58,8	14,8
2004	299.475	162.261	63.167	30.482	7.142	54,2	256,9	48,3	11,3
2005	360.876	170.594	73.472	36.392	7.953	47,3	232,2	49,5	10,8
2006*	-	185.019	74.659	34.946	8.050	-	247,8	46,8	10,8
As of the first quarter of *2006									
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>									

### ii) Foreign Debt Stock / Export Ratio

This ratio, which indicates the country's capacity in repaying of the debt, gives us some clues regarding long-term effects of export revenues over the total debt stock. In the case of this ratio is between % 165-275, the country is said to be mid-level debtor, if it exceeds %275, then the country is accepted to be an excessive debtor country. Table 2.8 indicates that while this ratio was 426.7% in 2000, it traced a decreasing tendency thanks to the increase in export volume and by the end of 2004 it dropped to 256.9% which promoted Turkey to mid-level debtor country status. As of the first quarter of 2006 this ratio was around 247.8%.

### iii) Total Foreign Debt Servicing / Export

This ratio is named as debt servicing ratio which indicates in what degree the country's export revenues are allocated to foreign borrowing expenses and it is widely used in measuring debt burden. This is an important criterion for both analyzing foreign debt, and analyzing the country's international liquidity problems. In the case of this ratio reaches to high values, the debtor country falls in a difficult situation in fulfilling its liabilities regarding foreign debt. If this ratio is % 18-30, the country is said to be mid-level debtor. When this ratio exceeds % 30, the country is called excessive debtor country. In the lights of data given in Table 2.8 we see that, although this ratio dropped from 79% in 2000 to 46.8% as of the first quarter of 2006, Turkey can still be regarded as excessive debtor country in terms of this ratio.

### iv) Foreign Debt Interest Servicing / Export

This ratio is mostly used in calculating the cost of foreign borrowing. While this ratio fluctuates among 12-20%, the country is said to be mid-level debtor, when it reaches to above 20%, the country is said excessive debtor country. When commenting on this ratio, foreign debt interest servicing and speed of export increase should also be taken account. According to the Table while Turkey seemed to be excessive debtor country in 2000, it promoted to mid-level debtor country status in 2002 and by the end of 2005 low-level debtor country.

By evaluating all the indicators in Table 2.8 at common denominator, we can say that, while Turkey can be named as an excessive debtor country between 2000-2004, it promoted to mid-level debtor status at the beginning of 2005 and thereafter stays here. The reason is not the decline in Turkey's debt stocks. As in the past Turkey's debt stock has an increasing trend as well. But it is mainly due to high growth rate of Turkey's economy, increasing export, and declining debt burden by these positive developments.

## 2.4.2. By Numbers Turkey's Foreign Debt Stock

### i) Foreign Debt Stock According to Their Maturity

As depicted in Table 2.9, while Turkey's foreign debt was 118.503 million dollars by the end of 2000, it was 170.594 million dollars by the end of 2005, and mounted to 185.019 million dollars as of the first quarter of 2006. While the share of short-term debt within the total debt stock was 23.9% in 2000, it traced a big decline and decreased to 14.4% in 2001, and 12.6% in 2002. However, short-term debt entered into an increasing trend just after 2002. This increase was mainly due to private sector borrowing, since public sector was not holding short-term foreign borrowing. However, foreign debt with mid- and long-term maturity has steadily increased. As of the first quarter of 2006, 22.3% of the total debt stock of Turkey is composed by short-term debt, while 77.7% of the total debt stock is composed by mid- and long-term debt.

Table 2.9 Turkey's Foreign Debt Stock According to Their Maturity

Years	Total Foreign Debt Stock (Million \$)	Short-Term	Mid-Long Term	Maturity Structure (%)	
				Short (%)	Mid-Long (%)
2000	118.503	28.301	90.202	23,9	76,1
2001	113.560	16.403	97.157	14,4	85,6
2002	130.164	16.424	113.740	12,6	87,4
2003	145.000	23.013	121.987	15,9	84,1
2004	162.261	32.569	129.692	20,1	79,9
2005	170.594	38.218	132.376	22,4	77,6
2006*	185.019	41.210	143.809	22,3	77,7
As of the first quarter of *2006					
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>					

### ii) Structure of Foreign Debt Stock According to Debtors

As seen in the Table 2.10, as of the first quarter of 2006, total debt stock was 185.019 million dollars of which 84.464 million dollars was public sector liabilities, while 100.555 million dollars was private sector liabilities. Almost all recent public sector borrowing emanates from IMF credits. The reason behind low level of private sector debt in 2000-2003 time interval was the 2001 economic crisis. Private debt has gained an increasing trend after 2003, and finally exceeded the public debt in 2005. This was mainly due to declining public sector borrowing and increasing foreign liabilities of banking sector (Adiyaman, 2006, p.11).

Table 2.10 Structure of Foreign Debt Stock According to Debtors

Years	Total Foreign Debt Stock (Million \$)	Public*	Private	Debtor Structure (%)	
				Public (%)	Private(%)
2000	118.503	62.703	55.801	52,9	47,1
2001	113.560	70.421	43.139	62,0	38,0
2002	130.164	85.584	44.581	65,8	34,2
2003	145.000	93.842	51.157	64,7	35,3
2004	162.261	95.205	67.056	58,7	41,3
2005	170.594	83.542	87.052	49,0	51,0
2006**	185.019	84.464	100.555	45,7	54,3
*Public sector borrowing including Central Bank					
As of the first quarter of *2006					
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>					

### iii) Structure of Foreign Debt Stock According to Creditors

By analyzing Table 2.11, we can say that Turkey's creditors as being rather non-official character. If we count international institutions, 16.9% of Turkey's total debt stock as of the first quarter of 2006 is composed by official character debts. While debt to governmental institution was recently declining, debt to international

institutions had doubled from 2000 to 2006. This was especially due to increasing credit utilizations from the IMF.

Table 2.11 Structure of Foreign Debt Stock According to Creditors

Years	Debts to International Institutions %	Debts to Governmental Institutions %	Bond Issue %	Other debts to Private Sector %	Total Debt Stock (Million \$)
2000	11.411	8.668	21.828	76.597	118.503
2001	22.005	8.524	21.031	61.999	113.560
2002	30.756	9.249	23.595	66.564	130.164
2003	33.169	9.412	27.112	75.306	145.000
2004	32.249	8.728	30.079	91.205	162.261
2005	24.868	7.075	31.571	107.080	170.594
2006*	23.426	6.864	34.118	120.611	185.019
As of the first quarter of *2006					
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>					

#### iv) Structure of Foreign Debt Stock According to FX Composition

Foreign exchange composition of Turkey's foreign debt is depicted in Table 2.12. It is clear from the table that among all national currencies Turkey has mostly preferred to borrow with US dollars denominated currency. As of the first quarter of 2006, 56.3% of Turkey's foreign debt stock is composed by US dollars denominated currency, while 31.3% of debt stock is composed by Euro denominated currency. The share of the currencies other than US dollars and Euro in total borrowing has seemed to have decreasing tendency in time. The fact that about 90% of the total debt stock is being subject to US dollars and EUR denominated currencies, is a good reflection of changing exchange rates' negative effects on Turkey's foreign debt stock (Adiyaman, 2006, p.12).

Table 2.12 Structure of Foreign Debt Stock According to FX Composition

Years	USD	Mark	Euro	Japan Yen	SDR	Other	Total (Million \$)
2000	64.359	23.132	14.813	7.447	4.186	4.566	118.503
2001	57.266	826	34.163	5.176	14.106	2.024	113.560
2002	60.996	0	39.853	5.312	22.018	1.987	130.165
2003	66.212	0	48.188	4.516	24.012	2.071	144.999
2004	79.201	0	54.848	3.442	21.447	3.323	162.261
2005	93.387	0	54.420	2.789	14.653	5.345	170.594
2006*	104.113	0	57.914	2.657	12.981	7.354	185.019
As of the first quarter of *2006							
Source. Republic of Turkey Prime Ministry Undersecretariat of Treasury, <a href="http://www.hazine.gov.tr">www.hazine.gov.tr</a>							

## CHAPTER 3

### FOREIGN DEBT MANAGEMENT IN TURKEY

In recent years, there has been increasing attention on the way in which governments manage their debt, and how this can contribute to macroeconomic situation and financial stability. In this section, I will outline these linkages and current thinking on sound practices, as well as the institutional environment for modern public debt management.

Before proceeding further, it is useful to clarify what is meant by public debt management. Public debt management can be defined as:

“The process of establishing and implementing a strategy for managing the government’s debt in order to meet the government’s financing needs, its cost and risk objectives and any other debt management goals the government may have set, such as developing and maintaining an efficient market for government securities” (Wheeler, G. 2004, p.4).

#### 3.1. Increasing Importance of Foreign Debt Management in the World and Turkey

Public debt management with its focus on risk management, evolved in the 1980s in a number of smaller OECD countries. It was a response to both necessity and new opportunities. The necessity to improve public debt management arose from the escalation in public debt levels as a percentage of GDP, while the volatility of exchange rates and interest rates had also increased, implying very substantial risks to the government’s budget. This had been caused by the ending of the Bretton Woods System in the early 1970s, followed by increased inflation in the next decade.

At the same time, new ways of managing risk became available with the development of financial futures in the 1970s and, more importantly for public debt managers, the swap markets in the early 1980s. Other opportunities became available through the 1980s as capital market liberalization and financial deregulation made more markets available to sovereign borrowers. By the end of 1980s, rapid financial innovation resulted in a vast array of structured financial products being offered to sovereign borrowers on a daily basis.

We observe intensified efforts in developing countries through the aid of international financial institutions in establishing foreign debt management techniques beginning from the late 1970s and the throughout 1980s. For Turkey, the situation was not different. Starting from those years, the need for establishing an effective foreign debt management became very apparent. Especially, foreign debt management problems emerged in our country by the end of 1970’s, had a special role in providing motivation for taking important steps towards establishing foreign debt management system. At the same time, it opened way for creating an



institutional set-up for foreign debt management's functions such as, politics, operation, accounting, and statistical analysis. (Bal, 2001, p.231)

The 1980s, were the years in which intensified efforts exerted on building-up institutional and organizational structure with respect to debt management in general. Structural changes in borrowing instruments, increasing interest rates and foreign exchange risks, new financial techniques have all become an internal part of these efforts.

By the 1990s, foreign debt management structure of developing countries had been overviewed by international institutions and suggestions on shifting from passive to active debt management has been consistently advocated. These efforts also much favored in Turkey as well.

While these developments were taking place, macro-economic management of foreign debt has also gained importance. Government debt managers' work is distinct from that of a government's fiscal policy advisers, although they share the same concerns that the government's debt is on a sustainable path. Government debt managers examine the structure of the government's portfolio of debt and the changes in it, with a view to ensuring that the expected cost and risk of the debt portfolio remain within tolerances acceptable to the government. Fiscal policy, by contrast, is usually concerned with the effects of aggregate government spending and taxation on a range of macroeconomic variables, including the level of public debt, and with the microeconomic impacts of individual tax and spending policies on resource allocation, welfare and economic growth. Nevertheless, there are important interactions between government debt management and macroeconomic policies. For example, government debt managers need to have a sound understanding of fiscal risks, including contingent liabilities, in order to inform development of the strategy (Anderson, September 2006).

In determining the scope of foreign debt management, there is another aspect; 'management of private sector debts' which should be taken into account. Prior to the year 1989, private sector debts were negligible because of implemented foreign exchange regime. However, as mentioned in the previous section, after the implementation of floating exchange rate regime starting with the 1990s, the situation has reversed. Although private sector foreign debts are not directly related with the state foreign debt management, they are not negligible in value for the country's foreign debt management.

In the early years of 1980s at Chile and last years of 1990s at Eastern Asia countries' economies, we see crises mainly emanating from the private sector foreign borrowings. Therefore, these experiences indicate the importance of closely watching the private sector foreign borrowings in the scope of debt management. (Bal, 2001, p.232).

On the other hand, as in the other developing countries, Turkey's foreign debt stock changes in conjunction with developments in the world financial markets. In

addition to this, instability in the foreign exchange market makes foreign debt stocks to be highly sensitive to the developments in the international markets. In such an environment, the scope of Turkey's foreign debt management should be arranged in a way that it would include financial risk management as well.

While sound public debt management on its own cannot prevent financial crises, it can be an important factor in supporting the macroeconomic framework and enhancing the credibility of macroeconomic management. This is particularly important in an increasingly interdependent global economy where capital accounts have been liberalized, and herding behavior among investors can result in contagion effects between markets.

Under the lights of all these developments and accompanying increase in debt stocks, the importance of effectively working debt management system is becoming more apparent for Turkey. There is no doubt that, well-established institutional infrastructure of debt management plays a vital role for an efficient foreign debt management. For this reason in the next step this issue will be analyzed more closely.

### 3.2. Institutional Infrastructure for Debt Management

The "Regulation on the Principles and Procedures for the Coordination and Administration of Debt and Risk Management", drawn up within the framework of Law No. 4749 of March 28, 2002, on the Regulation of Public Financing and Debt Management, and published in the Official Gazette of September 1, 2002.

"The purpose of this law is to set the procedures and principles related with domestic and external borrowing, receipt of grants, lending and extension of grant and debts, cash management in a coordinated manner with fiscal and monetary policies, effective management and monitoring of the guarantees to be extended by the Treasury, the financial claims and State External and Domestic Debt arising from such borrowing and guarantees, arrangement of financial relations between the Treasury and Institutions and reimbursing all kinds of obligations assumed by the Treasury, taking into consideration development targets of the country and maintaining confidence and stability of the markets and macroeconomic balances" (Legal Ground of Law No. 4749, Grand National Assembly of Turkey).

When we look at laws and regulations on foreign borrowings in Turkey, up to law numbered 4749 and its implementation starting date on January 1, 2003 we observe a dispersed institutional infrastructure in the public borrowing area. This dispersed institutional infrastructure, for years, was the main reason for ongoing inefficiently-working debt management.

#### 3.2.1. Legislation Concerning Public Sector Foreign Borrowing

In terms of public sector foreign borrowing we can basically refer about two laws. These are; Regulation of Public Financing and Debt Management Law No. 4749 and Law No. 1211, The Law on the Central Bank of the Republic of Turkey.

### 3.2.1.1. Law No. 4749 on the Organization of Public Financing and Debt Management

Law No 4749 on the Organization of Public Financing and Debt Management, also known as the Borrowing Law, was drawn up and put into effect on March 28, 2002.

“In recent years, the question of public financing has increasingly come onto the public agenda, in parallel with the rise in the debt burden. Accordingly, in April 2002, Law No 4749 on the Regulation of Public Financing and Debt Management was put into effect. The aim of the Law is to ensure fiscal discipline, an important factor in the resolution of the debt problem. In addition, the Law seeks to increase transparency and accountability in the management of debts and claims.” (Babacan, April 2003).

The Law is one of the basic laws of public financial administration, and includes provisions of considerable practical importance. The evaluation of major points of the Law can be classified as follows:

#### i) Increasing Financial Discipline

A series of arrangements are made to ensure discipline and accountability not only in debt management but also in public financial administration as a whole.

**a) Designation of a single borrowing authority:** Provisions have been included granting authority to the Minister responsible for the Treasury so as to ensure that responsibility for actions which create liabilities for central government is entrusted to a single authority, in line with international practice. The Minister responsible for the Treasury has been given the authority not just to raise domestic and external debt but also to grant Treasury guarantees, to change the conditions of the guarantees given, to receive and award grants, to extend loans to public bodies and institutions and to manage the Treasury claims which come into existence in this way. Thus an important contribution has been made to fiscal discipline by ensuring that all transactions that may create fiscal obligations on behalf of the Republic of Turkey are managed by a single authority (Public Debt Management Report, April 2003).

Besides financial discipline, by Law No. 4749, the accountability of public debt management has also been enhanced by consolidating all public borrowing legislation, specifying a single authority to take responsibility for all transactions that create fiscal liabilities for the public sector and uniting the concepts of borrowing and public claims.

**b) Limit:** The Law revises both quantitatively and qualitatively the limits on borrowing and guarantees which were determined by Budget Laws before the Law took effect. It also introduces a limit on the domestic borrowing instruments that may be issued against loans.

- **Borrowing Limit**

The Borrowing Limit, encompassing domestic external borrowing, is calculated as follows:

$$\boxed{\text{Borrowing limit} = \text{Total Initial Budget Allocations} - \text{Estimated Budget Revenues}}$$

- **Guarantee Limit**

Before the Law, the limit on guarantees specified in the annual Budget Laws only imposed an upper limit on the amount of Treasury-guaranteed credit to be provided for local administrations and state economic enterprises. Under the new arrangement, guarantees to be provided for build-operate-transfer projects are also included in the limit. The amount of the limit on guarantees is to be determined each year through an article of the Budget Law for the year in question.

- **Limit on Loans**

Before the Law, there was no limit whatsoever on the amount of domestic borrowing instruments that could be issued as loans. Under the new arrangement, the amount of such issues to be made outside the general borrowing limit is restricted by a limit to be determined in the Budget law for the year in question (Public Debt Management Report, April 2003).

**c) Inclusion of foreign project credits in the budget:** The use of external credits for investment expenditures was previously monitored off-budget. In other words, while external project loans obtained from foreign sources were included on a project basis in the investment programs for the year in question, no amount was included in the budget during initial budgeting to correspond to the amount of such loans to be used. This situation gave rise to a discrepancy between the budget financing requirement and the actual amount of borrowing carried out. Under the Law, it is foreseen that the use of such resources borrowed for use in project expenditures should be included in the budgets in advance in line with international practice, ensuring fiscal discipline (Public Debt Management Report, April 2003).

**d) Permission for public external borrowing without guarantee:** Even if they carry no Treasury guarantee, all kinds of financial facilities obtained from abroad by public bodies and institutions are subject to the permission of the Undersecretariat of the Treasury. Furthermore, guarantees to be provided by these bodies and institutions in favor of other bodies and institutions have been made subject to the permission of the Undersecretariat.

## ii) Increasing Transparency

Uncertainty relating to the borrowing policies to be implemented in financial markets is perceived as a form of risk by market participants. This results in a risk premium which is reflected in higher borrowing costs. In order to reduce the risk premium on public sector borrowing, it is essential that the financial markets should be able to foresee the borrowing policies which are implemented. To this end, information about the work of the Treasury in the area of borrowing and cash management is regularly made available to the public through various media, giving the markets access to information in this sphere. Monthly borrowing programs are drawn up with the aim of making it possible for the financial markets to foresee the borrowing to be undertaken in the forthcoming period, and regular meetings are held with market participants to ensure an exchange of information on borrowing.

“Together with fiscal discipline, transparency and accountability, the way in which debt management is organized is also an important factor that plays a role in putting these principles into practice. The stocks of liabilities and assets have to be managed in such a way as to maintain general economic balances and ensure the healthy functioning of the financial markets. This in turn requires an effective debt administration employing well-trained human resources with a high level of technical expertise.” (Babacan Ali, Public Debt Management Report, April 2003).

As part of the effort to increase the transparency of the public sector, and in accordance with the legal basis provided by Law No. 4749, activities of this kind are being extended and improved in the ways described below: (Public Debt Management Report, April 2003).

**a) A single legal framework:** Matters related to public finance have been conducted in the framework of the annual Budget Laws and Law No. 4059 on the Organization of the Undersecretariat of the Treasury but have also been subject to various provisions of other legislation such as Law No. 244, Law No. 1267, Law No. 6274 and Decree No. 32. Due to developments in financial markets, various difficulties have been experienced in practice in terms of the application of these arrangements in the dynamic conditions of today's financial markets. A single basic legal framework has now been provided. It has thus become easy to follow which legal bases financial transactions related to public financial management are carried out on (Public Debt Management Report, April 2003).

**b) Definitions:** The Law brings together and defines all of the terms in common use in the area of public financing and debt management, thereby ensuring harmony in practice and minimizing problems arising from the use of terminology.

**c) Risk account:** The smooth conduct of Treasury cash and debt management may be upset when the Treasury makes payments to meet obligations arising out of guarantees on behalf of the debtor institutions. In order to overcome this problem, a risk account has been set up for the redemption of obligations of this kind. The account is a bank account of the Treasury with the Central Bank. Payments made from the account are made out of its own revenues. The revenues of the account are

made up of loan fees, guarantee fees, repayments made by the institutions, interest earned on the balance of the account and transfers from the budget. This account has been set up to improve the effectiveness of cash and debt management on the one hand and at the same time to ensure that obligations arising from guarantees entered into outside the knowledge of the National Assembly - due to the fact that assumptions of guaranteed debt have hitherto occurred off-budget - are met within the knowledge and authority of the Assembly.

**d) Debt Management Report:** In line with the provisions of the Law, it has been laid down that a Debt Management Report containing information for the relevant budgetary year on domestic and external financing obtained, Treasury guarantees provided, Risk Account transactions, grants received and provided and transfer and on-lending of external debts, together with details of the financial markets and debt management should be sent once every three months to the Speakership of the National Assembly for submission to the Plan and Budget Committee, to the Prime Ministry for submission to the Council of Ministers, to the Ministry of Finance, to the Court of Accounts and to the Undersecretariat of the State Planning Organization.

**e) Informing the National Assembly:** In addition to the Debt Management Report, Article 14 of the Law provides that the Plan and Budget Committee of the National Assembly should be kept informed through meetings with a special agenda to be held at least once a year with the minister responsible for the Treasury.

### iii) Increasing the Effectiveness of Receivables and Debt Management

**a) Determination of General Bases for Principles and Strategies:** In accordance with international practice, the Law sets out a general framework for the principles and strategies related to the management of debts and receivables. Accordingly, it is laid down that, for example, financing needs are to be met at the lowest possible medium and long-term cost and within an acceptable level of risk (Article 12), that existing risks will be monitored and evaluated as part of the borrowing strategy (Articles 12 and 17/A), that active risk management will be employed (Article 12 and Article 17/A), that an efficient market will be created for state borrowing paper, that attention will be paid to transparency and accountability (Article 14) and that a single authority will exist for borrowing in the name of the state (Article 4) (Public Debt Management Report, April 2003).

**b) Risk Management:** Fluctuations in interest and foreign exchange rates have an important impact on the cost of public borrowing. Contingent liabilities such as Treasury guarantees and Build-Operate-Transfer agreements create uncertainty about the state's borrowing requirements. This makes it necessary to be able to determine the risks related to public borrowing and to design borrowing policies in the light of these risks, so that the extent of the debt administration's exposure to such risks can be controlled. Law No. 4749 adopts the principle of implementing an active risk management strategy and taking measures to limit the potential effects of the

contingent liabilities incurred by the state. The following arrangements have been made under the Law to establish the necessary legal and organizational infrastructure for the management of public debts and receivables on the basis of risk analysis:

- **Creation of a Middle Office:** The necessary organizational arrangements have been made to establish a middle office (risk management unit) - one of the most fundamental and important units of the organizations responsible for public debt management - and to conduct risk management work accordingly. The working principles and procedures for the said unit have been set out in a regulation.

- **Formation of a Debt Management Committee:** A Debt Management Committee has been set up within the Undersecretariat of the Treasury under a regulation published on the basis of the authority granted by the Law with a view to ensuring coordination and efficiency in debt management.

- **Grants:** The necessary changes have been made to strengthen the inadequate legal infrastructure concerning the receipt and award of grants in the name of the Republic of Turkey. In this context, the minister responsible for the Treasury has been designated as the authority which receives grants of all kinds, apart from those obtained for the purpose of the defense and security of the Republic of Turkey, other than those obtained from the EU. The authority to award grants rests with the Council of Ministers.

- **Short-Term Borrowing:** It has been made possible to conduct cash operations on the money markets in order to finance short-term cash deficits stemming from cash flow considerations and to increase the efficiency of cash management. Bearing in mind the potential effects on the money markets, the limit on the amount of short-term borrowing that may be carried out within any year has been fixed in the following manner:

Total Initial Budget Allocations for the Relevant Year x (1/100)
--

- **Interest on cash surpluses:** An arrangement has been made to enable the Treasury to benefit from the cash surpluses in its accounts. Accordingly, the Central Bank will pay interest on these cash surpluses. Bearing in mind the size of the surpluses that might arise in the Treasury's accounts, the following limit has been imposed on the amounts on which interest will be paid:

Total Initial Budget Allocations for the Relevant Year x (1/100)
--

- **Collection of past due Treasury receivables:** The legal infrastructure within which Treasury claims are incurred and managed has been strengthened, making it possible for past due Treasury claims to be collected in accordance with the provisions of Law No 6183 on the Procedures for the Collection of Public Claims. Moreover, in order to ensure that resources used as loans are recovered on

the date of maturity, arrangements have been made for debt payment accounts to be set up with the indebted institutions and for the Treasury to carry out inspections and seek information from these institutions.

• **Compromise settlements:** A provisional article of the Law provides for a one-off compromise settlement in respect of the penalties and accrued penal interest applying to Treasury claims which already existed as of the date on which the Law entered into force, thus facilitating the collection of such claims. (Public Debt Management Report, 2003, p.90-91-92)

After analyzing the Law No. 4749 with details, we can conclude that the legal infrastructure for application of effective and active foreign debt management techniques has been completed and an applicable debt management system has been constructed.

### 3.2.1.2. Law No. 1211, The Law on the Central Bank of the Republic of Turkey

According to Article 53/6 as amended by Law No. 4651 of April 25, 2001;

“The Bank will manage the gold and foreign exchange reserves of the country consistent with the monetary policy targets and practices. With this objective and compliance with the terms and conditions to be determined by itself, the bank may perform all kinds of banking activities in the domestic and international markets including; spot or forward purchase and sale of gold, foreign exchange, securities, and derivative products, as well as lending and borrowing operations, by taking into consideration of the security, liquidity, and return priorities respectively” (CBT, 2001 p. 50).

Central Bank is able to directly borrow from foreign countries, international institutions or foreign banks without having Treasury guarantee.

### 3.2.2. Legislation Concerning Private Sector Borrowing

There are two main legislation with regard to private sector foreign borrowing in Turkey: (i) Law No. 1567 Law regarding the Protection of the Value of the Turkish Currency, (ii) Foreign Capital Encouragement Legislation.

#### i) Law Regarding the Protection of the Value of Turkish Currency

Although its publication date is too old (it has been published in Official Gazette No. 1433 dated February 02, 1930) by the Council of Ministers’ decisions it has been continuously improved and it constitutes the most important legal basis for private sector borrowings in Turkey.



In the scope of Law No. 1567 the most advanced arrangements were published in Official Gazette No. 20249 dated August 11, 1989. According to Article 17 of Decree No 32;

“Residents may freely obtain foreign credits, in kind or in cash, provided that they utilize such credits through banks or special finance institutions” (CBT, 1995 p. 20).

Residents who obtain foreign credits with a maturity of more than one year should register them in the Debt Log kept by the Undersecretariat of Treasury. Monitoring of the credits, except public sector credits with the maturity of less than one year, are carried out by the Central Bank.

## ii) Foreign Capital Encouragement Legislation

As a country in the Customs Union with the European Union, Turkey has enacted and issued the Direct Foreign Investment Law (Law No. 4875, the Foreign Investment Law) published in the Official Gazette on June 17, 2003 with a view to attracting direct foreign investments, in addition to the foreign capital invested in Turkey through the Securities Exchange (i.e. the Istanbul Stock Exchange), for the purpose of removing some bureaucratic obstacles in its legislation and facilitating the foreign capital investments.

Foreign investors are fully free to make direct foreign investments in Turkey. This type of investment was subject to permission in the repealed Foreign Investment Encouragement Law (Law No. 6224, the Repealed Foreign Investment Law), it is overt that this provision of the Foreign Investment Law means to say that direct foreign investments are not subject to permission.

The principle is that the foreign investor is not required to make an application for permission prior to making investments. This provision is in fact a result of a principle existing in our legislation since past ‘foreign investors are subject to equal treatment with local investors’.

## 3.3. Coordination of Foreign Debt Management in Turkey and External Finance Committee

Since foreign debt transactions are related with the different institutions of the state, there should be a good coordination among them for a successfully operating foreign debt management. Because, in the case of they move independently from each other when performing their functions, such an application would result some breakdowns in foreign debt management process.

It bears great importance that, State Planning Organization (SPO) which determines Turkish economy development perspectives, macroeconomic plan and programs, Central Bank (CB) which obligated with determining and implementing monetary policy, Treasury which primarily responsible with applications of public

debt management and budget deficit financing, sharing their accumulated information on a common platform on the way of creating an effective external debt management.

It became widespread in developing countries to have an external finance committee towards providing coordination in external debt management process. To meet the demands of modern debt management, there have been considerable institutional changes within governments - over the last 20 years nearly all of the 30 countries that are currently members of the OECD have seen major reforms in the areas responsible for public debt management, as well as a number of emerging market and developing countries. These developments reflect that debt management is a specialized activity within government, as one of the largest financial market participants in the country, and that managing this effectively within traditional ministry structures may be challenging (Anderson, September 2006).

An examination of organizational arrangements across OECD countries reveals a range of different forms, for example:

- Offices or departments within ministries (e.g. Italy, Japan, Brazil, Czech Republic, Spain, and New Zealand);
- Agency within the central bank (e.g. Denmark);
- Agencies established by executive decision (e.g. UK, France, and Australia);
- Agencies established under specific laws (e.g. Ireland, Iceland, Austria, Portugal, Slovak Republic, and Sweden);
- Agencies that are established under general company law (e.g. Germany, Hungary).

There has been considerable debate in OECD countries about the best “model”. There are also considerable differences in the detail of the institutional arrangements, both within and across the categories described above, e.g. the degree of managerial autonomy over budgets, the use of governing, executive and advisory boards, relationship with ministers and parliament, and coordination mechanisms with other parts of government (Anderson, September 2006).

Given this picture, what can be said about “best practice” institutional arrangements for public debt management? Although the specifics of individual arrangements vary, there are a number of sound principles that can be drawn:

- There is a legal framework that clarifies who has the authority to borrow (typically the Minister of Finance) and undertake other transactions on the government’s behalf. Lines of accountability and reporting responsibilities are clear.
- The activities and performance of public debt managers should be monitored by an appropriately qualified body and it should be subject to external audit;

- Decision-makers and the public are provided with regular and high quality information on the public debt and the strategy for managing it;
- Debt management objectives and strategy are set for the medium- to long-run and are transparent.

For building-up such committees, top managers of the institutions of external debt management are being played a great role. Although these committees are commonly related with public external debt management, they also engage in composing of general external borrowing politics of the country, and making the related analyses.

If we turn to Turkish case, on the way of achieving coordination between related debt management units on February 3, 1998, the representatives of Treasury, CB, the Ministry of Finance, SPO and Chamber of Accounts participated to constitute ‘Committee on Monitoring the External Debt Utilization’. This committee was an important corner stone in providing coordination between the related external debt management units. However, this committee mainly focused on controlling and supervising public sector external debt and not much more than that. But from such committee, which established aiming at providing coordination between the debt management units, a more active role were being expected in determining the country’s external borrowing politics. This expectation brings the need for monitoring the private sector external debts, which have increasingly accumulated currently, in the foreground. Current belief reveals that, since private sector external borrowings are carried out through the banks and private finance institutions, representatives of these institutions under the title of Banks Association of Turkey, should participate and share their opinions on the way of well-operating external debt management committee.

Another current step taken towards establishing a more effective coordination in external debt and risk management is the regulation published on September 1, 2002 in Official Gazette numbered 24863 with the name; ‘Principals on the Debt and Risk Management Coordination and Implementation’.

Turkey introduced institutional reform with the enactment of the Law on Regulating Public Finance and Debt Management (Law 4749) in 2002. This Law places an emphasis on managing risk and was instrumental in setting up the ‘middle office’. There is a requirement that the government develops a debt management strategy, as well as the production of an annual report on public debt. These measures place Turkey at the forefront of sound practice in transparency of its debt management operations. Other achievements include implementing functional separation between the front, middle and back offices, developing in-house an information technology system that meets the needs of debt management and, perhaps most importantly, building up a strong, highly qualified team to perform these vital tasks. Effective coordination mechanisms have also been set up across the various debt management departments, under the aegis of the Debt Management Committee.

In conclusion, Turkey has achieved a great deal over the last five years in the management of its public debt, including the development of a debt management strategy, stronger institutional framework, and a thorough analysis of risks. At the same time, prudent macroeconomic management, leading to falling inflation and reduced public debt levels, has facilitated a mutually reinforcing process of reducing both currency and interest rate risk in the debt portfolio.

### 3.4. Developments in Monitoring External Debt in Turkey

Monitoring of the external debt in Turkey is carried out by the cooperation of Turkish Treasury and CBT. Within this cooperation process, the Treasury monitors mid- and long-term public debts, while CBT mainly focuses on private sector debts.

Monitoring mid- and long-term external debt and efforts on establishing external debt data base coincidence with the beginning of the 1980's in Turkey. With the suggestions, demands, technical and financial assistance of international institutions like IMF, the World Bank, the system started to establishment process within the Turkish Treasury in 1983. Project, which started implementation on July 1985 and named as 'External Debt Database System' was the first step towards this direction. The system, which was established by the common efforts of Central Bank, Treasury, IMF and the World Bank, provided foreign debt records transformation to the computer-based environment and in short time interval it became a unique information source for our country's external debts.<sup>1</sup>

As of December 31, 1983, at first, mid- and long-term external credits stored in database as stock information, projections have been carried out with respect to foreign debt repayments in relation with the coming years, and subsequently credits were included to the system, as far as they have been registered to the external debt data set. Through the system, various statistical tables can be generated with respect to mid- and long-term credits. Through combining of the external debt stocks born from mid- and long-term credits which start in any time interval, credits monitoring by the CB, and debt stocks emanating from short-term movements, overall information regarding external debts are formed (Sarı, 2004).

As a result of common studies of Treasury and Central Bank and established cooperation, external debt information was centralized, and this situation facilitated formation of a healthier external debt management. Technical problems emanating from the complexity of our country's foreign debt structure, to a large extent, have been overcome by the increasing usage of computer facilities.

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<sup>1</sup> Some information that hold place in Turkey's external debt database system and in monitoring mid- and long-term external debts are as follows; i) Debtor Information, ii) Creditor Information, iii) Agreement Information, iv) Debt Payment Information, v) Some used Formulas and Calculation Information (Akçay, 1994, p.112).

For a long period of time External Debt Database System has played an important role in monitoring the external debts. In general, the system was satisfactory in tracking and analyzing the debts. As the time passing, the system, which was praised by IMF and the World Bank started to encounter some difficulties in meeting the changing needs.<sup>2</sup> In general, in the scope of External Debt Database System significant steps have been taken in monitoring external debts and international standards could have been reached. However, because of the fact that short-term debts were excluded from the system and being monitored by a different institution (CB), the coordination problem in reaching general debt stocks data, became more and more apparent. (Yazıcı, 1993, s. 173).

In recognition of the deficient and mostly criticized points of the system in early stages of the 1990's, Treasury finally started to work on the data systems project which is deeply needed by the economic management. The project not only aimed at developing institutional structure, but also aimed at modernizing of data systems in the scope of Public Economic Enterprises (PEE), foreign trade, the Banking Sector. This project, which was provided by the support of the World Bank amounted 9.2 million dollars, has been managed by Turkish Treasury under the corporation of foreign and Turkish specialists. Workings on the Foreign Finance Information System, which is related part of foreign debt was started on February 1, 1994 and finally the system was opened servicing on June 12, 1997 (Sarı, 2004).

Comparing to the earlier system, Foreign Finance Information System was simpler, more comprehensive and at the same time more flexible, and also capable meet the requirements of statistics and accounting recording purposes. Thanks to the credibility and structure of the supplied data, the system is introduced to the many countries by the World Bank, and mentioned with honor by the IMF (Bal, 2001, p.253).

As in the case of old system, through this new system, while monitoring of the mid- and long-term external debt of the public and private sector are performed, short-term external debt information are kept by Central Bank. By Foreign Finance Information System, the scope of the foreign debts has been enlarged so that it includes all kind of public and private sector foreign debt.

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<sup>2</sup> The problematic areas related to the foreign debt of the system intensify on the following points; i) Difficulties observed in recording specific payments and servicing between the Treasury and Central Bank, ii) Inefficiencies and some problems in monitoring short-term debts, iii) Abundance of external credits types and their unfamiliar complex structure, iv) The need for accumulated and detailed data set, v) Discrepancies in recordings of the creditors and debtors, vi) inability in timely delivering of the foreign debt data to the General Management of Public Finance. vii) Some problems emanating from debit accounts kept in TL terms. (Bal, 2001, p.251-252).

Through the project which designed by the Turkish Treasury, a big step has been taken with respect to monitoring of the debts. Still some steps continue to be taken on the direction of operating this system.

Through these positive steps taken, deficient points of monitoring foreign debt which is the most problematic part of the passive foreign debt management, to a large extend, was solved. Consequently, traditional functions of foreign debt management became successfully applicable. Despite there are still some deficient points in this area, they are far from being permanent and they have diminishing importance as the time passes. Lacking information on Public Sector utilization of foreign debt, problem of foreign debt with guarantee, accounting and recording problems, and inability in timely enrollments of private sector foreign debt utilization and repayment information, are the main reasons that create inefficiency.

Many problems emanating from independent administration of external debt database and accounting system still exist. This situation caused by the differences in data, gave a way for criticisms like; 'Treasury is not aware of its debt'. This situation is actually emanating from recording system of the Treasury. Having recognized the deficient points of the system, some steps have been taken and finally in July 1997 'Project on Automation and Modernization of Treasury Accounting System' introduced. It is prospected that the problems would be reduced with the completion of the project entirely (Sarı, 2004).

In conclusion, steps taken starting from the 1980's on the way monitoring the external debts are generally successful in Turkey. In line with changing needs, developing technologies, and institutional developments in this field, continuously developing system was constructed, in this regard Turkey became one of the leader country in the world. By the contributions of External Finance Information System, External Debt Database System, recording process of mid- and long-term debts at the Treasury data set and with other developments facilitating monitoring of the external debts, we can conclude that except a few problematic areas, problems related to external debt monitoring are being solved with regards to passive debt management. Despite all these positive developments in tracking of the foreign debts, it is possible to say that there are some problematic areas waiting immediate solutions. Some comments and recommendations of Chamber of Accounts are accepted to be beneficial in solving these problems. Some recommendations are as follows;

"i) Within the Treasury structure two integrated system, accountancy and data system, should be independently constructed with the manner that they control each other, ii) Present debt stock records should be reviewed, records should be proved by debtor and creditor information and debt data sets should be reconstructed, iii) The old recording mistakes, to a large extend, were due to the deficiencies belonged to internal controls. In order to ensure credibility and accuracy in the new system, control mechanism should be restructured" (Chamber of Accounts, 2000, p.9).

Seeing all these developments, we can infer about current intensified efforts on structuring an effective foreign debt management, Law No 4749 on the Organization of Public Financing and Debt Management of which details above given has special importance. We can come to the conclusion that except a few problematic

areas, problems related to external debt monitoring are being solved with regards to passive debt management. However, the fact whether this is sufficient or not is related with the activity level of foreign debts and the level of concern on the macroeconomic management dimension. The last section of the thesis focuses especially on this sufficiency evaluation, and some required precautions will be considered towards eliminating present deficiencies.

## CONCLUSION

External debt management is a widespread concept which includes various dimensions. Every country tries different kinds of ways to establish an effective and modern debt management, according to their own historical background, organization structure, and development level. The general tendency of the countries is sliding their external debt management from passive into active.

But, in order to control today's debts, these complementary two ways gain meaning only if they are evaluated by the macroeconomic management. Because external debt stocks are results like all the other economic variables. This result is the reason of the external debt supply and is the extension of the economic politics that were applied in that period. No matter how modern external debt management established, unless the economic policies are not considered in relation with the macroeconomic policies, it will not be probable to talk about an effective external debt system.

In this respect, an effective external debt management is the component of three different dimensions which complete each other. Passive external debt management, active external debt management, and macroeconomic management. In other words, appraising the external debt management system in a country passes from fixing its place where the external debt management perception and applications stand in this triple stage. It is clear that this perspective is also valid for this work which aims to evaluate Turkey's external debt management system.

With the most general definition passive external debt management means the country's full knowledge with respect to its external debts. Although it is not a concept universally perceived and accepted for the effectiveness of external debt management, it has some specific main principles in connection with effective management. These principles are especially related with the fulfillment of the functions of external debt management like, politics, arrangement, statistical analysis, accounting. Furthermore, monitoring of external debt with all dimensions is accepted among these principles. It is very obvious that, these principles are related to passive management dimension of external debt management.

These principles were mostly applied tools for developing countries in composing external debt management structure in the 1980's. In this period many countries had taken positive steps towards performing necessary institutional and organizational changes in the scope of international financial institution's demands and supports. Thanks to these steps significant improvements could be generated for these countries on the way of setting passive structure of the external debt managements. These efforts had been continued after the 1990's period.

Surely, Turkey could not be expected to stay out of this process. Starting from the 1970's in our country, foreign debt management concept had started to gain importance. But, during these years necessary steps have not been much taken. This



disregard had resulted in the emergence of significant deficiencies in supplying healthy information and analyses regarding country's foreign debts.

In this regard, negotiations conducted in 1978-1982 period on foreign debt postponement are important. As a result of negotiations, some obstacles had been encountered in estimating how much debt to whom Turkey were owed and in order to solve this dilemma, foreign specialists have been invited to Turkish Grand National Assembly.

Thereby the period as of the mid-1980's in Turkey, was the period in which conscious efforts have not been taken regarding foreign debt management. So, inefficiency of institutional and organizational regulations of this period attracts attention. Also it is not possible to talk about incorporations among different institutions at this period.

Today at the point we have reached, if are to evaluate Turkey's development path on the way of passive external debt management, in general we can infer about positive gains. In the framework the Law No. 4749 that came into force since January 1, 2003, especially for the public borrowings, the necessity for a solid legal structure, to a large extend, have been set and legal infrastructure for external debt management were granted.

Despite this law constitutes legal structure for public borrowings it does not include any decision with respect to private sector borrowings and this is thought to be a big deficiency. In line with our legal system, there is no restriction for private sector borrowing, so they can freely borrow. Although public authorities do not undertake to pay private sector borrowings, the problems rose from the repayment of such borrowings may distort the reliability of the country in the eyes of foreigners. Regarding banking sector debts, this situation is more apparent. Sometimes, especially the period of economic recessions and instabilities, governments can compulsory give guarantees for the country's banking sector liabilities. In this regard, governments should not stay negligent with respect to private sector debts.

In this framework, the Law. 4749, Turkey's most important legal regulation in relation with foreign borrowing, has been expected to include some regulations regarding the private sector borrowings as well. Surely, this should not to be detrimental to the principle of private sector independency in foreign borrowing, it should guide them in line with the country's macroeconomic politics and applications. This holistic look on foreign borrowing would contribute in perceiving foreign debts on a macroeconomic platform.

In monitoring and recording the foreign debts the most problematic field is related with the private sector borrowings. The problems emanating from banks' late presentation of information regarding private sector borrowings to the Central Bank causes late announcement of the foreign debt statistics by the Treasury.

In order to have a more accurate reflection and assessment of foreign debt statistics, there should be some regulations and revisions in the recording process by which the Treasury makes measurement. It is commonly believed that, especially in separation of the debts by mid- and long-term, instead of agreements' original maturity, the days remained to maturity should have been predicated on making healthier analysis.

Despite the all positives steps taken, coordination among institutions, which constitutes an important dimension of foreign debt management, is considered not yet to be established entirely, and bearing some defects within it. It is believed that these defects would only be overcome by the establishment of an organization like external debt financing committee of which details would be expressed in the coming pages.

Under the light of all these evaluations, except a few problematic points passive external debt management process in Turkey has been completed in general. As a result of developments in one fourth century, in the scope of established foreign debt management system in Turkey, responsible parties for foreign debt management today can easily reach the comprehensive information concerning the foreign debts.

For the period hereafter, our general tendency concerning foreign debt management system would be establishing more active foreign debt management rather than existing passive management infrastructure, by developing mechanisms which allow contemporary risk management techniques, and transforms foreign debt management system from passive to active.

Currently, passive external debt management and its related applications are not as sufficient enough as in the past for meeting and solving the new problems. This situation revealed the problem concerning effective management of foreign debt stocks against financial risks into the agenda. Foreign exchange rates, interest rates, agricultural and metallurgical product prices, fluctuations in petroleum prices and problems arisen in relation with them, have gained new dimensions to foreign debt management. It is pretty obvious that the new dimension is about risk management which meant evolution of foreign debt management process from passive to active.

Transformation from passive debt management to active external debt management is a painful process which may include some risks and difficulties. In this regard, the fact whether the required infrastructure is completed or not conveys a special importance. All the process with respect to passive external debt management should be, to a large extent, completed. It seems to be rational that, depending on the level of development the countries should expand transformation process into time. Nevertheless, risk analysis of the economy, legal and institutional regulations for responsible parties should also be arranged within the scope of this transformation process.

Currently, many of OECD countries are in the struggle to transform their external debt management system from passive to active. Although, many of OECD

countries not having performed main requirements of the passive external debt management, they are in such a struggle to realize transformation from passive to active external debt management. In this framework some main recommendations generated in the 1990's by OECD countries' reforms concerning foreign debt management are as follows; i) implementing a separate debt management politics that independent from monetary politics passes through Central Bank's focus on its main obligations only, leaving the politics like debt/liability management to Ministry of Finance and Treasury. ii) Constructing for an effective debt management, liability management politics should be far from interventions and should be transparent. iii) Debt management should be delegated to portfolio managers who got the all information and experience that modern management techniques require, and their performances should be checked along with predetermined criteria for better debt management. iv) For the success of debt management, a well-qualified team should be made up and required wage, source and infrastructure should be provided.

Except some problematic areas, Turkey has almost completed infrastructure of passive debt management. In terms of risk management, although positive steps have already been taken, it is not at the desired level, and necessity for the management of these risks increases as the time passes. With the legal regulations introduced by the Law No. 4749, Treasury gained strength in dealing with risk management, a legal infrastructure has been set up in line with the transactions in this field. In the preceding applications, since there was no legal basis for the transactions made in risk management, transaction were accompanying high risks, which causing debt managers avoid from these kinds of operations.

There are serious doubts concerning utilization of these techniques Turkey, combined with the above mentioned problems and risk management techniques which contain risk itself.

Risk management is indicated as rationale in doing swap transactions. However there are serious doubts with respect to the fact that intended application would be the risk management. In this regard, Treasury's tendency towards giving fresh information, doing immediate transactions and making short-term forecast on the rate of exchange, gives a speculative impression about debt management.

Apart from utilization of risk management techniques, one of the most important obstacles on front of an effective and active external debt management transformation in Turkey is the restrain in measuring magnitude of the obligation which must be financed by the Treasury. Except from budget, for years Treasury was obligated to finance, Public Economic Enterprises (PEE), municipalities, and the funds apart from the budget. This obligation in turn significantly restricted the Treasury ability to predict magnitude of the financing requirements. This restriction, in turn by creating a significant external and internal debt accumulation dynamic, constituted a significant obstacle against effective debt management. Nevertheless, it is believed that the limit applications launched by the Law No. 4749 would bring important contribution to the predictability of the magnitude that would be financed.

Increasing importance of risk management techniques in the scope of financial risks, and difficulties in solving corporation in foreign debt management are both exhibited the importance of establishing an autonomous foreign financing committee or debt management office. This tendency which started as of the mid-1980's, at the same time, was perceived as an important intermediary in countries' evolution of foreign debt management system from passive to more active and effective. In other words, these kinds of organizations gradually became an important dimension of active external debt management systems.

These models, which brought many significant changes in legal and institutional structures with itself, have been implemented in some countries like; Sweden, Ireland, Colombia, Hungary, Australia, and Denmark.

In this framework while some countries designate these organizations within the existing institutions like Treasury and Ministry of Finance, some others felt need for establishing completely independent organizations. Debt offices' independency can vary according to condition whether debt office is placed in Treasury or in Ministry of Finance.

It is argued that establishing a separate debt administration has the following benefits; (i) Establishing an organization which aims at effective management of the debts would provide a ground for better analysis for the market structure, better reactions to the changes in the market, and bring about emergence of savings facilities in the cost of borrowings. (ii) At any price, instead of borrowing, effective management of the debts would be aimed. (iii) Transactions which can not be performed within the general administration like elastic wages, and employment politic, quick decision making would be also easily carried out. (iv) All authorities which were formerly gathered in the hands of different institutions would bring together under the administration of one institution and this would bring effectiveness for decision making process. Furthermore, since new techniques would be given to this administration for better management, available tools would increase.

It is claimed that, according to the country's conditions whether it is independently established or constructed within one institution. Through the establishment of debt offices, debt management would be able to specialize in risk management, and also would work more effectively. According to the claim, risk management requires a different specialization. Moreover, each person employed in these units should focus on a single issue only.

The need for this kind of offices became more vital as the time passed and today their duty is not just making biddings, but they are engaging in such duties; preparation of the markets, knowing the customers and analyzing the customer behaviors, increasing the effectiveness in the markets in which customers existing, finding new customers, making decision; from which markets should be borrowed and what maturity they should bear, decreasing the potential risk emanating from the debts.

In Turkey, through providing specialization, risk management can be made more efficiently, more effective debt management can be granted. Like in the other countries, Ireland (independent), Sweden (organized within the Ministry of Finance), in Turkey such an organization may be set in the coming years.

If we consider Turkey's economic conditions, constructing an independent debt management would accompany with some drawbacks. In comparison with other OECD countries, Turkey's share of debt level within national income is fairly high, and this reality means that Treasury's weight on the market is fairly big. On the other hand, if we are to think that Turkish finance markets are not as much depth as the other countries', it is well obvious that a small mistake that probable to occur in debt management would bring huge costs to the economy. For this reason when taking in to account of all the economical equilibriums, it seems very unfavorable to establish an autonomous organization, since such an organization would directly affect the markets. Therefore, unless finance requirements of budget decreases, separately construction of payer unit (Treasury) and funds providing unit (Debt Management) would not be true.

When looking at the countries' experiences regarding this issue, three points gain importance in working debt management offices effectively. First item of them is the separation of borrowing aims from other politics, secondly, providing coordination with the related units while realizing borrowing management, thirdly the following the tools that can be used, establishment of a single data net that gathered within one unit, developing risk management methods and its application, and providing required technological supplies. In this context, debt management within the Treasury has been lined aims for borrowing by Borrowing Law, and taken special care on transparency principle. Thus, first requirement has been realized. On the other hand in order to provide second requirement, a committee in the form of consultant should be constructed which provides coordination between the institutions, delivers information to the parliament. Third requirement is about to technological adequacy and establishment of a single data net. To quickly realize this purpose, Treasury should start required infrastructural works.

However, from the other point of view, it is possible to encounter with a different picture; Treasury administration in our country is obligated not only with performing the external debt management but also obligated with performing many functions with respect to economic management. While this fact makes Treasury stronger, it also makes this institution to be poor in efficiency. Essentially, the role of Treasury in foreign debt management process have been emanated from the obligation to finance a big part of public sector borrowing need and this circumstance caused Treasury to be main responsible institution for debt management.

It is not seem to be rational to expect a transparent, autonomous, accountable external debt management from such institution. About this issue in Turkey's privacy, this institution must be re-designed to be more autonomous. A debt management that holds own independency and accountability can comfortably perform its functions that active operations require. Since, for the current situation,

Treasury has been surrounded with many tasks with respect to the economy, and has the administration with low political independency, has been left destitute from net information regarding magnitude of financing requirements that it has to meet are some of the reasons that make the Treasury expose to many obstacles in effective debt management. So, it is very normal for such an institution having difficulties in coping with those problems.

These negative facts within the Treasury make it compulsory to have an autonomous organization constructed out off the Turkish Treasury. However, this is not a must. It is commonly believed that the necessary steps have to be taken in this context to construct a more autonomous debt management mechanism.

In the scope of active external debt management, it is not sufficient by itself to construct a transparent, autonomous and accountable debt management office. It might be beneficial to some extent set up a financing committee over the debt management office. Within the system main tasks of this committee may be formulized as, determining country's foreign borrowing politics and strategies, providing coordination among the related institutions, making strategic decisions necessitated for active external debt management.

While representatives of all public institutions and enterprises who share duties in foreign borrowing process taking place in a such committee, private sector representatives should also take their places, so that coordination will be ensured between both parties in dealing with the solving the problems. Since all the private sector foreign borrowings are made through banks and private finance institutions, Banking Regulation and Supervision Agency or Banks Association of Turkey, are the institutions which also should take their places in this committee. It is considered that with this committee in which Turkey's foreign financing politics and strategies with respect to foreign borrowing will be determined, and related long-term decisions will be taken, will also contribute to analyzing foreign borrowing fact in a broader perspective on the issues like fiscal discipline, external balance, macroeconomic planning. At the same, macroeconomic management of foreign debts will be also positively benefited from this perception.

In the scope of fulfilling Turkey's effective foreign debt management requirements, the above mentioned institutional organization should also be supported by some other factors. In this context, with a holistic evaluation, risk analyses of Turkish economy should be done, detailed programs should be prepared in relation with this. Like in the other countries, in Turkey there are some restrictions and obstacles in utilizing of risk appliances as well. Lacking in credibility, high costs of utilizing appliances, institutional inadequacies, and insufficient number of expert employees are among the most important reasons behind these restrictions.

In this framework, the following points are very important i) making risk analyses of the country's economy and foreign debt related units, measuring their possibility level to face with the risks, ii) making legal and constitutional regulations in private and public areas towards using the related appliances, iii) making

introduction studies to the related units regarding subject techniques, and gaining them experiences, iv) starting pilot applications beginning from public sector and then spreading to the private sector, v) continues reviewing of these processes, correcting the defects and troubles, and providing guidance services.

Management of public receivables is should be in conformity with the implementation of debt management processes. Some part of bond and project credits borrowed by Treasury from abroad in favor of public institutions, are not repaid in time or completely not repaid by these institutions. These un-repaid credits and Treasury's undertakings in turn lead to an increase in state's borrowing requirement and this requirement reflects to the foreign debt stocks as well.

Delay in public receivables collection mechanism is not only important for external debt utilizations, but also important for domestic borrowing. Problems in repayment of debts emanating from domestic borrowing would certainly reflect its effects onto foreign financing. This point of view is getting more and more significance in today's financial relations in which separation between external and domestic debts disappears.

Beginning from the 2002, efficiency in receivables of Turkish Treasury's started to improve. By the Law No. 4749 and some regulations made in accounting system some arrangements have been introduced, and new principles have been adopted. These arrangements doubtlessly will achieve positive developments in the collection of receivables.

Under the light of all these information, when determining Turkey's development level in foreign debt management, it does not seem possible to say that the positive developments in terms of passive external debt management are also observed in terms of active external debt management. Although some positive steps have been taken in relation with this issue, it is pretty obvious that we are at the beginning of the process yet. Taking action towards achievement of above outlined requirements, holds great importance on the way of reaching for more effective foreign debt management with lowered risks. However, the process can not be completed by those. Unless foreign debt management is looked on the ground of macroeconomic politics, physical infrastructure constituted by active and passive external debt management would not be much successful.

Foreign debts are the result of applied macroeconomic policies. If you are not pleased with current structure of your debt stocks and its magnitude and if you are aiming to direct both stock and magnitude of foreign debt to specific points, your remedy is to think comprehensively on the causes of these circumstances. So, effective foreign debt management is the debt management which takes foreign debts in conjunction with macroeconomic thought.

Turkey is a deeply indebted country and one of the most important factors lying under this debt dynamic is the public sector deficit. Although it is currently being diminished, still exists. Public sector deficits together with the contribution of

high level of interest rates that endured to finance them, are continuing to enlarge the country's debt stocks. In such a country with high level of public deficits, it may not be much possible to get desired results from a debt system which complies with the universal standards determined for passive debt management.

For this reason, tight fiscal policies that bring fiscal discipline in the foreground by decreasing public deficits are considered as the important politics tool that contributes management of foreign debt stocks in the macroeconomic framework. While tight fiscal policies serve in bringing domestic and external debt stocks into the desired level, by eliminating concerns on sustainability of the debts, they can also lower costs of borrowing. As a matter of fact, by the affect of applied tight fiscal policies, course of PSBR/GDP ratio that one of the most important indicators of public sector deficit after the 2001 crisis gives positive signals regarding shape of our country's foreign debt stocks that will take in the future.

On the other hand, by affects of foreign debt interest payment as well, Turkey has fallen into a situation that continually searching for foreign debt. Turkey applies foreign borrowing not only for financing current account deficits, but also for accumulation of formal and special reserves. For Turkey where there is deficiency in the amount of foreign investments, structural current account deficit and its financing problem are gaining much more importance.

Within the whole macroeconomic framework, foreign financing requirement has reached to such an important point that country's growth dynamics became largely bound to foreign financing facilities. Because, Turkey, as a country adopted export oriented growth strategy, is obligated to import goods in order to export more products. This is why our imports roughly two third of our imports are intermediary goods. By adding low value in their processing, these imported intermediary products are being exported. In this context, the greater growth in Turkish economy necessitates more and more import, this fact draws current account balance into deficit and for financing this deficit, borrowing becomes as an frequently applied instrument.

From this aspect, in the long-run, policies towards changing the country's manufacturing structure hold special importance. Trying to lower independency to abroad, and also directing factors of production to the areas with high added value are both compose crucial points for the policies that should be implemented.

The Effects of foreign exchange rate regime on external debts can not be neglected. Foreign exchange rates which are not realistic, and not generated by the market forces of the economy will never give a correct data with respect to share of total debt stock within the GDP. In this context, floating exchange rates accompanied by tight fiscal policies are crucial in terms of the credibility of implemented macroeconomic policies as well.

Active and passive external debt management concepts have been designed on the idea of managing the existing debt stock in the best and most effective way.



However, it also appears as a requirement that the external debts should be evaluated in the scope of macroeconomic management process. In other words, an advanced debt management system would prove insufficient unless the necessity of external borrowing is considered at length or the effect of the processes and policies that lead to external borrowing on the current amount and structure of debt stocks are carefully evaluated and the management of these processes and policies are brought on the agenda.

In this context, in Turkey the main requirements of passive external debt management has been, to a large extent, fulfilled while in terms of active external debt management only elementary steps have been taken. However, for the macroeconomic management we can infer about a great negligence. Trying to transform economical structure which sharply necessitates external financing may provide an important step in evaluating external debt in the scope of macroeconomic management process. Surely, this transformation process is not a process that can be realized from past to present and will expand into time. But it is obvious that for such an environment in which borrowing is perceived as success, achievement of this will be fairly difficult.

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