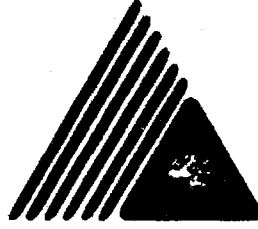


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THE TURKISH CASE**

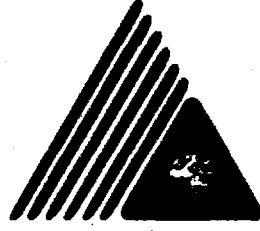
by

Ebru Tomris AYDOĞAN

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**Submitted to the Graduate Institute of Social Sciences
In partial fulfillment of the requirements for the degree of
Master of Arts in
International Economics and Finance**

ISTANBUL, 2004



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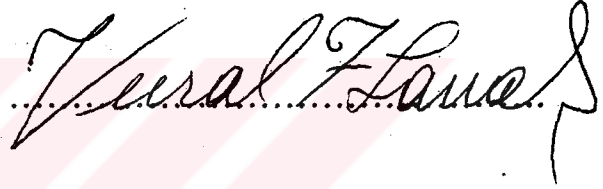
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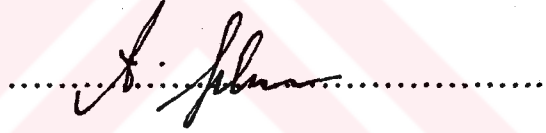
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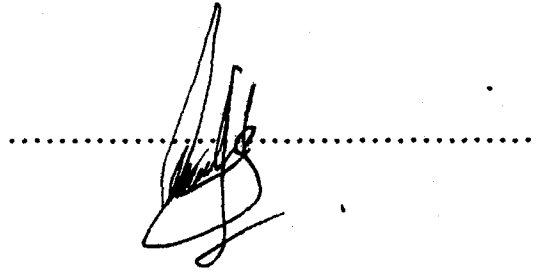
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LIST OF ABBREVIATIONS

AD	:	Aggregate Demand
AS	:	Aggregate Supply
BOP	:	Balance of Payments
BRSA	:	Banking Regulation and Supervision Agency
CA	:	Current Account
CAB	:	Current Account Balance
CAC	:	Current Account Convertibility
CBRT	:	Central Bank of Republic of Turkey
CPI	:	Consumer Price Index
EMS	:	European Monetary System
EMU	:	European Monetary Unit
ERM	:	Exchange Rate Mechanism
FDI	:	Foreign Direct Investment
GAAP	:	Generally Accepted Accounting Principles
GDP	:	Gross Domestic Product
GNP	:	Gross National Product
IMF	:	International Monetary Fund
ISE	:	Istanbul Stock Exchange
ISS	:	Import Substitution Strategy
KA	:	Capital Account
KAB	:	Capital Account Balance
KAC	:	Capital Account Convertibility
MNC	:	Multinational Companies
NFLA	:	Net Factor Income Abroad
NX	:	Net Exports
OMO	:	Open Market Operations
OPEC	:	Organization of Petroleum Exporting Countries
OR	:	Official Reserves
ORSB	:	Official Reserves Settlements Balance
PI	:	Portfolio Investment
PSBR	:	Public Sector Borrowing Requirement
SDIF	:	Savings Deposit Insurance Fund
SIS	:	State Institute of Statistics
SPO	:	State Planning Organization
SSAP	:	Stabilization and Structural Adjustment Program
UT	:	Undersecretariat of Treasury
WPI	:	Wholesale Price Index

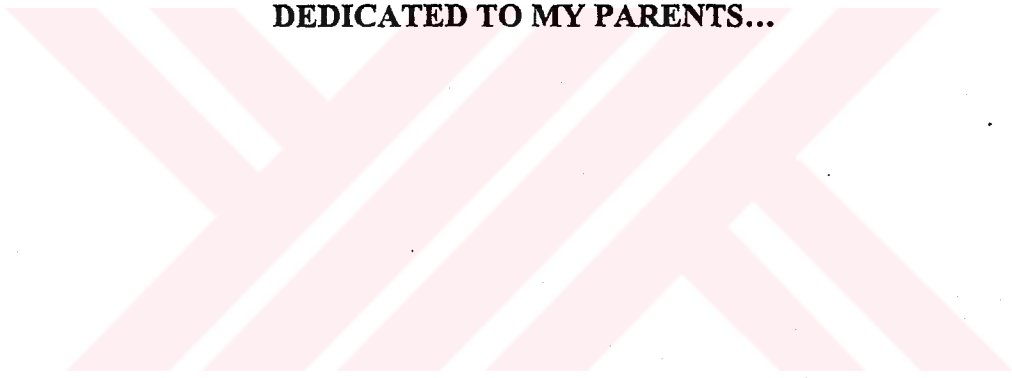
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ABSTRACT

The Capital Account Convertibility (KAC) is a significant outcome of the globalization process. The restoration of stability and growth, in order to increase the efficiency and saving in the economy were the major aims of the KAC, in other words financial liberalization.

The analysis of the financial liberalization on the Turkish economy shows that, the economy has been exposed to significant amount of hot-money flows during 1990s. The statistical data used in this study verifies, the increase in short-term capital in and outflows, after the convertibility of the Capital Account.

The results indicate that, the vulnerability of the Turkish economy increased due to the sudden and volatile flows of capital. The correlation between the increasing speculative capital flows, portfolio investment, financial crises, unexpectedly low levels of foreign direct investment, and instability supports the argument of premature liberalization in Turkey.

Finally, the successful implementation of the economic policies is suggested, together with controls on hot money flows, in order to achieve macroeconomic stability, and increase the amount of FDI, and the real rate of growth (rather than the speculation led growth observed) in the economy.

Keywords: Capital account, capital flows, financial liberalization, FDI and PI.

JEL Classification: F, F2, F3, F21, F32.

ÖZET

Sermaye Hesabının Konvertibilitesi globalizasyon sürecinin önemli bir sonucudur. Ekonomideki verimliliği ve tasarrufu arttırmak için istikrar ve büyümenin sağlanması, Sermaye Hesabının Konvertibilitesi, başka bir deyişle finansal liberalizasyonun ana amaçlarıydı.

Finansal liberalizasyonun Türkiye ekonomisi üzerindeki etkilerinin analizi, 1990'larda ekonominin önemli miktarlarda sıcak para hareketlerine maruz kaldığını göstermektedir. Bu çalışmada kullanılan istatistiki veriler, kısa vadeli sermaye giriş ve çıkışlarının Sermaye Hesabının Konvertibilitesi'nden sonra arttığını doğrulamaktadır.

Sonuçlar, ani ve değişken sermaye hareketlerine bağlı olarak, Türkiye ekonomisinin incinebilirliğinin arttığını göstermektedir. Artan spekülasyon sermaye hareketleri, portföy yatırımları, finansal krizler, beklenmedik seviyede düşük yabancı sermaye yatırımları ve istikrarsızlık arasındaki ilinti Türkiye'deki vakitsiz liberalizasyon tartışmasını desteklemektedir.

Sonuç olarak, ekonomideki makroekonomik istikrarın sağlanabilmesi, yabancı sermaye yatırımlarının ve reel büyümenin (gözlemlenen spekülasyon büyümenin aksine) artırılması için, ekonomik politikaların başarıyla uygulanması ile birlikte sıcak para hareketlerinin kontrol edilmesi önerilmektedir.

Anahtar Kelimeler: Sermaye hesabı, sermaye hareketleri, finansal liberalizasyon, yabancı sermaye yatırımları ve portföy yatırımları.

JEL Classification: F, F2, F3, F21, F32.

1. INTRODUCTION

The outward oriented economic liberalization of Turkey started with the implementation of the neo-liberal growth strategy after 1980. From then on, capital account liberalization became the integral component of the whole liberalization process in Turkey. It seemed an inevitable path to be followed, in order to adopt the Turkish economy to the new world order that was created by the increasing speed of globalization. Countries one after the other, started to open up their current and capital accounts. The convertibility of the current and the capital accounts were major economic reforms, especially for the developing countries.

Turkey has traditionally followed the “import substitution strategy” (ISS) in a semi-open economy model that was finalized in 1984, and the “export promotion strategy” in an open market model that became the dominant strategy as of 1984. More emphasis was given to the strengthening of the economic infrastructure and transparency. A fast development strategy was launched, under highly imperfect market conditions in Turkey. Some of the many problems that Turkey had faced were: the highly imperfect market functioning; the demands and priorities of successive governments; the fast democratization in the country which is expected to be reflected in the planning process; the extremely centralized economic and social policy tradition, and the lack of sufficient data. Although, the liberalization of the trade regime and the capital account had positive effects on the economy, they also heightened the risk of financial crisis, since the economic conditions were not stabilized at that time.

The Stabilization and Structural Adjustment Program (SSAP) was introduced in January 1980. This program aimed to increase the foreign currency reserves, as a result of increasing foreign trade. This set of policies increased exports and decreased inflation at the beginning. The liberalization policy was made more explicit in currency rates and incentives and also for export guarantees in 1984. The implementation of these policies led to a radical transformation in Turkey. January and August 1980 period was the period for the restoration of stability. The policies to decrease inflation were adopted in September 1980 and continued till the general elections of November 1983. The attempts of increasing the public sector investment lasted till November 1987. Stagflation and low rate of growth increased after 1988. Although, the rate of growth of private investment in

tourism and housing increased, the attainment of a reasonable rate of growth, fair and equal distribution of incomes and price stability targets were deteriorated during 1989.

A new capital market legislation, price and tax reforms were introduced with the SSAP. The liberalization of foreign trade and the **capital account convertibility (KAC)** were the major aims of the SSAP. These policies also had impacts on the agricultural sector. The rising gap between high and low incomes also led to an increase in the unemployment level. Privatization had increased, whereas the public investment had decreased.

With all diligence, the liberalization of the capital account started in August 1989. But, the economic conditions in Turkey were not stabilized yet. It was an early and rapid transformation for the Turkish economy. The development was supposed to be achieved gradually, in other words phase-by-phase. The major reforms like: the liberalization of foreign trade regimes, export oriented policies and privatization of the economy were achieved. But, curbing the ongoing inflation, creation of employment and surplus, and elimination of distortions on factor prices were not. The developments of the capital account are analyzed in two phases: **1980-1989**: the decade before the KAC, and **1990-2003**: the decade after the KAC in Turkey.

The KAC left the Turkish economy prone to crisis, just like many other developing countries, which attempted to switch to full KAC and were left in an extemporaneous situation. Some of the aspects of the Turkish experience still remain to be covered, since there were major fluctuations, booms and busts before and after the introduction of the KAC. The KAC increased the arbitrage opportunities of the Turkish and foreign investors. The huge amounts of capital flight or hot money flows in and out of Turkey are yet other problems that came into the Turkish economic scene with the full KAC. The foreigners generally did not prefer to make direct investments in Turkey. They rather preferred to invest in Turkish financial securities. Hence, by doing so, they were capable to escape their money easily out of Turkey. This situation left the Turkish economy in a fragile situation. Although, the investments of foreigners increased after KAC, they did not reach the expected levels. The application of the controls on capital flows remained a subject of controversy.

Turkey has faced profound economic and political diversifications during 1980s. The neo-liberal era of post-1980 struggled with many problems. The KAC aimed to restore the long time forgotten stability and growth. The efficiency in the economy was to be increased, together with the savings. But, the policies that were followed were generally short-term policies that increased the instability in the economy, leading also to an increase in crony capitalism. Thus, the problems of inflation, fiscal deficits, and income inequality could not be solved.

Due to the depreciation of the Turkish currency, the Turkish economic performance was successful till 1987. From then on, contrary to expectations, and with the succeeding KAC and lowered depreciation, the economy came to an impasse and entered a vicious circle. The Turkish economy in the first phase, implemented a crawling peg exchange rate regime, followed by floating exchange rate regime in the next phase. The external balance was distorted. Turkey faced three economic crises in 1994, 1999, and 2001, as a result of many policy reversals and the impacts of the crises in other countries. The formation of the financial markets left the economy prone to hot capital flows. They in other words, increased the short-term investments, not long-term ones. A positive outcome of the KAC was that the investors became able to choose from a wide variety of financial instruments. The notion of the external and internal balances of the economy gained more importance after the KAC. The openness of the economy increased rapidly after the orthodox policy package and the KAC. The banking sector also went through a series of reforms and deregulated the interest rates after 1980. The aim was to draw the domestic savings to the financial system. The creation and foundation of new financial instruments and the establishment of new financial institutions prepared the base for the KAC. But, the reforms and the infrastructure of the Turkish economic and financial system were not sufficient enough to ease the volatility and the fragile situation that the Turkish economy was confronting.

Since, most of the studies reflect the results of short and medium term data, this study will be beneficial for reaching a decision about the effects of the Capital Account Liberalization in Turkey for the last two decades, and will provide a deeper understanding of the above stated aspects of the Turkish economy.

The data used in this study come from the State Institute of Statistics (SIS), State Planning Organization (SPO), Undersecretariat of Treasury (UT), and the Central Bank of the Republic of Turkey (CBRT). These sources provide the official statistical data and information on issues surrounding the financial sector in Turkey.

The paper presents the data in a time series analysis for more than two decades, covering 1980-2003. The effects of Capital Account Liberalization on Turkish financial sector are analyzed in two stages: Before and after 1989. The statistical differences, if any, will be compared for two decades. General trends and composition of the set of variables and data given are explored in terms of these effects.

In the following section, I present an overview of the **Balance of Payments (BOP)** and its accounts. The third section presents a literature survey on the Capital Account Convertibility. It also entails the historical summary of the Capital Account Liberalization. The fourth section aims to provide an analytical overview of the Capital Account Convertibility. The fifth section of the paper will be analyzing the impacts of Capital Account Convertibility in Turkey. The last section is reserved for an overview and conclusion.

2. BALANCE OF PAYMENTS – BOP

A nation's BOP account is a statistical record of all transactions taking place between its residents and the rest of the world during a given period. This record is vital to understanding both the working of national economy, and the disturbances and adjustments affecting the international transactions, and therefore policymakers should carefully analyze it. The BOP accounts also provide the starting point for any serious study of international transactions. Four major accounts of the BOP, shown on Table 2.1 are: the current account, the capital account, official reserves account and errors and omissions.

Table 2.1
The BOP table

- I) Current Account (CA)**
 - 1) Foreign Trade Account
 - a- *Exports (X)*
 - b- *Imports (M)*
 - 2) Services Account (Trade of Services Account)
 - a- *Tourism*
 - b- *Banking and Insurance*
 - c- *Transportation and Communication*
 - d- *Foreign Assets Income*
 - 3) Unrequited (Unilateral) Transfers
 - 4) Factors' Income Earned Abroad
- II) Capital Account (KA)**
 - 1) Direct Investment
 - 2) Portfolio Investment
 - 3) Loans and Credits
- III) Official Reserves (OR)**
- IV) Errors and Omissions**

This chapter analyzes the basic accounts of the BOP, the relation between the CA and the KA, and BOP and national income accounting system.

2.1. Basic Accounts of BOP

2.1.1. Current account (CA)

The most important part of the BOP is the CA. The CA records trade in goods and services, as well as transfer payments. It lumps together sales and purchases of produced goods and services and thus, relates to the country's current nominal income. It includes transactions that either yield national income or result from its expenditure.

Its first major category includes exports and imports of merchandise. It also includes exports and imports of services. Transportation services (including freight and insurance charges for international movements); touristic services (including all expenditures of a country's citizens when they are abroad); business and professional services and services produced abroad by domestic capital stock are also included. The current account finally includes unilateral transfers, gifts, and donations.

The foreign trade account may give surplus, when exports exceed imports and deficit when imports exceed exports. The foreign trade account deficit is considered as *ex-post deficit*. The financing of this deficit might be made by the services account. Tourism, banking and insurance, transportation and communication and foreign assets income (which shows the profit earned in foreign countries and transferred to homeland) are included in the trade of services account. Services account also may be interpreted as causing an inflow (outflow) of foreign currency. The earnings transferred to a country by its citizens living abroad are considered as **capital inflows**. The profits earned abroad by multinational corporations' (which are transferred to their homeland) are considered as **capital outflows**. Unilateral transfers (unrequited transfers) refer to aids and grants given to other countries. These items define whether the CA gives deficit or surplus.

The CA of a national economy reflects the difference between what national economy produces and consumes. The "Trade Account" covers the value of exported and imported goods. The "Services Account" covers the value of exported and imported services. The CA and trade account are sometimes confused. Trade account only shows the relation between exports and imports. CA covers the trade account, the services account and the unilateral transfers. Trade account deficit is an ex-post deficit, since the goods have already been exported and imported. The services account and, unilateral (unrequited) transfers are

used for the financing of trade account deficit. The deficit of the CA is financed by the surplus of the KA. Thus, any CA deficit should be matched by the same amount of KA surplus and, any CA surplus should be matched by the same amount of KA deficit. If KA is not sufficient to finance the CA deficit, then the official reserves are used for financing. Trade account deficit should not be interpreted as the CA deficit, since services account and, unilateral transfers are also taken into account while the CA balance is calculated. In an open economy, the CA contains ex-post records.

The current account balance (CAB) corresponds to the net acquisition of foreign assets by the country as a whole. Under a CAB surplus, the economy may lend abroad, buy some foreign stocks and bonds, or the country's central bank may increase its holdings of foreign currencies. In other words, a surplus in CAB implies that the country is increasing its holdings of foreign assets or lending funds abroad and so it is acquiring net claims on foreigners. A country facing a CAB deficit has to finance it by borrowing from another country, selling some of its stocks, bonds, and other financial assets, or reducing its holdings of foreign currencies (OR assets). Or, a deficit means that the country is selling assets to foreigners or borrowing funds from abroad. The behavior of the CAB deficit is closely linked to that of the trade balance deficit.

2.1.2. Capital account (KA)

The KA gives us the mirror image of the CA. The KA shows the difference between sales of assets to foreigners and purchases of assets issued abroad. The KA records purchases and sales of assets, such as stocks, bonds, and land. There is a KA surplus, or a net capital inflow, when receipts from the sale of stocks, bonds, land, bank deposits, and other assets exceed payments for purchases of foreign assets (Dornbusch and Fischer, 1987, p.181). The KA contains (as shown in Table 1) three principal types of transactions. Direct investment occurs when the residents of one country acquire or increase control over a business enterprise in another country. Long-term “portfolio investment” (PI) involves international transactions in securities with an original term to maturity greater than one year. Short-term capital flows involve securities with original terms to maturity of less than a year (Caves and Jones, 1985, p.293-294).

A direct investment refers to a foreign company making an investment in another country by establishing a producing unit. It is therefore, also referred to as “**foreign direct investment**” (FDI). A portfolio investment refers to a foreigner buying assets, bonds in another country. At maturity period, the interests paid to the holders are transferred abroad by them. Loans and credits refer to the big companies that borrow directly from other countries, in order to pay their deficits. The portfolio account shows those transactions carried out in foreign currency to buy (sell) bonds, securities and equities. PI is the most important financial transaction of our time.

The KA is strongly influenced by interest rates, exchange rate expectations, risk perceptions, and a number of other variables determining the movement of funds across borders. It is an aggregate of international transactions involving a wide variety of financial instruments. The KA registers all asset transactions except for those involving the monetary authorities’ international reserves. A capital account surplus or deficit arises depending on whether the receipts from the sales of assets registered by the KA have exceeded or fall short of purchases of those assets (Riviera and Batiz, 1985, p.139).

2.1.3. Official reserves (OR)

The KA is used to finance the CA deficit. $CA + KA = 0$ equality shows that there is no change in the official reserves (OR). Official reserves are used when there is a surplus or deficit. Every country’s central bank keeps official reserves in foreign currency. Foreign currency reserves are needed for unexpected situations and events. National economies may need foreign goods and services. Thus, each national economy should have foreign currency reserves in order to meet certain economic and military situations. The central banks keep certain amount of foreign currencies in their reserves, as a result of globalization and open economies. Hence, for our purposes we use equation (2.1) that includes the OR:

$$CA + KA +/- OR = 0 \quad (2.1)$$

The sum of the current and the capital accounts is called the official reserve settlements balance (ORSB). It measures the intervention of monetary authorities in foreign exchange markets and is particularly meaningful in an economy under a fixed exchange rate regime (Riviera and Batiz, 1985, p. 139). If the CA and KA total exceeds zero $CA + KA > 0$, the OR increase. The OR increase with an increase in foreign investment and inflow of capital (sale of domestic bonds to foreigners) to the homeland. In this case, the country becomes a lending country. If the CA and KA total is lower than zero $CA + KA < 0$, the OR decrease. In this case, the KA is not able to finance CA deficits. Thus, the country needs additional currency. The country will then either use its OR or become a borrowing country. The OR are managed by the central banks. If OR are greater than zero ($OR > 0$), then there are extra foreign currencies in the vault of the central bank. In other words, with an increase in OR we become a lending country. If OR are lower than zero ($OR < 0$), we become a borrowing country.

2.1.4. Errors and omissions

The statisticians record most flows in BOP with approximate accuracy. They interview large firms to find the accurate BOP of a country. Questionnaires are distributed to these firms and corporations in order to prepare the annual BOP statistics. But, it is generally hard to get honest answers to these questions. The information about the offsetting debit and credit items associated with a certain transaction may be gathered from different sources. The data gathered from various sources may differ in coverage, accuracy, and timing. Since the BOP accounts do not balance in practice, the accountants bring the BOP to balance by adding a statistical discrepancy to the accounts. Thus, errors and omissions are not totally dependable. The data of the banking system show inconsistent results at the end of the year. The exported amount shown on the BOP of the exporting country does not generally meet the imported amount shown on the BOP of the importing country. Since, the exports and imports are already realized at the end of the year, the errors and omissions are added to calculate the total balance. They cover the net discrepancy in measurements. The statistical discrepancy is also widely regarded as reflecting unreported asset transactions. The statistical discrepancy is frequently added to the other items in the BOP accounts.

2.2. Relation Between the CA and the KA

The convertibility of the CA needs to be achieved for the successful convertibility of the KA. The trade and financial sector reforms should be made with the introduction of the CA liberalization. The financial sector reforms include the **open market operations (OMO)**, interest liberalization, and the **“Generally Accepted Accounting Principles” (GAAP)**. The convertibility of the KA refers to a series of reforms that allow foreigners to buy domestic assets and vice versa. As an outcome of this process, the domestic financial markets become integrated with the others.

Financial liberalization or opening up of the KA requires that, the transmission phase should be carefully managed and handled. Thus, before the attempts of financial liberalization, it is crucial that the CA is fully liberalized. Hence, the timing of liberalization should be made in advance. The CA and KA are closely related, since, liberalization of the CA is a prerequisite for the convertibility of the KA. The CA of a national economy reflects the difference between what national economy produces and consumes. The KA records the net trade between domestic and foreign citizens in various financial claims. The CA and KA are two major accounts of the BOP that are analyzed in order to reach the final BOP balance in an open economy, whether it is deficit or surplus. The deficit (surplus) in BOP is the sum of the deficits (surpluses) on the current and capital accounts.

The CA and the KA are closely related. Thus, one needs to understand the BOP accounting framework thoroughly. Tables 2.2, 2.3, 2.4, and 2.5 show the accounting records of exports and imports of goods and services for the CA and inflows and outflows of capital for the KA.

Every transaction has two sides. We buy something, and pay for it. Or we sell something, and receive compensation. The accounting rules tell us how to classify and record every transaction.

Table 2.2

Exporting an item valued \$ 1,000. - is recorded as:

	<i>Debit (-)</i>	<i>Credit (+)</i>
Bank deposit	\$ 1,000. -	
Export		\$ 1,000. -

Table 2.3

Importing an item valued \$ 1,000.- is recorded as:

	<i>Debit (-)</i>	<i>Credit (+)</i>
Bank deposit		\$ 1,000. -
Import	\$ 1,000. -	

Best visualization of the transactions is made through the use of T-accounts. The purchase of an import is classed as a debit, because we are obliged to make payment to foreign sellers in some form. Table 2.2 shows that, the sale of an export is classed as a credit, because foreign buyers make payment to us in some form. Table 2.3 shows that, a surplus in an account indicates that the receipts exceed the payments, whereas a deficit indicates that payments made by that country are greater than the payments received. Each transaction in the BOP is recorded two times, one as "debit", one as "credit".

In both the current and capital accounts the balances are recorded as differences between corresponding subtotals of credits and debits. A positive balance is favorable or active if it appears in the CA, implying a majority of debits in the KA. A majority of credits (or receipts) in the CA makes the balance positive. A CA balance with a majority of debits is called unfavorable or passive.

Table 2.4 and 2.5 show the recording of outflows and inflows of capital. The receipt for exported capital is an imported bond or share, representing a claim on that future income stream. The import of securities is a debit, giving rise to a payment, and is thus treated just like the acquisition of an asset in the balance sheet of a firm. The transfer of balances into foreign hands represents the corresponding credit. But, this import of

securities is called a **capital export**, because liquid purchasing power is sent abroad. An export (import) of capital is an import (export) of securities.

Table 2.4		
An outflow of capital valued \$ 10,000.- is recorded as:		
	<i>Debit (-)</i>	<i>Credit (+)</i>
Bank deposit		\$ 10,000.-
Outflow of capital	\$ 10,000.-	

Table 2.5		
An inflow of capital valued \$ 10,000.- is recorded as:		
	<i>Debit (-)</i>	<i>Credit (+)</i>
Bank deposit	\$ 10,000.-	
Inflow of capital		\$ 10,000.-

The rule for BOP accounting states that; if a transaction results in a receipt from the rest of the world, the cause of the receipt should be recorded as a **credit** (e.g., exports of merchandise) and the receipt itself should be recorded as a **debit** (e.g., increased holdings of foreign exchange). If a transaction results in a payment to the rest of the world, the cause of the payment should be recorded as a debit (e.g., imports of merchandise) and the payment itself should be recorded as a credit (e.g., reduction in holdings of foreign exchange) (Caves and Jones, 1985, p. 289). The sale of an export is classed as a credit, because the foreign buyer is obligated to make payment to us in some form. A deficit shows a rise in payment. A surplus shows a decline in payment. The major question is 'in which form might that payment be made?'

Table 2.6 shows the T-Account for a BOP transaction by assuming that $CAB = 0$. First, country A's export valued at 10 million US dollars (US \$) might be compensated through barter by the shipment of an import also worth 10 million US \$. Then, the export is recorded as a 10 million US \$ credit, the import as a 10 million US \$ debit.

Second, country A's export of merchandise valued at 50 million US \$ might be shipped as a personal gift, to a friend in another country. The export is recorded as a 50 million US \$ credit in the accounts. To complete the double entry system, we debit the "unilateral transfers to foreigners", by 50 million US \$.

Third, when country A's export of 10 million US \$ is credited and a transfer to the seller is made by the purchaser in foreign exchange, it draws down the foreign exchange holdings of the purchaser and is recorded as a debit of 10 million US \$.

Fourth, if country A's exporter accepts payment in Euro valued at 20 million US \$, the country's holdings of Euro will increase which will be recorded as a 20 million debit.

Table 2.6
T-Account for a BOP transaction

(Million US \$)	<i>Debits (-)</i>	<i>Credits (+)</i>
-Merchandise imports	-10	-Merchandise exports +90
-Unilateral transfers to foreigners	-50	
-Reduction in foreign holdings of country A's currency	-10	
-Increase in country A's holdings of foreign exchange	-20	
	-90	+90

Table 2.7 shows that, native tourists' 10 million US \$ consumption is recorded as a debit, since they result in a payment to other countries. The credited item would be the foreign holdings that have increased by 10 million US \$. If country A's investor purchases shares worth 50 million US \$ in an American company, he decreases his US \$ holdings by 50 million US \$, debiting his checking account by the same amount.

Table 2.7
Imports and foreign exchange

(Million US \$)	Debits (-)	Credits (+)
		-Increase in foreign
-Imports of services	-10	holdings of country A's currency +10
		-Reduction in country A's
-Imports of securities	-50	holdings of foreign exchange +50
	-60	+60

Even though every transaction has two sides in the accounting system, this fact in no way implies that demand and supply for foreign exchange will be equal (Caves and Jones, 1985, p. 291). Some countries keep their exchange rates fixed. If the transactions drive up the foreign price of the dollar, foreign governments may decide to sell an equivalent amount of dollars to keep its own currency from depreciating.

2.3. BOP and National Income Accounting System:

The national income accounts and the BOP accounts are important tools for analyzing the macroeconomics of open and interdependent economies. In an open economy trade does not have to be balanced, since the economy can borrow (lend) from (to) the rest of the world. The payments to foreigners are recorded with a minus sign, whereas the receipt from foreigners is recorded with a plus sign.

The gross domestic product (GDP) measures the output produced within a country's borders. A country's gross national product (GNP) is equal to the income received by its factors of production. National income accounts give us regular estimates of GNP, the basic measure of the economy's performance in producing goods and services.

$$NX = X - M \quad (2.2)$$

$$CA = NX + NFIA \quad (2.3)$$

Equations (2.2) and (2.3) show that, the CA is closely linked to net exports (NX), which are calculated by subtracting imports (M) from exports (X), and net factor income abroad (NFIA), which can be obtained from different sources. If the NX are greater than zero (NX>0), there would be trade surplus. If NX are less than zero (NX<0), there would be trade deficit. NX and NFIA together define the current account. First included in the NFIA is foreign stocks or securities that make up the PI. Another item included in the NFIA is direct investment. All financial activities are divided into two groups as portfolio or direct investments. Workers' remittance is another item that is included in the NFIA.

$$\mathbf{GDP = C + I + G + (X - M) \quad \text{or} \quad \mathbf{GDP = C + I + G + NX} \quad (2.4)$$

$$\mathbf{GDP + M = C + I + G + X} \quad (2.5)$$

Equations (2.4) and (2.5) define the GDP of an economy. The total of consumption (C), investment (I) and government expenditures (G) is named as the absorption capacity. NX plus NFIA gives the CA balance. If CAB is greater than zero (CA>0), leading to a surplus, then there would be outflow of capital and, the country would become a lending country. If the CAB is less than zero (CA<0), leading to a deficit, then there would be inflow of capital and, the country would become a borrowing country. GDP plus M gives the aggregate supply (AS) while C, I, G total gives the aggregate demand (AD) in the economy and, X give the foreign demand for domestic goods and services. If AS is greater than AD (AS>AD), there would be surplus of production and, if AD is greater than AS (AD>AS), there would be inflation with an increase in the prices.

$$\mathbf{GNP = C + I + G + NX + NFIA} \quad (2.6)$$

$$\mathbf{GNP = GDP + NFIA} \quad (2.7)$$

As shown above in equations (2.6) and (2.7), the GNP is the total of the GDP, and the NFIA. The GNP increases when the CA is positive and it decreases when the CA is negative. The GNP is greater than the GDP when CA is positive. GDP does not show the gross amount of national income of a national economy. But, GNP shows the total amount of national income of a national economy.

When the GNP exceeds GDP, residents of a given country are earning more abroad than foreigners are earning in that country (Dornbusch and Fischer, 1987, p.33). The national income expenditure point of view states that $Y = C + I + G$, whereas national income in terms of savings (S) equal to $Y = C + S + T$. Equation (2.8) derived from equation (2.4) gives the national income. Equation (2.10) shows the application of the national income in terms of savings (S) in lieu of Y in equation (2.9). By applying the savings equality to this equation we derive another formula known as the “Twin Deficit”. Equations (2.11) and (2.12) define the “Twin Deficit”.

$$Y = \text{GDP} = C + I + G + (X - M) \quad (2.8)$$

$$X - M = Y - (C + I + G) \quad (2.9)$$

$$X - M = (C + S + T) - (C + I + G) \quad (2.10)$$

$$X - M = (S - I) + (T - G) \quad (2.11)$$

$$CA = (S - I) + (T - G) \quad (2.12)$$

The difference between savings (S) and investment (I) gives the private savings amount. The difference between tax revenues (T) and government expenditures gives the public saving amount. The CA gives deficit when the investment amount is greater than the savings amount ($I > S$) and, when the government expenditures are greater than the tax revenues ($G > T$). These are the causes of the CA deficit. The situation when private savings and tax revenues are not sufficient to finance the CA deficit is called the “Twin Deficit”. These are the fundamental reasons of the CA deficit. Tallman and Rosenweig (1991, p. 1) indicate that:

“ The twin deficit story as it pertains to a flexible exchange rate regime claims that an increased government deficit places incipient upward pressure on real, or inflation adjusted, interest rates, attracting foreign capital in search of these higher returns ”.

Rosenweig and Tallman (1993, p. 580) also state that, the incipient upward pressure put on real interest rates induces incipient capital inflows that lift or appreciate the real exchange value of the currency, which erodes competitiveness and, after a time lag results in increased trade deficits. The Mundell-Fleming model assumes that an increased

government deficit policy such as a tax cut raises aggregate demand, which then places an incipient upward pressure on the domestic real interest rate. This interest rate pressure induces an incipient net capital inflow from abroad, appreciating the domestic currency's real foreign exchange value. After a lag, appreciated domestic currency pushes the nation's trade balance towards deficit. According to the model, increased government deficits ultimately widen the trade deficit under fixed and flexible exchange rate regimes. However, this model is not wholly accepted. Another model incorporating Ricardian Equivalence suggests that, a substitution of debt for taxes by the government that increases the fiscal deficit could be offset by increased private savings, rather than increased net foreign borrowing, in other words trade deficit. The Mundell-Fleming approach argues that the fiscal balance affects subsequent trade balances, whereas Ricardian equivalence approach implies that (temporary) government purchases, not government balances, impact the trade balance.



3. CAPITAL ACCOUNT CONVERTIBILITY (KAC):

LOOKING BACK and AHEAD

World trade can only grow with the help of a stable monetary system. International trade is realized with money, which is defined as a medium of exchange, standard and store of value. The development of the international monetary system increased the international trade and investments. World Monetary System creates an interdependent world. Trading countries change their currencies for other national currencies. National currencies determine the exchange rate. It creates ties, link and monetary interdependence between countries. A stable monetary system should meet the **liquidity, adjustment and confidence** functions. That is, the monetary system should provide enough liquidity; it should be able to correct the BOP problems and also help implementation of national economic policies. The monetary system should also be **dependable**. The value of domestic currency and exchange rates should be stable enough for the economy.

It is possible to classify the history of the modern World Monetary System into four periods. The first period is between 1870-1914 and known as the “**International Gold Standard**”. The second period covers the years between World War I and II (1914-1944) and is named the “**Gold-Exchange Standard**”. The third period is between 1944-1971, and is the period, which is defined with various names like the “**Bretton Woods System**”, “**IMF System**”, and “**Fixed but Adjustable Exchange Rate System**”. The last period however, is the international monetary system of our time, defined as “**Floating Exchange Rate System**” (Savaş, 2004, p. 53).

This chapter analyzes the history of KAC in three stages: before Bretton Woods, the Bretton Woods System, and after Bretton Woods.

3.1. Before Bretton Woods

In pre-modern times, the trade between nations was financed with precious metals like gold and silver. The trade happened between those nations that accepted metallic money. Thus, it depended on the willingness of the countries to trade. In time, ‘**great currencies**’, like Solidus, Dinar, Ducato etc. occurred as reserve money. Gold was the most valuable metal. Gold and silver were too precious and risky to be carried around. To

eliminate this risk of carrying money across the borders, later on bank notes (100 % convertible into gold) started to be issued. It was possible to re-deem the bank notes with gold.

The international gold standard system had been developed by the end of the 19th century, when the need for free trade had increased. There was a need for a formalized system for the settlement of international transactions. The international gold standard was introduced in 1870 and lasted until 1914. The countries set a par value for their currency against gold and they tried to maintain it. The official gold price was fixed. There were no controls on current or capital account transactions. The currencies were converted into gold at a fixed price. Supply and demand variations set the price level and the exchange rate between national currencies were determined by their gold content: **USD 20.67/ounce of gold, GBP 4.2474/ounce of gold, USD 4.86656/GBP**. The gold standard automatically limited the rate at which a country could expand, as its money supply would be determined by the growth in gold reserves (Mikkelsen, 2002, p. 2). At the same time, the bank notes issued by the national state were hundred percent convertible into gold. The theory stated that, the exchange rates in international trade would be determined according to the gold content of national currencies. Hence, the value of national currencies increased the importance of the value of exchange rates, which depended on gold. The central banks were able to buy (sell) gold freely. Citizens were also free to import or export gold freely (Savaş, 2004, p. 54).

The most important characteristic of the system was the unrestricted capital mobility with fixed exchange rates. It was a credible system of pegged rates, which is crucial for the success of a rigid currency regime. There was perfect competition, but no government intervention in the system. The prices were flexible, meaning that the inflationary (deflationary) pressures would all reach the equilibrium of the BOP, with inflows (outflows) of capital. Some proponents of the system argue that, the gold standard system has superior characteristics. The system theoretically was **impersonal, fully automatic, and politically symmetrical** (Savaş, 2004, p. 55).

The second period was the interwar period, also named as the “**interregnum between British and American hegemony**”. There was a chaotic situation in the world between the two world wars (1914-1944). Currencies were allowed to fluctuate over fairly wide ranges in terms of gold and each other. Some countries went in and some out of the gold

standard during the period. With the outbreak of World War I, countries suspended currency convertibility and put embargos on exports in order to protect themselves. The gold standard came to an end with these interventions. Hence, the fixed exchange rate system that was a crucial part of the gold standard was replaced with the floating exchange rate system. Some countries adopted the floating exchange rate system. There was a deep instability in international trade and monetary system. The solution was found in “**Genoa Conference**” that was held in 1922, in order to stop this chaotic situation. It was decided that, the gold-exchange standard would be used instead of the gold standard. According to this solution, national reserves would not only be made up of gold, other currencies besides gold would also be used as reserve, and hence, the need for gold would decrease and the available gold stock would be used economically (Savaş, 2004, p. 58). Therefore, international reserves should be enriched with foreign currencies. But, this was a major defect for the world monetary system since the gold stocks could not be increased in proportion to the increase in international trade. Gold was the major payment instrument and it was also used as collateral. There was shortage of gold. The conference stated that, new gold mines should be discovered in order to solve this problem. It was also decided that, countries should economize and save gold. Majority of countries were not able to increase their gold reserves.

A new international monetary system that depended on fixed exchange rates, that was backed up with not only gold, but with foreign currencies convertible to gold was established. Great Britain in 1925, decided to return back to the gold standard. The gold-exchange standard was applicable after Great Britain provided sterling’s convertibility to gold, and allowed gold exports once again. But, the instability in the world monetary system continued. In 1931, a bank crisis sprung from one country to the other in Europe. Britain was forced to convert huge amounts of sterling to gold. Due to this demand, Britain once again suspended convertibility. The international monetary system broke down and hostile blocs had been established. The largest of these was the “**sterling bloc**”. A second bloc after 1931 was informally grouped around the United States (the “**dollar area**”), and a third around France (the “**gold bloc**”) (Savaş, 2004, p. 59).

The ongoing instability in the world monetary system led to rise in the tension between these countries. Countries made competitive devaluations in order to increase their exports, and decrease their BOP deficits. There were speculative flows of capital

across borders. The United States, Great Britain and France agreed to stabilize the exchange rates among themselves in 1936 with “**Tripartite Agreement**”. But, these attempts were ineffective. From 1934 to the end of World War II, exchange rates were theoretically determined by each currency’s value in terms of gold. During World War II most currencies lost their convertibility. The chaotic situation of the world monetary system continued until 1944.

3.2. The Bretton Woods System

Before the World War II ended in 1944, an international conference was held in New Hampshire, Bretton Woods. A new world monetary system was created in **Bretton Woods Conference**. After World War II, the US that was the only supplier of military goods emerged as a superpower with its enormously increased gold reserves. The European countries’ gold reserves were exhausted. According to the resolution adopted by the Conference, the US would adopt the gold standard and fix the dollar price of gold, and agree to buy and sell at this price (one ounce of gold equals 35.- US dollars). All other countries tied the value of their currency to gold through the US dollar indirectly. Exchange rates were allowed to deviate up to 1 % from the target. Only the US was required to back its currency with gold (Mikkelsen, 2002, p. 3). The gold exchange system was adopted in the Bretton Woods System. US dollar was 100 % convertible into gold. The Bretton Woods System period lasted until 1971.

The conference established a US dollar based international monetary system and the **International Monetary Fund (IMF)**, for aiding countries with the BOP and exchange rate problems. The Bretton Woods System also established the **Bank for Reconstruction and Development** or with its popular name, the **World Bank** for post construction and general economic development.

The international monetary system that had been working spontaneously since ages started to be managed and controlled by an international establishment. This meant that, a new era began in terms of world monetary system, and international relations. The system defined as the “**IMF system**”, “**pegged and adjustable exchange rate system**”, and “**gold-exchange system**” was actually not a new and original system. Many countries before and during World War II had used it (Savaş, 2004, p. 63).

In Bretton Woods System the par value of gold was fixed. There were capital controls and macroeconomic autonomy. The goal was to promote international trade. Only US dollar had a direct relation with gold. The system allowed current account convertibility. Under the leadership of US and Britain, the Bretton Woods Conference argued that capital mobility was the reason for economic crises between two wars. It therefore did not allow capital mobility. Thus, capital flows were restricted under the Bretton Woods System. The US and Britain believed that free flows of capital would lead to instability in the world. Hence, they agreed to limit the capital movements throughout the borders. They set up certain codes of behavior in order to stabilize the world monetary system. One of the pillars of the Bretton Woods was that, the speculative flights of capital were to be controlled for stability. The CA was fully convertible, whereas the capital movements were controlled, meaning that the capital convertibility was not allowed. Keynes and US delegate Harry White both supported the control of capital mobility. They argued that the free movements of international capital could disrupt the policy autonomy of new and future welfare states. According to them, the prime cause of unstable exchange rates was the speculative movements of capital (Savaş, 2003a).

The US became the hegemonic power in the world with the establishment of the IMF. The US became the center of the Bretton Woods system. The US was the “Nth” country, where as all other countries were expressed as N-1 (Savaş, 2004, p. 71). Thus, the US dollar’s value was kept constant in terms of gold. Self interest and altruistic behavior led the US to adopt this system. US became the lender of last resort. The system was in favor of the US. Other countries absorbed the excess amount of dollars. The US therefore gave some concessions to Japan, and Europe.

Due to excess demand, the US dollar was in shortage during 1944-1958 (the dollar shortage period). The US was always going to be ready to redeem dollars, according to the rules of “The Articles of Agreement”. The success of the system depended on the US. Exchange rates were fixed. Most currencies were “Current Account Convertible”, for trade only. Monetary stability was established with currency controls and trade restrictions until 1958 (Savaş, 2004, p. 74).

The US BOP deficit increased rapidly after 1958. The period named as the “shortage of dollar” was over. Between 1958-1970, the US increased the supply of dollars without taking the amount of gold reserves into consideration. It used liability financing. This era

was the “dollar glut period”. During the Bretton Woods system, the US had large BOP deficits. It used its seignorage right and dumped dollars on the world market to finance its deficits. It tried to stop capital flight with interest equalization tax, and regulations etc. There was an ongoing speculation about US’ ability to buy (sell) gold at USD 35.- per ounce. The US dollar appreciated, and was overvalued. The US BOP deficit increased, and European countries devalued the value of their currencies in order to increase their exports to US. Triffin in his book “Gold and the dollar crisis” pointed out that, a fundamental contradiction existed between the mechanism of liquidity creation and international confidence in the system. With increasing imports and supply of the US dollar, countries would want to redeem their dollars into gold (Savaş, 2004, p. 75). As the dollars in the hands of the foreigners increased, the credibility of the US dollar’s convertibility decreased.

Under Bretton Woods System, US was required to convert dollars into gold. It feared that, confidence in the dollar would decline, with a decline in its gold reserves. Hence, the system of pegged exchange rates collapsed. The IMF started financing the current account deficits of the countries. The US requested the European countries to revalue their currencies. But, Europe rejected its request (Savaş, 2004, p. 78). On August 15, 1971 President Nixon announced that; “the golden window was closed”. The US rejected its responsibility to change dollars for gold. The currencies started to float and appreciate against the US dollar. In December 1971, the so called G-10 countries US, Germany, Belgium, France, Holland, Great Britain, Sweden, Italy, Japan and Canada agreed on the devaluation of the dollar at USD 38.- per ounce of gold. Others revalued their currencies. The band was set at +/- 4.5 %. The agreement was named as “Smithsonian Agreement” (Savaş, 2004, p. 81). The confidence had been lost by then and this tendency brought down the Bretton Woods System. Jamaica Conference was held in 1976. It eliminated the Bretton Woods System and accepted the floating exchange rate system.

After the collapse of Bretton Woods System, it was proven that the reason behind the crisis that spread out (Great Depression) between two World Wars was not the convertibility of the KA. Experience from Bretton Woods indicated that, even under restricted capital mobility the international monetary system could not be stabilized. The years after Bretton Woods witnessed an increase in financial liberalization attempts

throughout the world. The break-down of the system led the path to the convertibility of the KA. Countries started integrating with each other once again.

3.3. After Bretton Woods

Convertibility was not widespread in Europe until the late 1950s. The KA liberalization began during this period. It was spread throughout the world rapidly in 1970s. It gained momentum between 1986 and 1998. During the 1990s, emerging economies welcomed large flows of FDI and PI to their countries. Liberalization of the KA and FDI are the most crucial phases for developing countries. Hot money became a major instrument for international transactions. With the outbreak of the two OPEC crises in 1970s the current accounts of countries without oil reserves gave large deficits. They began to borrow from Europe and the US. Huge amounts of dollars and Euro dollars emerged in international financial markets. KAC became de facto. Financial liberalization became an ongoing process in many countries during 1970s. After 1973, when fixed exchange rates had been abolished, the KAC was accepted. Major developments in multinational companies (MNC), growth in technology, computers and communication systems has all led to globalization and liberalization of world economies. With liberalization, the hedging of risk in international markets became easy and MNC benefited from this opportunity. Funding, investment and deficit financing of the companies and countries became improved.

The financial liberalization required the partial or full opening up of the capital account, together with permission for FDI, lending and, borrowing. It was thought that, KAC would allow the financial markets to be more efficient. However, this was not always the case. The free movement of capital also brought certain risks that led to crisis in the financial markets. These crises are referred to as the banking and currency crises or the "twin crises". With the introduction of the KAC, the financial markets in developing countries became more vulnerable to shocks and fluctuations. The cycles in the stock market also affected these countries deeply. The emerging economies that accepted KAC were severely punished by the volatility in the financial markets. Countries that made financial liberalizations in post-KAC years also had to deal with contagious effects of crisis in other countries. They had to confront all sorts of problems like inflation, capital

controls, transition costs of KAC, bankruptcy risks in the financial sector, interest rate parity, crisis management, FDI, and last but not least the stability of their currencies. The transition to KAC was a rather hard learning process for them to face. Countries were affected by the sudden flight of capital. The speculative movements of capital, whether inflow or outflow threatened the developing countries more than the developed ones, since their financial systems were more fragile. The developed countries had strengthened their financial systems already. Some countries began to find solutions to these problems. Some used capital controls; some levied a certain tax –Tobin tax- to foreign capital that entered a national economy in huge amounts. Both were not useful, and they were ineffective.

During 1973-1984, the US dollar was still the dominant currency as unit of account for reserves, settlements etc. This led to an asymmetry once again. The dollar was used for intervention. There was monetary autonomy. Floating exchange rate was accepted and, adjustable peg regime was eliminated. Developed countries started to apply voluntary export restraints and consumer safeguards.

The period between 1985-1992 is called the “Plaza-Louvre Era”. The US dollar had nearly appreciated to one sterling. The “Plaza Agreement” was accepted in 1985 and, lasted until 1987. Its aim was an orderly devaluation of the US dollar and, to encourage the development of Japan. The US coordinated monetary policy in the long run. It therefore had an effect on the exchange rate. In 1987, “Louvre Agreement” was accepted in order to stabilize and keep the exchange rates at certain levels and, encourage the development of Japan. Each country was supposed to choose a target zone and, intervene with the currency market to stabilize these rates. Deutsche Mark and Japanese Yen were unofficially selected as target zones. The band was set at a +/- 5 %. These attempts were also not successful. Financial globalization, liberalization of the capital account, and establishment of MNC all led to FDI and, PI. These changes triggered the crises in the banking sectors all throughout the world. Some countries decided to switch from floating exchange rate system to currency boards and, dollarization (Savaş, 2004, p. 85-86).

In 1979, the European Monetary System (EMS) was established. The system fixed the nominal exchange rates to promote international trade. There was destabilizing speculation during the establishment of the system. After the EMS, the European Monetary Unit (EMU) was founded. The introduction of Euro to the world monetary system in 1999 led to a rise in the competition between major currencies. The stability of Euro and the

results of the ongoing competition between Euro and US dollar are yet to be analyzed in the future. This competition will surely affect the international monetary system deeply.

With globalization, the financial markets were also globalized and, there were no restrictions on capital movements. The innovations in the information technology allowed the capital to be transferred from one country to the other within seconds. There is a keen competition between developing countries for obtaining foreign funds. Capital inflows (outflows) may cause extremely important changes in the national economy. These flights lead to an economic crisis in severe cases. The years after 1970s were the years of turmoil. The OPEC crises in 1970s were followed by other crises within the next decade. The Chilean liberalization of the 1970s collapsed during 1982-1983. It was this decade that witnessed the increasing number of financial liberalization attempts and the European Union. Turkey with many other countries started liberalizing its financial sector and, hence introduced the KAC. The “**Tequila Crisis**” of 1994-1995 started in Mexico and, spread to Argentina and Brazil. The “**Asian Crises**” affecting Thailand, The Philippines, Malaysia, Indonesia, and South Korea in 1997, was followed by the crises in Russia in 1998, Brazil in 1999, and in Turkey in 2001.

4. CAPITAL ACCOUNT CONVERTIBILITY (KAC): ANALYTICAL OVERVIEW

The liberalization of the KA opens up the domestic economy to the world. It is a gradual process where restrictions to foreign investors are eliminated in time. KA liberalization is a process accompanied by fiscal and financial reforms. These reforms and strategies should be planned systematically. The most important problem of opening up a KA is the risk of capital flight. The KAC is therefore correlated with some restrictions and controls on the capital to ensure that large flows do not affect economic stability. Policy makers must take short-term inflows and outflows into account. The KAC in poor and developing countries should be analyzed and introduced carefully.

Successful KA liberalization requires that the preconditions and general conditions be fulfilled. The pre-conditions of the KAC require that, the CA balance, foreign exchange reserves and inflation be kept at acceptable levels, with an independent central bank. The establishment of foreign exchange rules and regulations is also a pre-condition of KAC. Some economic reforms and changes in policies should be made for financial liberalization.

Liberalization leads to an increased interaction between domestic economy and returns of the world stock. From then on, economic fundamentals are affected by world returns. Stabilization programs often accompany the KAC. Financial liberalization leads to an increase in privatization attempts in the local economy. It is expected that solvency problems would decline with the KAC.

This chapter analyzes the definition, conditions and importance, stages, pace and sequence of the KAC, the control mechanism, the effects of KAC on FDI, PI, and developing countries, and the economic effects of KAC, arguments against and in favor of the KAC.

4.1. The Definition of KAC

“KA liberalization is the freedom to convert local financial assets into foreign financial assets and vice-versa at market determined rates of exchange. It is associated with changes of ownership on foreign (domestic) financial assets and liabilities and embodies the creation and liquidation of claims on or by the rest of the world. Capital

account convertibility can be and is coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary (fiscal) measures relating to foreign exchange transactions, which are of a prudential nature (Schneider, 2000, p. 6)".

The modern theory of international finance emphasizes the risk in financial markets. In the traditional theory of international trade, KA liberalization was seen as allowing foreigners to hold domestic capital leading to welfare gains, by leading to a higher capital stock and higher GDP growth, as well as GNP growth, as labor gained at the cost of both domestic and foreign capital (Schneider, 2000, p. 9).

The current account convertibility (CAC) is a process that should be applied with reforms accompanying the changes in the KA. Before the CA liberalization and the opening up of the KA, macroeconomic stability, reforms in the financial sector and the labor market and fiscal policies should be carefully programmed. **Moral hazard** and **asymmetric information** affect the financial sector. In some cases, asymmetric information may lead to moral hazard. This may in return lead to instability and increase the risk of a crisis. **Herding** may lead to parallel actions in the market. The reforms of the industrial and financial sector take time. These economic reforms and reform areas are very important for an orderly opening up of the KA. Hence, a program to reform the economy, as well as the financial sector, in order to increase the prudential and preventive controls to raise the capital standards, leads to a successful liberalization of the KA.

The KA liberalization brings with it flexible exchange rate management. Theory states that, fixed exchange rates encourage unhedged short-term borrowing in foreign currency, which at last might lead to a crisis. KAC allows anyone to freely move from local currency into foreign currency and back. It increases competition, leads to a deepened financial sector, and efficient and rational allocation of resources.

4.2. Conditions and Importance of KAC

The preconditions of the KAC are an independent monetary policy, a sound macroeconomic policy and, fiscal consolidation together with flexible exchange rates and,

indirectly led policy tools, a reform in the financial sector and, supervision of prudential and regulatory norms.

The KAC requires that countries apply floating exchange rate regimes or currency boards. Recent crises have proven that there was weak interaction between fixed exchange rate regimes and fragility in other sectors. Pegging the exchange rate means giving up of independent monetary policy. But, countries that have high inflation apply pegged exchange rates. With the increase in the degree of the KAC, the demand for floating exchange rates also increases.

The general conditions of an orderly liberalization of the KA or KAC, cover the preconditions and some other vital conditions to be fulfilled. The general conditions of the KAC (which are explained below) are: fiscal consolidation, inflation rate, financial sector reform, monetary policy, exchange rate policy, CA balance, foreign exchange reserves, preventive and prudential norms, supervision, lowering tariff barriers and diversified export base (Schneider, 2000, p. 22-24).

- ***Fiscal consolidation*** helps stabilize macroeconomic policy and controls, volatile, short-term capital inflows to the country due to high rates of interest and large fiscal deficits.
- ***Inflation rate*** should be kept at a single digit rate. Stabilization could be achieved by low inflation rates that would decrease the interest rate and discourage capital inflows. It is crucial that these rates are realistic; otherwise there would be capital outflows from the country.
- ***Financial sector reform*** should be the main element in the KA liberalization program. Macroeconomic instability and crises may be caused by the financial system failures and inflows (outflows) of capital. Crony capitalism and corruption leave the banking sector in a fragile condition, especially in the developing countries. The main objective of such a reform should be OMO that are led by independent central banks. The OMO and interest rates are the indirect policy tools. The “GAAP” should be put into action. The banks should be analyzed in terms of risk and international prudential standards should be set up.

- **Monetary Policy** should be indirectly controlled by the central banks, by applying OMO. The central banks also manage sterilization operations during appreciation and depreciation of the domestic currency, by also using reserve requirements and taxes.
- **Exchange Rate policy** is also one of the vital elements of the KA liberalization. Highly appreciated domestic currency is not preferable since it decreases competitiveness of the economy.
- **CA balance** deficit indicates a move towards growth and investment in the economy. But, high deficits may lead to a decrease in money supply and thus, may increase the speculations about a decrease in the economic growth rate and a crisis.
- **Foreign exchange reserves** affect the KAC and they also increase the faith in exchange rate policy and other policies.
- **Prudential norms** are crucial for the KAC. Their aim should be solvency, liquidity and stability of the financial system. It is preferable according to country experiences to apply strict prudential restrictions before the KAC.
- **Supervision** refers to a body that follows the developments in the banking and financial sectors. The supervisory body should be both efficient and effective at the same time in order to assure that its regulations are taken into account.
- **Lowering tariff barriers** refers to a reform in the trade system, in order to liberalize the economy. The exports increase with lower tariffs.
- **Diversified export base** refers to a wide range of countries and economies to export products. This allows the country to diversify risk, by giving it the opportunity to choose from a selection of countries. Thus, the country is then able to hedge itself towards sudden flows, shocks and crisis. It also decreases the risk of contagion by diversification. The promotion of FDI is thus an important factor in terms of creating an export-diversified base.

The KAC affects all parts of the national economy deeply. For this reason, liberalization attempts require appropriate monetary and fiscal policies and exchange rate regimes, as well as a supervisory and regulatory body and capital control mechanism in the financial architecture to be set up. The KAC requires sound macroeconomic policies. Tax regulations should be revised and the government should be able to back up and finance

the economy. The financial framework needs to be monitored with fiscal control. The increase in the public debt may lead to **capital flight**. Central banks would not be effective enough to control the economy if the fiscal control is not applied. In the absence of fiscal control, monetary policy is assigned to internal balance, which can only be achieved with the aid of capital controls to insulate the country from international capital movements. The aim of the policy should be to assign fiscal policy to attain internal balance and monetary policy to attain external balance. Sound government finances would help in the achievement of this objective. The assignment of monetary policy to the external objective could be achieved through fiscal control (Schneider, 2000, p. 25).

A stable growth, foreign and domestic savings are other requirements of KA liberalization. The bond and stocks markets should be liberalized after the liberalization of the financial sector. The regulations should be put into action in order to increase transparency and protect the rights of the shareholders. The offshore bank borrowing should be liberalized last. The government should not intervene with the financial sector and management of the KA. This should lead to a decrease in rent seeking and corruption. The interventions should be market based since, investors' confidence decreases with increasing controls. Some tools like a minimum stay requirement could be used in order to decrease the amount of capital flight.

The fiscal policy must be robust. The exchange rates should float freely. The central bank should apply a sound monetary policy and build up its international reserves. Previous lessons from Asian Crises have taught us that, both domestic and international financial architectures should be strengthened in order to avoid future crises in the banking and financial sectors. Experience suggests that crisis protection could not be guaranteed with a closed KA. International initiatives may give sanctions to developing countries in terms of controls. While countries are liberalizing both ways (domestically and internationally) capital controls get harder with increasing domestic liberalization and technological innovations.

4.3. Stages, Pace and Sequence of KAC

The case against moving from the CAC to full convertibility of the KA is based on two premises. First, most of the benefits of capital mobility may be reaped via partial

mobility, principally FDI and PI. Second, full convertibility invariably brings with it, enhanced risk of the “twin crises”, one in the currency market and the other in the banking sector (Panagariya, 1998, p. 1-2).

A need for the establishment of a supervisory body arises with CAC. For effectiveness, there should be no interactions from political authorities. Macroeconomic policy, fiscal consolidation, an independent monetary policy based on indirect tools and flexibility in exchange rate management are important conditions of the KAC.

The payments for exports and imports of goods are made in terms of foreign (domestic) currency. It is crucial that the CA transactions are liberalized up to some extent, before the opening up of the KA. The pace and sequencing of this liberalization and necessary adjustments on the CA are also vital for the KA liberalization. Movement towards CAC requires that inflation, CA balance and foreign exchange reserves are stabilized at optimal levels. The restrictions on the CA in order to avoid the capital loss in the transition period to KAC should also be taken into account. Some countries liberalize both the CA and KA at the same time, while others prefer to liberalize the CA first and then to liberalize the KA later on. A de facto liberalization may be faced in the KA due to the flight of capital caused by the CA liberalization.

The financial sector needs to be restructured before it is opened up or liberalized. The CAC will gradually occur. One of the conditions of an orderly liberalization of the KA is that the CA should be in balance. The CAC is achieved when international transactions are paid by convertible currencies. It is preferable to achieve liberalized CA transactions before the opening up of the KA.

The CAC allows free inflows and outflows for all purposes other than the capital purposes. It allows residents to make and receive trade-related payments (receive foreign currency for export of goods and services and pay for imports, traveling, gifts, medical treatment etc.).

Currency convertibility is the ability to exchange money for gold and other currencies. There is a differentiation between current (convertible) and capital (subject to controls) account transactions. The operational framework for the CA transactions strengthens the effectiveness of management of the KA. Some believe that preconditions to liberalize the KA are unnecessary since conditions can be created along the liberalization

process, while others believe that the liberalization of the KA cannot be successful unless certain preconditions are met.

The liberalization of the CA generally precedes the liberalization of the KA. The success of the CAC depends on the strength and financial consolidation of the banking system. The impact of CAC would be the most on the financial system of the country. CAC greatly affects the banking system. The delayed introduction of full currency convertibility increases the cost of capital.

The CAC provides effective participation in the world economy. Countries are cautious in liberalizing their currency regimes. The interrelation between the world economy and domestic producers are expanded with the CAC. With fixed exchange rates, the foreigners are not encouraged to invest in the country. Local producers would also find it hard to export their products to other countries. There are also some advantages of fixed exchange rates. The CAC brought with itself a new relaxation to the economy, especially in terms of expenditures and investment. In a world of volatile exchange rates, the traditional dictum regarding the global equalization of interest rates failed to take place.

The KAC benefits are correlated with the establishment of an orderly liberalization procedure. The benefits of KA liberalization refer to the maximization of efficiency in the world's use of capital, individual freedom of income and wealth disposition, macroeconomic discipline, and financial market discipline. KA liberalization is a desirable objective in the long run. But, the degree of liberalization should gradually move towards partial to full KA liberalization.

The sequencing and pace of the CAC and the KAC should be carefully managed and monitored. While liberalization is generally beneficial, it also greatly increases a country's vulnerability to reversals in capital flows that can precipitate severe currency and BOP crises (Schneider, 2000, p. 13). Countries that are moving towards KAC should focus on the pre-conditions of liberalization. Macroeconomic policy, risk, exchange rate management, taxation, scale of benefits (benefit-cost comparison), sequencing and pacing are some of the costs of liberalization.

Economists argue about the two types of transition to KAC. The first one is called the "big bang" transition and the second one is called the gradualist transition to KAC. The former refers to a quick transition to KAC, in other words opening up of the KA. The latter

refers to a gradual transition, which is beneficial for developing countries, meaning that the opening up the KA should be achieved step by step.

Schneider (2000, p. 16) indicates that, experience reveals that a gradual approach to KAC is an achievable and largely beneficial policy objective for developing countries to pursue. Hence, full KAC should be gradually achieved and only then, the benefits would outweigh the costs of the KA liberalization.

Some argue that, quick liberalization of the KA is better, since resources are not efficiently allocated with the restrictions on free capital flows. Another view states that, it is crucial to move towards liberalization, by reforming the financial sector and liberalizing the CA first.

Eichengreen (2000, p. 1108) states that, national responses to KAC and capital flows should be to open the KA only after financial markets have been liberalized. He argues that, FDI should be liberalized first, stock and bonds market next and offshore bank borrowing last. Relying on market friendly instruments for managing the KA, aligning domestic institutions and policies to the KA regime, and building reserves are other important aspects of liberalization and control of capital flows. International responses to taming capital flows would either be sanctions or peer pressure.

The pace and sequencing of the CAC and the KAC is very important and therefore, there should be some controls and restrictions on the CA at the beginning and early stages of liberalization, in order to prevent the capital flights from the country.

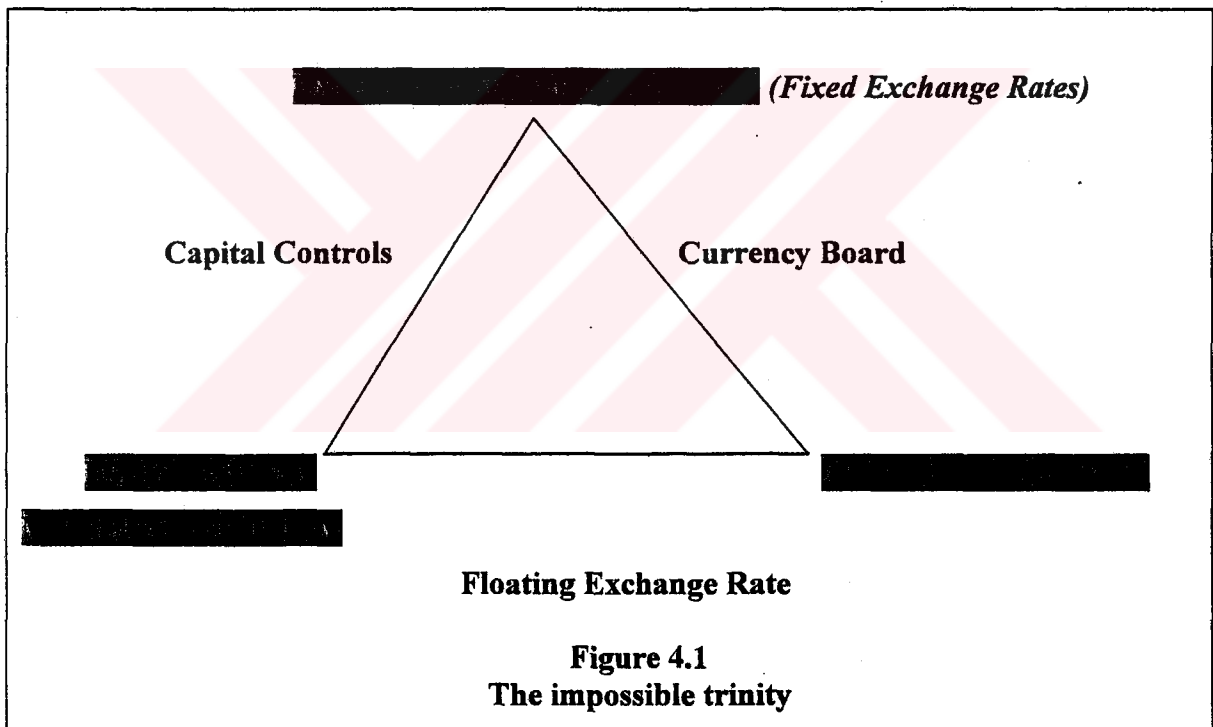
The composition of capital flows, capital controls, corporate balance sheets, transparency, multilateral institutions and the international financial architecture, capital account liberalization and growth are the major issues concerning the KAC. There are steps to be followed in order to reach a successful KA liberalization. Reforms in the banking sector and other institutions (public or private), together with reforms in policies should be planned. Countries that open up their KA without these reforms are vulnerable to crisis. The macroeconomic policy should be re-analyzed. Rodrik (1997, p. 12), indicates that there are at least three components of such a strategy:

- 1) ***Improving the credibility of the state apparatus:*** There is a great need to improve the quality of the judiciary and of the public bureaucracy and to root out corruption.

- 2) *Improving mechanisms of voice*: There is a need to improve the channels through which non-elites (indigenous people, workers, and farmers) can make themselves heard, and to bring them (or their representatives) into the decision-making councils.
- 3) *Improving social safety nets and social insurance*: The provision of social insurance is an important component of market reforms. It avoids the distributional and social consequences of globalization.

4.4. The Effects of KAC

4.4.1. The Trilemma



The KAC leads to the abandonment of currency pegs. Bhattacharya (2004, p. 1) argues that, in the long run foreign borrowing destabilizes currency pegs. Floating exchange rates allow a country to conduct an independent monetary policy and absorb shocks. It is known that, fixed exchange rates, international capital mobility and independent policy cannot all function together. Only two of these goals can coexist simultaneously. This situation is referred to as the “impossible trinity”, “trilemma for open

economies” or “eternal triangle”. This concept states that two of these factors could be used jointly. Figure 4.1 shows that, exchange rate stability is more important for emerging economies. It helps to control inflation in developing countries.

It is argued that the tax on foreign borrowing is high during the introduction of financial liberalization. But, it is low during later stages of liberalization. Large amounts of foreign borrowing by domestic firms may lead to the instability of the currency.

Financial liberalization increases the number of assets available and stimulates the diversification of risks in portfolios. Herding leads to destabilized emerging markets. The KAC increases the risk of currency crisis. Therefore, it is crucial to open up the KA after the liberalization of financial markets. Opening up of the KA, allows investors to exchange their currencies and also increases arbitrage opportunities. The liberalization of the financial system, including the banking sector leads to an increase in the competition between domestic and international banks, thereby also increases the quality of service. The domestic financial sector is upgraded with the introduction of international banks to the system. Thus, the domestic financial system should be strengthened at the beginning of the KAC.

The KAC thus requires that macroeconomic stability be ensured under flexible exchange rates. Macroeconomic objectives of an economy are divided into two groups: External and internal objectives. The internal objectives consist of full employment, price stability, higher rate of growth, and fairly unequal income distribution, whereas the external objectives consist of the CA balance, and exchange rate stability.

The theory of international finance states that, if the domestic interest rate is higher than the foreign interest rate, the domestic currency is expected to depreciate by the amount equal to the difference between these two interest rates. Francis *et al.* (2002, p. 936) argue that;

“ There are several means by which liberalization can affect interest rate parity via the currency channel. First, countries such as Argentina, Colombia, Jordan, Mexico, and Taiwan included the reduction of exchange rate controls and/or freely floating currencies as an important component of financial market liberalization. Others, such as Mexico and Thailand have been forced to abandon fixed exchange rate regimes in the post-liberalization period.”

The adjustment process of the KAC is a long one and it is country specific. Real product growth, real exchange rates, real interest rates are important factors in emerging economies after the capital market liberalization. Real interest rates decrease with an increase in the real money balances. The real interest rates approach the market determined equilibrium values. Thus, financial sectors are deregulated after liberalization. Experience suggests that, emerging markets integrate successfully to others. The other sectors of the domestic economy are affected through the mechanism of adjustment. Interest rates do not have an imperative role before financial liberalization. They affect the exchange rates and are affected by the returns on stocks and real money balances. Real interest rates and foreign exchange rates are influenced by local stock returns. Risk premiums and factors should depend on realistic mechanisms in developing countries. Risk should be diversified internationally. The interest rates should decrease with increasing capital inflows.

4.4.2. On national saving and investment

“The theory suggests that, inflows of capital would complement national savings, and, that financial liberalization would improve the allocation of scarce funds both internationally and inter-temporally. In a world of freely mobile capital, investable funds would flow from high saving to low saving countries (Yeldan, 2003, p. 211)”.

The neoclassical theory states that, the KAC leads to the free movement of capital, from capital abundant countries to capital scarce countries. The developing countries increase their interest rates, and thereby draw foreign capital to their countries, in order to reach the desired growth level. This **inflow of capital** increases the **savings** in developing countries, until the rates of interest decline back to the world interest rate levels. The success of KAC depends on the provision that, the public and money market balance is achieved. The full KAC is not a wise choice to be made, if the necessary reforms are not finalized, and the economy is not in equilibrium. Thus, before moving on with full KAC, the public consumption and **investment expenditures** should be decreased, subsidies should be cut, public enterprises should be privatized, and a tax reform that controls **capital flight** and increases competition and efficiency should be put into force (Kepenek and Yentürk, 2004, p. 215). The opponents of the neoclassical theory state that, the financial markets are prone to crisis, and the above-indicated statements are only right for

efficiently operating markets and under the assumption that the interest rates would be equal throughout the world.

The full KAC leads to a move in the savings from the informal to formal sectors of the economy. Some economists argue that, the increase in the rates of interest and the abolishment of the pressure on the savings increases the number and variety of the financial instruments. This in return leads to an increase in the financial efficiency. The increase in the **savings** level decreases the **cost of capital** and increases the **investments**. Hence, the increase in savings leads to an increase in the **costs of credits**, and risks, encourages the **speculative investments**, but also wards off the **FDI**. Others argue that, the increase in the costs of credits lead to a negative effect on the investments. The increase in the interest rates increases the costs of investment. This effect triggers the inflation. Thus, an **increase in the interest rates** lead to a decrease in investments. The developing countries are generally more crisis-prone due to these negative impacts. The monopolistic situation of the economy and the restricted internal market, together with the increasing interest rates lead to an increase in the prices of the goods that are not subject to trade. The increasing interest rates lead to a decrease in the profit margins of the exporting firms. The increase in the interest rates, just like the appreciation of the exchange rate leads to a decrease in the **amount of competition in the economy**. The full KAC increases the financial deepening of the economy. But, rather than promoting FDI, it promotes PI. The increase in interest rates generally destroys the efficient allocation of the resources, due to rising debt ratios. It also increases the banking sector risks (Kepenek and Yentürk, 2004, p. 213-214).

The high interest rates lead to high earnings from the PI. Hence, high earnings received from the PI do not allow the capital to be transformed into investments. The increasing interest rates lead to short-term investments, in other words PI. In return, the interest rates increase even further. Hence the interest rates, which are the fundamental policy tools for investments could not be used.

A targeted CA deficit with perfect capital mobility implies a cross-section correlation of saving and investment. A decrease in private savings may be controlled by restrictions and controls of capital or by changes in policies. In such cases, national saving and investment could move towards the same way, without changing the CA deficit. With increasing production and investment under perfect capital mobility, a correlation between

saving and investment exists. The decrease in the amount of imports lead to an increase between the saving – investment correlation. High capital mobility is related to low correlation between domestic saving and interest rates. Low capital mobility leads to high correlation between saving and investment.

The investment-saving balance is distorted with the flight of capital from developing countries. The rising BOP and public deficit lead to speculations about a forthcoming devaluation. The economic uncertainty is the primary cause of capital flight. The increasing debts lead to a decrease in the domestic savings. The investment-saving balance is harder to achieve, and the investments are inversely affected. The capital inflows increase the domestic consumption, and the domestic demand. The domestic currency becomes appreciated, and imports increase, thereby negatively affecting the investments in the developing countries (Kepenek and Yentürk, 2004, p. 218).

4.4.3. On exchange rates

One of the most important conditions of the open KA is a flexible exchange rate system. As the degree of the KAC increases, the degree of the flexibility of the exchange rates also gradually increases. A well-developed and deep financial market is required for the successful application of exchange rates bands. The country competitiveness and inflation are important factors to be taken into account in deciding on the exchange rate system to be used.

The KAC backs up flexible and floating exchange rate system, since capital movements are quicker with this system. Some countries prefer to use exchange rate bands to decrease the volatility of exchange rates. The idea behind the opening up of the KA points to risk diversification internationally. The participant or the transactor is able to flee his capital to another country easily and quickly. Capital flight is easier with PI, when compared to the FDI. Speculation, herd psychology and moral hazard affect the participant's behavior. Uncertainty leads to sudden fluctuations in the exchange rates. Flexible exchange rates are prone to high volatility. The risk hedging is vital for participants of the financial sector in this case.

Under the floating exchange rate system, there is no Central Bank intervention in the market. The foreign exchange market is at equilibrium, since the exchange rate adjusts

itself in order to acquire the balance between the demand and supply for foreign exchange. The BOP must be zero, $BOP=0$, without the intervention of the Central Bank. This condition indicates that the Central Bank does not intervene under floating or fully flexible exchange rates. The current and capital accounts are balanced with the continuous adjustments of the exchange rates. The Central Bank, under the fully flexible exchange rates, sets the M_s at will. Under the fully flexible exchange rates, the abolishment of the Central Bank intervention requirement eliminates the link between the BOP and the M_s (Dornbusch and Fischer, 1987, p.205). An **outflow of capital** leads to the **depreciation** of the domestic currency, whereas an **inflow of capital** leads to the **appreciation** of the domestic currency under flexible exchange rates.

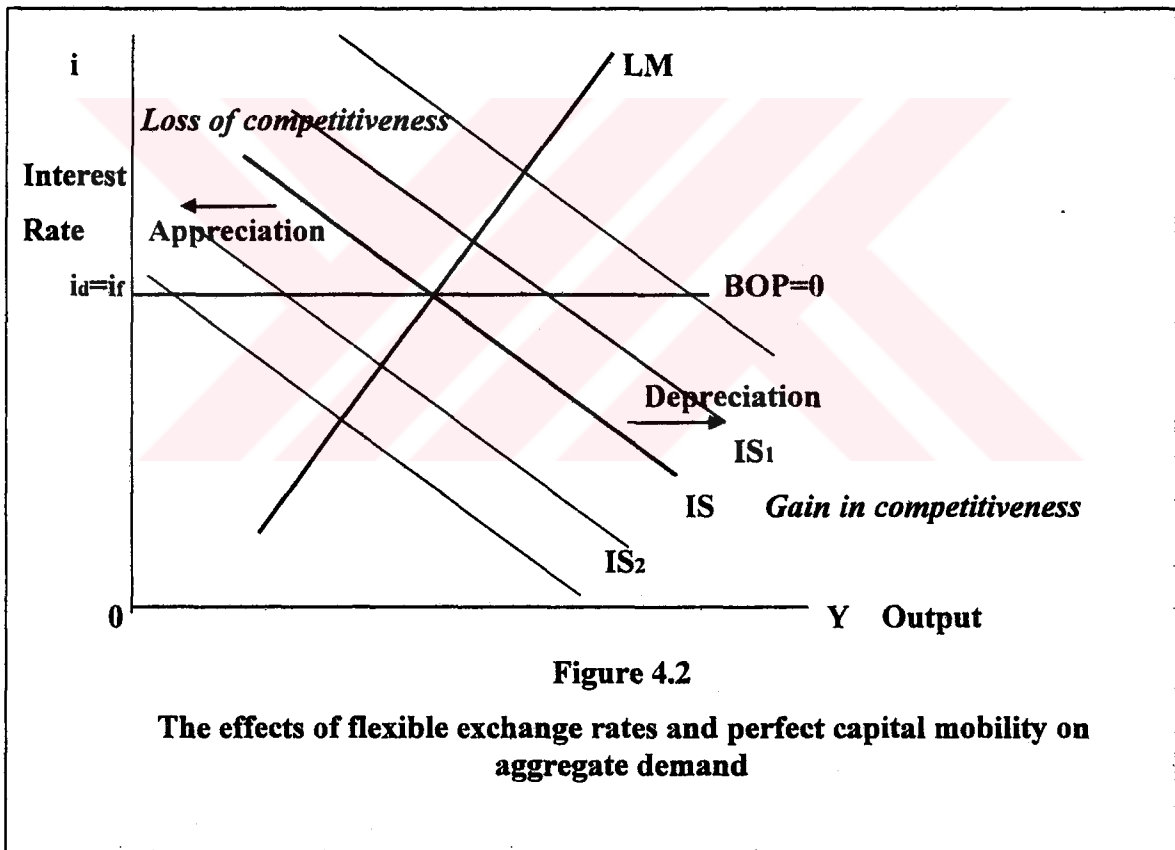


Figure 4.2 shows that, the capital in and outflows highly affect the aggregate demand under flexible exchange rates and perfect capital mobility. A **capital outflow** occurs when the domestic interest rate is lower than the foreign interest rate, $i_d < i_f$. The IS shifts to IS_2 . The outflows of capital lead to the **depreciation of the domestic currency**. Hence, the country becomes **competitive**, and the domestic goods become cheap for foreigners. The

exports increase with an increase in the demand for domestic goods. The IS_2 shifts **rightwards** to IS as a result of decreasing domestic interest rates ($i_d < i_f$), increasing capital outflows, and the depreciation of the domestic currency. In contrast, an increase in the domestic interest rates, $i_d > i_f$ shifts the IS to IS_1 , and leads to an increase in the **capital inflows**. The inflows of capital lead to the **appreciation of the domestic currency**. Hence, the country **loses its competitiveness**, and the domestic goods become expensive for foreigners. The **exports decrease**, and imports increase (foreign goods are cheaper) with a decrease in the demand for domestic goods. The IS_1 then shifts **leftwards** to IS as a result of increasing domestic interest rates ($i_d > i_f$), increasing capital inflows, and the appreciation of the domestic currency.

The implication of the perfect capital mobility suggests that, *ceteris paribus* the BOP is at equilibrium when the domestic and foreign interest rates are equal to each other, $i_d = i_f$. At any point **above the BOP=0**, there is an **appreciation** in the exchange rate, a decrease in competitiveness, and aggregate demand. As an outcome, IS_1 shifts **leftwards** back to IS in order to bring the BOP back to its initial equilibrium. In contrast however, at any point **below the BOP=0**, there is a **depreciation** in the exchange rate, an increase in competitiveness, and aggregate demand. Thus, IS_2 shifts **rightwards** back to IS in order to satisfy the BOP=0 condition.

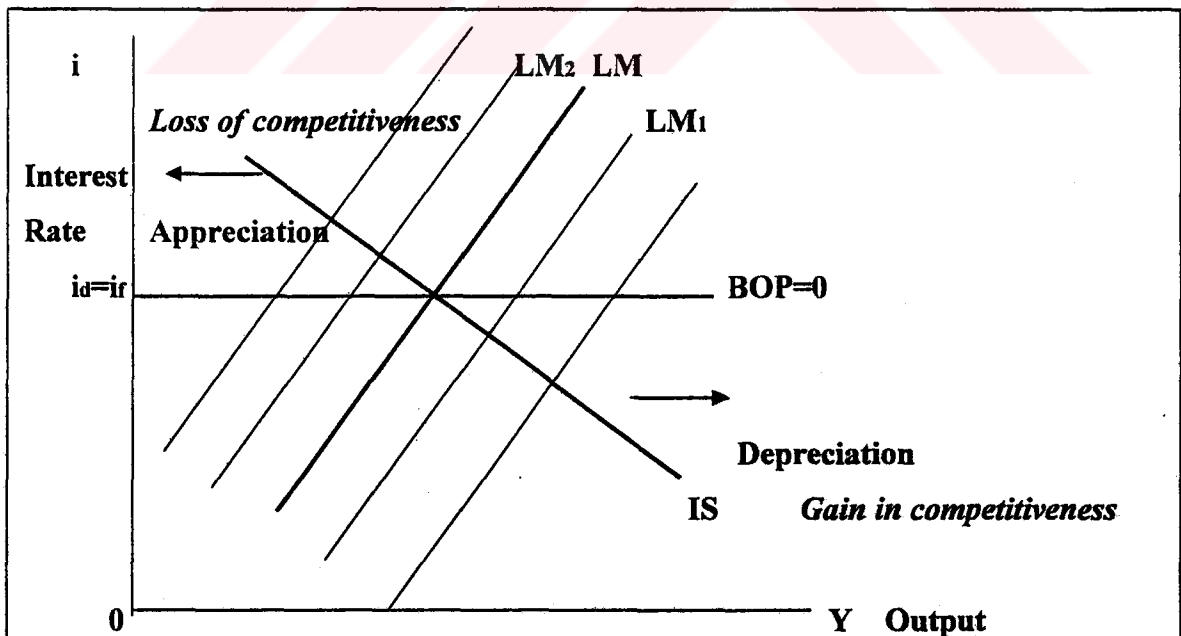


Figure 4.3

The effects of flexible exchange rates and perfect capital mobility on money supply

Figure 4.3 shows that, at any point **above the BOP=0**, there will be an **appreciation** in the domestic currency. Hence, **LM₂** shifts **rightwards** back to **LM** in order to bring the BOP back to its initial equilibrium. Conversely, at any point **below the BOP=0**, there will be a **depreciation** in the domestic currency. As an outcome, **LM₁** shifts **leftwards** back to **LM** in order to satisfy the BOP=0 condition.

Table 4.1				
Summary of consequences of exchange-rate regime and degree of international capital mobility for effectiveness of fiscal and monetary policy on internal balance				
Exchange-rate regime	Capital mobility	Time period	Monetary policy	Fiscal policy
Fixed "	Immobile	-	Ineffective	Less effective
	<i>Mobile</i>	<i>Short run</i>	<i>Ineffective</i>	<i>Effective</i>
		<i>Long run</i>	<i>Less ineffective</i>	<i>Less effective</i>
Flexible "	Immobile	-	Effective	Effective
	<i>Mobile</i>	<i>Short run</i>	<i>Effective</i>	<i>Ineffective</i>
		<i>Long run</i>	<i>Less effective</i>	<i>Less ineffective</i>

Source: Caves and Jones, 1985, *World Trade and Payments*, 4th Edition, Little, Brown and Company, USA, Table 21.1, p. 431.

Table 4.1 summarizes the consequences of exchange-rate regime and degree of international capital mobility for effectiveness of fiscal and monetary policy on internal balance.

Under the **floating exchange rates**, **monetary policy** is highly **effective**, whereas **fiscal policy** is **ineffective** in changing output. Application of an **expansionary monetary policy** leads to **depreciation**, increases exports, and output. In contrast, an **expansionary fiscal policy** causes an **appreciation** and crowds out net exports.

The rapid increase in net foreign assets leads to an increase in the monetary base and inflation. The increase in the foreign currency deposits makes the application of the monetary policy difficult. It is also a sign of the lack of confidence to the domestic currency, also being one of the primary causes of the increase in the interest rates. The

KAC and financial liberalization lead to disequilibria in private banking sector. The banks operate under open positions. Hence, the credit stocks become larger, consumer credits and private consumption increases. It encourages the domestic demand and growth, and discourages the exports (Kepenek and Yentürk, 2004, p. 218).

4.4.4. On prices

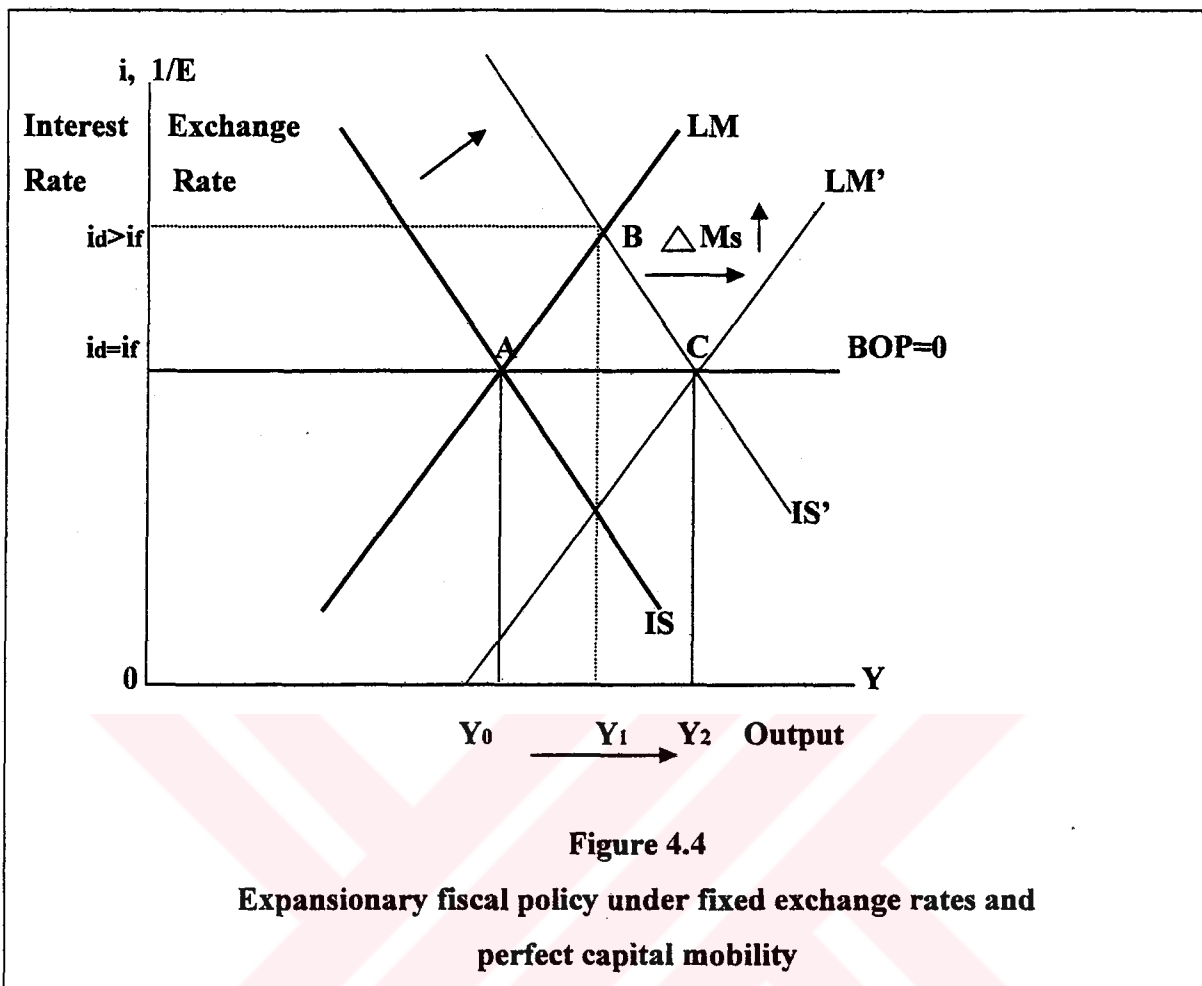
The Central Bank applies sterilization policies in order to protect the economy against huge capital in and outflows. Thus, the prices remain stable with the application of these policies. Otherwise, a sudden outflow of capital may increase the prices if the Central Bank does not intervene. In such a case, the increase in the prices leads to inflationary pressures in the economy. A part of the capital inflows that are not transferred to international reserves helps financing the BOP deficits. The domestic currency appreciates as a result of the capital inflows. Hence, the imports become cheaper for domestic citizens, whereas the exports become expensive for foreigners. The prices of the exported goods increase with the appreciation of the domestic currency. The developing countries are negatively affected by these capital inflows. The appreciation of the domestic currency has an inverse effect on the foreign trade. The developing countries' competitive power decreases as an outcome of the overvalued domestic currency. The technological advances and efficiency could not be rapidly transferred to developing countries, including Turkey. Thus, the competition depending on prices is still effective in these countries. The goods that are not subject to trade (construction, transportation etc.) are positively affected by the appreciation of the domestic currency, whereas the goods that are subject to trade (production, manufacturing, agriculture etc.) are negatively affected. The overvalued domestic currency contradicts with the notion of liberalization and export promotion. In other words, the KAC and the export growth applications reflect opposite results.

4.5. KAC and Economic Policies

4.5.1. On fiscal policy (under fixed exchange rates and perfect capital mobility)

Countries with successful KA liberalization attempts have shown a strong fiscal discipline. The hot money flows into the developing countries increase the public debt ratio, and the earnings of the public sector are forwarded to the payments of the debt interests. The increasing debts lead to an increase in the tendency to become indebted with higher interest rates. The vicious circle is continued with the efforts of finding external debts for the payments of the interests. The public sector balance becomes distorted by these efforts and actions. The increasing interest rates due to the KAC, together with the appreciation of the domestic currency, increase the earnings paid to short-term capital or hot money. The arbitrage opportunities in developing countries allow exchanging the earnings from domestic to foreign currency. They increase the amount of earnings, if an appreciation of the domestic currency is realized before the maturity date. The developing countries' arbitrage rates are higher than the developed ones. The increasing interest rates lead to a further increase in the public deficit. The government is obliged to stabilize the exchange rates under fixed exchange rate system. It therefore uses sterilization policies and OMO to fix the exchange rate at a certain level.

Figure 4.4 shows the effectiveness of the fiscal policy according to the **Mundell-Fleming Model**, under **fixed exchange rates**, and **perfect capital mobility**. The adjustments in the exchange rate bring the current and capital accounts to balance. The perfect capital mobility indicates that, the domestic interest rates are equal to foreign interest rates, $i_d = i_f$, and the BOP is at equilibrium $BOP = 0$. There are massive capital outflows when $i_d < i_f$, and there are massive capital inflows when $i_d > i_f$.



There are no infinite capital flows (in and out) at the equilibrium point A. The government uses fiscal policy to increase the national income. An increase in G , I , G , or NX leads the IS to shift rightwards to IS' , and the output level moves from Y_0 to Y_1 . The money demand (M_d) increases. The new equilibrium point is B. At B, the domestic interest rate exceeds the foreign interest rate $i_d > i_f$. Hence, there is a BOP surplus. The points above $BOP=0$ give **surplus**, whereas the points below $BOP=0$ give **deficit**. The increase in the domestic interest rate leads to an increase in the **inflow of capital**. This increase in the inflow of capital leads to an increase in the **supply of foreign currency**, and also to an increase in the **demand for domestic currency**. Thus, the **domestic currency appreciates**. Under fixed exchange rates, the central bank intervenes and uses **sterilization policies** and **OMO** to bring the economy back to $BOP=0$. It applies **expansionary OMO** and increases the money supply (M_s) to stop the appreciation of the domestic currency. It buys securities (bonds) and pumps domestic currency into the economy. The domestic

interest rate decreases and the LM shifts rightwards to LM'. The increase in the Ms leads to a decrease in the domestic interest rates from $i_d > i_f$, back to $i_d = i_f$, and an increase in the output from Y_1 to Y_2 . The new equilibrium point is C. At C, the domestic and foreign interest rates are equal. Hence, according to the **Mundell-Fleming Model**, under **fixed exchange rates** and **perfect capital mobility**, the **fiscal policy** is highly effective to affect the output.

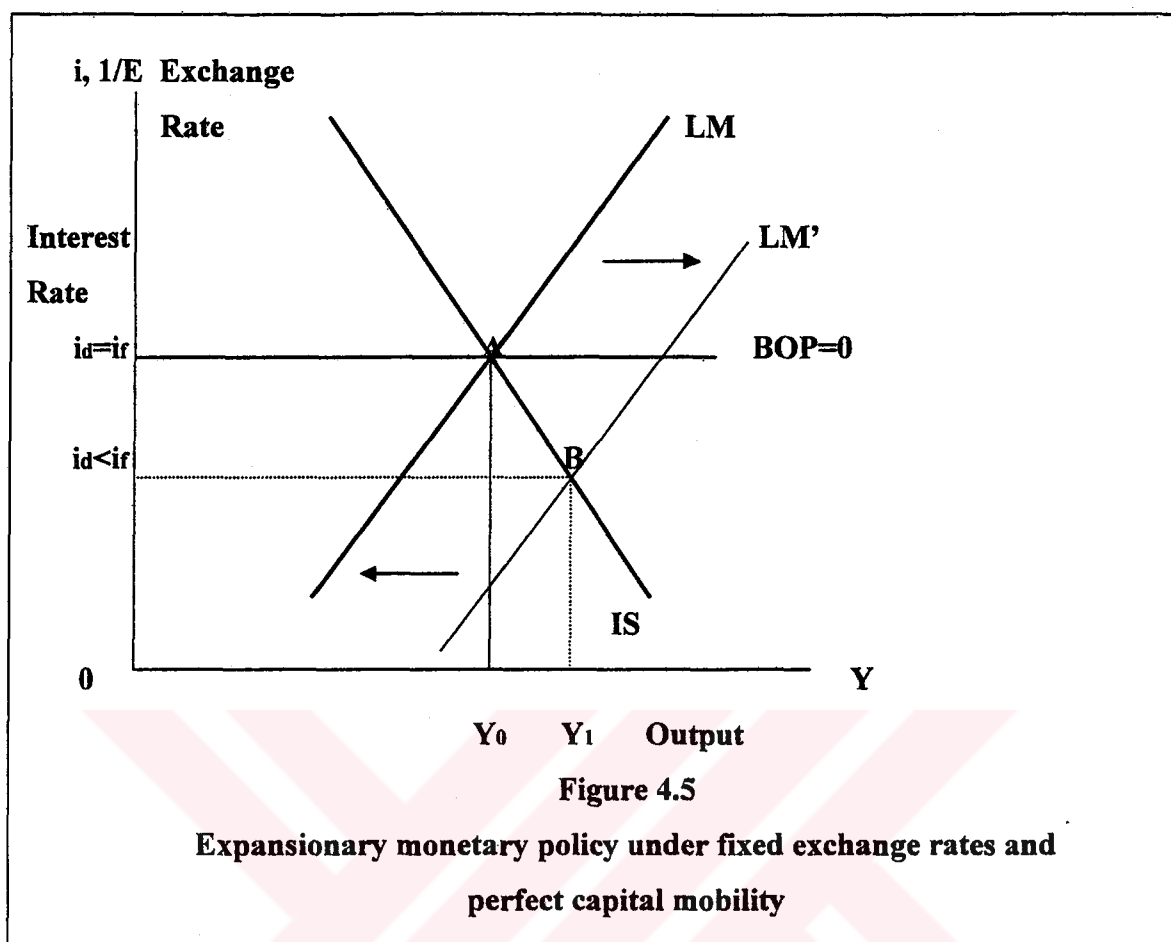
4.5.2. On monetary policy (under fixed exchange rates and perfect capital mobility)

The capital flows are managed through taxes and reserve ratio requirements applied to the banks. These are the indirect policy tools used by the central banks of developing countries. The developed economies generally stick to direct monetary policy tools. Financial liberalization has effects on the management of the monetary policy. Floating exchange rates might leave the country in a vulnerable and risky position, leading to capital flight. Sudden changes in the interest rates lead to large and harmful capital flights. It is vital for central banks to have control over financial policies in order to stabilize the macroeconomic situation of the economy and to prevent capital flights. The central banks use **sterilization policies** and **OMO** during the early and intermediate phases of liberalization attempts. They sell bonds and buy reserves and vice-versa, to arrange the exchange rates and interest rates.

The sterilization process also has costs. It affects the money supply, domestic public debt, interest rates and inflation. Therefore, it is more important to finalize all reforms with success in the long run to establish a safe base for capital movements.

Under **fixed exchange rates** and **perfect capital mobility** the governments cannot pursue an **independent monetary policy**, since the Ms is linked to the BOP. Hence, a **BOP surplus** indicates an **automatic monetary expansion**, whereas a **BOP deficit** indicates a **monetary contraction**. The domestic interest rates are equal to the foreign interest rates. Any movement from the equilibrium interest rates leads to **capital in and outflows**, and the **Central Bank intervention** becomes necessary to bring the economy back to its initial equilibrium point $i_d = i_f$.

Figure 4.5 shows the ineffectiveness of the monetary policy according to the **Mundell-Fleming Model**, under **fixed exchange rates**, and **perfect capital mobility**.



With an increase in the M_s , income also increases, thereby leading to a decrease in the domestic interest rate. The **expansionary monetary policy** shifts the LM rightwards to LM' . The initial equilibrium point A, moves to B, and the output level Y_0 moves to Y_1 . Although at B goods and money markets clear, the domestic interest rate is below the foreign interest rate level, $i_d < i_f$. The decrease in the domestic interest rate leads to an increase in the **outflow of capital**. The outflow of capital increases both the **supply of national currency**, and the **demand for foreign currency**. The BOP then gives **deficit** and, the **domestic currency depreciates**. Under fixed exchange rates and perfect capital mobility, the Central Bank intervenes and applies **contractionary OMO** and decreases the M_s to stop the depreciation of the domestic currency. It **sells securities (bonds)** and withdraws domestic currency from the economy, in order to decrease the M_s . By doing so, it leads to an increase in the domestic interest rates from $i_d < i_f$, back to $i_d = i_f$. The LM' shifts back to its original position LM. The decrease in the M_s leads to a decrease in the output from Y_1 to Y_0 . The new equilibrium point is once again A. At A, the domestic and foreign

interest rates are equal, but the output level does not change. Thus, according to the **Mundell-Fleming Model**, under **fixed exchange rates** and **perfect capital mobility**, the **monetary policy** is **ineffective** to affect the output.

4.6. Arguments Against KAC

The financial instability and the risk of financial crisis are the two major arguments against the KAC.

4.6.1. Arguments about financial instability

Economists in general believe that international capital movements are difficult to control and deal with. The failures in financial supervision and absence of **stabilized** financial and industrial structures may lead to major problems with capital inflows and outflows to and from a country. Capital movements should be monitored and controlled until the reforms are made in the financial and industrial sectors. The financial market operations should be supervised carefully before moving to full KA liberalization. Otherwise, the developing countries' economies would be vulnerable to crises. Capital flows should be controlled by exchange rates, macroeconomic policies, and a banking system that discourages moral hazard and corruption. Thus, KAC may lead to problems in achieving the **macroeconomic stability**.

During the establishment of the Bretton Woods, Keynes argued that:

“Freedom of capital movements is an essential part of the old laissez-faire system and assumes that it is right and desirable to have an equalization of interest rates in all parts of the world... In my view, the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this ”
(Savaş, 2003a).

Opponents of the KAC argue that, the short-term in and outflows of capital have high degree of capital mobility. They generally enter and leave the market quickly. The KAC can increase the financial markets' vulnerability to **instability**. It leads to an increase in the vulnerability to destabilizing, **inflationary capital flows** in emerging economies. Short-term inflows of capital lead to problems in the management of policies and **instability**. These flows need to be controlled, especially in developing countries.

"Animal Spirits" view proponents argue that liberalization does not result in a more efficient allocation of capital, because international capital flows have little or no connection to real economic activity. Specifically, KA liberalization has no effect on investment, output, or any other real variable with nontrivial welfare implications (Chari and Henry, 2002, p. 1). This view is generally supported for speculative purposes and relates to portfolio investments.

Rodrik (1998, p. 3) argues that, enshrining the KAC in the IMF's Articles of Agreement is an idea whose time has not yet come, since there is no panacea in reality. We have no evidence that it will solve any of our problems, and some reason to think that it may make them worse.

Another argument is whether and how the IMF should promote the KA liberalization. Some claim that, financial liberalization would be totally beneficial for all, when the **law of one price** could be applied throughout the world. They argue that only then, the degree of capital flight caused by speculation would decrease. But, the **price stability**, which is one of the major macroeconomic objectives of an economy, is hard to achieve. Risk of capital flows (in and out) is another cost to be paid with liberalization. The costs of liberalization outweigh the benefits for developing countries. Hence, **financial instability** and liberalization are correlated to each other in these countries. Opponents of KAC argue that, with increases in FDI in developing countries, the markets become increasingly volatile. Conditions like overvalued exchange rates, the risk of devaluation, high and fluctuating rates of inflation, **political instability**, poor domestic investment prospects and opportunities, low real rates of interest, and laundering of corrupt money lead to **capital flights** from the country and hence, **economic crises**.

4.6.2. Arguments about the financial crisis

Some arguments state that, the ongoing crises in the financial sector increase the cost of the KAC. There is a view that indicates that, these crises could be avoided up to some extent, by moving to flexible exchange rates. According to some economists, the capital mobility is not compatible with fixed exchange rates. The liberalization of financial sector is a complex case. **Currency and banking crises** are risked, when a strong financial and banking sector could not be set with urgent reforms, before moving to the opening up of the KA. With the exchange rate mechanism (ERM) crises in 1992-92 European currencies came under attack. UK and Italy withdrew from the ERM. Spain, Portugal and Ireland devaluated their currencies. Sweden and Finland switched to floating exchange rates. The **Tequila Crisis** and **Asian Crises** also led to a switch from pegged to floating exchange rates. Other countries like Mexico, Peru, Chile, South Africa, and Turkey struggled with exchange rate pressures during 1997 and 1998. Countries like Turkey, Russia, Brazil, South Korea, Taiwan, Thailand, Malaysia, Italy, Spain, Vietnam, Indonesia, the Philippines, Mexico, Finland, Norway, Portugal, Sweden, the Czech Republic, and United Kingdom abandoned the currency pegs since 1992. Argentina abandoned its currency board. In 1997, there were severe devaluations in Southeast Asia. China and India still apply capital controls. Asian Crises showed that currency crisis could affect all countries, even if their BOP deficits are low. Countries become vulnerable to crises. Speculative attacks and contagion effect heighten the risk of crisis in all economies. Currencies become unstable due to the increase in debt. Under currency pegs, the central bank defends the domestic currency against attacks. Export oriented countries abandoned their pegs one by one after Asian Crises (Savaş, 2003b).

Opponents of the KAC argue that, emerging economies become prone to currency and banking crises after financial liberalization. The new pattern of growth leads to an **instability in currency and banking systems** of developing countries. Increasing capital inflows may lead to an increase in the probability of **currency crises**, with the appreciation of domestic currency. This appreciation may lead to devaluation when the expectations of investors are not met. The devaluation leads to a difficulty in payment of loans and also an increase in the probability of **banking crises**. The KAC leads to an increase in the financial competition. The **degree of openness** determines the probability of crises. There is a

parallel movement between openness and risk of crises. Some argue that full KAC leads to failures in the financial system, and increases the crisis risk of developing countries. The lack of information in developing countries creates problems. The regulatory bodies are not structured well in these countries. Hence, robust policies and regulations should be applied in developing countries before switching to full KAC. The regulations in the system should be carried on. The necessary institutions should be set up at the beginning stage of KAC. Thus, the convertibility of the KA should be gradually done, since the system becomes fragile without effective bodies and institutions, transparency in the financial sector, inefficient supervisory institutions and lacking order. The **Tequila Crisis** of 1994 was caused by the **instability** in the economy and by **inefficient reforms**. The Tequila Crisis spread from Mexico to Brazil and Argentina. There were large outflows of capital, with declining debt and rising interest rates. Mexico's economy collapsed. Argentina tried to control its currency board. The increase in outflows of capital, led to a decrease in money supply and income, Brazil and Argentina escaped a catastrophe in 1995. The cause of the **Asian Crises** was channeled to the banking sector problems. Some opponents think that liberalization leads to **financial crises**, since from 1980 on, there was an increase in the liberalization process of developing markets.

Opponents of KAC argue that, liberalization is the major cause of crisis in the financial sector. Stock markets in emerging economies are segmented. With the introduction of the KAC they are transformed into **integrated world markets**. Hence, they are affected by **sudden flows of capital**.

Komulainen and Lukkarila (2003, p. 250) indicate that, currency crises occur with a decrease in FDI, output growth, and foreign interest rate and increase in domestic credit levels. The KA liberalization refers to external liberalization, whereas domestic interest rate deregulation refers to internal liberalization. Komulainen and Lukkarila (2003, p. 254) argue that;

“The probability of **currency crises** increases along with public debt, private sector liabilities, CA deficits, the ratio of M2 to reserves, foreign liabilities of banks, inflation, unemployment and overvaluation of the real exchange rate. In addition, currency crises seem to be highly related to banking crises, which supports the twin crisis argument.”

They indicate that, external liberalization leads to a decrease in the possibility of currency crisis. There would be inflow of capital with higher domestic interest rates, which then lead to an increase in the **possibility of crisis avoidance**. Hence, export growth leads to an increase in the **possibility of crisis**. Low FDI and high public debt also may lead to a crisis. An increase in the liability of the private sector leads to an increase in the probability of **twin crises**. Banking crisis generally leads to a currency crisis afterwards. Currency crisis occur less under an intermediate exchange rate regime before liberalization. In contrast, after liberalization just the opposite happens. Floating exchange rates are better than crawling peg or band in this case. Currency crisis seem to occur 2 years after the liberalization of domestic markets and 4.5 years after the liberalization of capital flows.

The unexpected changes in the global economy, irresponsible behavior of the lenders and borrowers (debtors), and the dependence of the third world countries on advanced capitalist states are the major reasons for **international debt crisis**. The amount of total debt, debt/capital+reserves ratio, debt/X ratio, debt/GDP ratio, debt/GNP ratio, government budget ($G - T$), and CA deficit or surplus together with public confidence and the distribution of foreign borrowing and the currency between consumption and investment expenditures are important indicators of an economic crisis which should be carefully analyzed. Emerging economies become prone to crises with extensive borrowing of domestic banks or enterprises. **Private sector foreign borrowing** leads to an increase in the **vulnerability to crises**. Turkey, Argentina, and Brazil faced high indebtedness after liberalization. Deregulation leads to an increase in PI, and also an increase in private and public sector indebtedness. Currency depreciation also leads to an increase in the probability of banking crisis. High public indebtedness and private sector liabilities lead to problems in the banking system.

4.7. Arguments In Favor of KAC

The economic gains and financial efficiency are the two main arguments in favor of the KAC.

4.7.1. Arguments about the economic gains

The benefits of KAC are: increases in capital inflows, rational allocation of capital, increase in efficiency and improvements in governance. Liberalization affects long-term capital flow and, FDI. The increasing amount of competition, increases the amount of **gains and benefits** to be received from financial and international capital markets.

Weller (1999, p.68) argues that full KAC leads to an increase in the **economic gains**. The liberalization of the KA attracts **new capital**, with an increase in interest rates. Rational expectations of growth in the economy lead to an increase in the investment and, therefore the **inflows of capital** would increase. With rising capital inflows there would be an appreciation in domestic currency leading to even more future inflows.

Proponents of KAC argue that, increases in the number of foreign investors lead to a decrease in the volatility of prices. Volatility of markets and prices should be carefully analyzed in order to decrease the **cost of capital and increase FDI**. The **volatility** decreases with increasing FDI. The amount and volatility of **capital mobility** should not have negative effects on the domestic financial sector. It is vital that, the amount of FDI in emerging economies is **stabilized**, since **gains from FDI** are greater than **gains from PI**.

Edison and Warnock (2003, p. 81) argue that, the more complete the KAC is, the greater are the subsequent exchange rate appreciation and capital inflows. As the degree of KA liberalization increases, the **capital inflows** also increase, the **cost of capital** decreases and exchange rate appreciates.

The “Allocative Efficiency” view states that removing restrictions on international capital movements permits financial resources to flow from capital-abundant countries, where **expected returns** are low, to capital-scarce countries, where expected returns are high. The flow of resources into the capital-scarce countries reduces their cost of capital, increases investment, and raises output (Chari and Henry, 2002, p. 1).

Gruben and McLeod (2002, p. 221) state that, there is a strong link between the KA **openness and lower inflation**. As the degree of openness increases, the inflation decreases. The KAC increases the interest rate elasticity of **money demand** and decreases the **seigniorage – maximizing rate of inflation**.

Proponents of KAC argue that **rates of return and growth** of the emerging economies are the **two important outcomes** of liberalization. Domestic economy becomes

integrated to the world markets with liberalization. **International mobility of capital** is important for rational allocation of global resources. Capital mobility leads to a **reduction in risk** and also leads to the **smoothing of consumption**. It stimulates growth and investment. International economy is positively affected by specialization in the production of financial services. Hence, **efficiency** increases. If global financial markets could price the risks and returns correctly, global **saving** could then be allocated to the most **productive investments**. Thus, external financial liberalization increases the **welfare gains** (Isaksson, 2001, p. 310).

4.7.2. Arguments about financial efficiency

Some state that liberalization increases **efficiency**. The investors are thought to have rational expectations about the financial liberalization process. An open market in some cases may be restricting FDI for a certain period of time. Liberalization is generally planned in advance and therefore, announcement of KAC is made before the actual date of opening. Assuming that there are rational investors in the market, the structure of the market immediately changes. Hence, markets become **efficient** before the opening date with such transformation.

Citrin and Fischer (2000, p. 1137) indicate that;

“ There are **two main arguments** in favor of KA liberalization. First, at the simplest analytical level, the case for KA liberalization is, with a relabeling of the axes, the same as that for free trade. At this simple level, **a country that opens its KA gains access to a potential pool of saving to finance investment opportunities**. Similarly, taking risk into account, KA liberalization makes possible the more **efficient international sharing of risks**. Further, **capital controls** are in practice generally a protective device for the domestic financial services industry, which tend to reduce its **efficiency**. Second, KA liberalization, along with deregulation of domestic financial markets, is an **inevitable step on the path of development** - all the industrialized countries by now have open KAs.”

Some argue that, the KAC transforms segmented emerging markets into internationally integrated world markets. **Full KAC** leads to a severe **decline in the cost of capital**, whereas **partial KAC** with controls lead to an **increase in the cost of capital**.

Other proponents indicate that, the KAC is not a choice to be made, since globalization has already taken its toll throughout the world. Thus, closed economies at some point in time will open their economies in order to interact with the world. Hence, the KAC is generally beneficial and brings **transparency** and **efficiency** to the economic system, decreases the risk of crony capitalism and corruption. According to them, KAC allows participants of the markets' to diversify risk internationally. Countries should decide on the degree of KAC for their economies.

4.8. The Control Mechanism

The economists regard KA liberalization as an integral part or component of the whole liberalization process in developing countries. They claim that countries and nations should accept it, since developed countries have liberalized capital accounts. It is thought to be irreversible and inevitable like globalization. Experience has proven that countries should approach globalization and full KAC with caution. Some controls and restrictions should be applied during this process. These controls have high costs. Capital controls affect efficient allocation of resources (meaning capital in this case). They lead to failures in macroeconomic policies. The risks in portfolios cannot be diversified with capital controls. Economic growth does not have a correlation with capital controls in the long run. Countries that are fastly developing are prone to removing capital controls with the growth in their economy.

Some proponents of KAC argue that, short-term capital movements that depend on speculation should be controlled and only then, capital movements between countries would be beneficial for developing countries. Arguments in general state that, capital controls should be lifted with caution and in time. Those who are in favor of KAC believe that it has positive effects on the economy as long as the pre-conditions are fulfilled.

The capital account controls are against the notion of the full KAC. Some countries apply a small tax for such transactions. Namely, the **Tobin tax** is used for transactions of capital flows. Tobin tax is a simple, uniform (internationally agreed) *ad-valorem* tax that is

applied to discipline the short-term flows of capital that affect long-term investments and trade. It is used on spot conversions of one currency into another, and prevents the interest rate arbitrage in the short-term. Exchange controls, transaction taxes or compulsory deposit requirements (other than the Tobin tax) are other methods used to increase the costs. The US levied the **interest equalization tax** to prevent its residents from investing in foreign bonds, during the Bretton Woods System. The **voluntary restraints** on banking and corporate transfers of funds abroad followed the interest equalization tax afterwards. Other capital controls, like the taxes on international interest earnings levied in the past are significantly different from the **Tobin tax**, in the sense that, the Tobin tax is much more market-friendly. Although, it is not considered as a disincentive to large-scale speculation against a currency, it reduces interest arbitrage and the attractiveness of small exchange rates, and increases revenue (Raffer, 1998).

The capital controls force investors to hold domestic assets. Hence, they have a positive impact on the tax base. The controls have a direct effect on the tax revenue collected from the international transactions.

The **capital controls** prevent the capital flows in the private sector. They can be divided into two groups: **Direct (administrative)** controls, and **indirect (market-based)** controls. **Administrative controls** restrict transactions of the KA, through **restrictions on the repatriation requirements, the CA, the KA, and use of funds**. **Market-based controls** affect capital flows by increasing the cost of capital, in other words capital flows. **Multiple exchange rate systems, cross-border capital flow taxation, and other indirect regulatory controls** are included in the market-based controls. Capital movements are indirectly affected by these controls, which increase the costs associated with the capital flows. Capital controls help stabilize the economy by decreasing the risk of financial crisis. Asideu and Lien (2003) argue that, there are three types of **capital control policies** on FDI:

- The existence of multiple exchange rates for KA transactions (**market-based controls**),
- Restrictions or controls on the KA transactions (**direct controls**),
- Restrictions on the repatriation of export proceeds (**direct controls**).

The national currency, international trade, capital movements, industrial sector, output and credit are affected with the crisis in the financial sector. The emerging economies become more fragile with the introduction of the KAC. The decline in international reserves and the depreciation of domestic currency lead to a crisis in the BOP. In such cases the interest rates increase in order to decrease the probability of a rather quick devaluation of the domestic currency. The banking crises occur when the bad loan ratio increases in the balance sheet of commercial banks. Hence, the mobility of capital should be regulated in order to avoid financial crises.

The controls of short-term inflows were successful in Malaysia and Thailand. Whereas Chile and Colombia were effective in controlling the composition of capital flows. These controls reduce inflows and decrease the constraint on the exchange rates to appreciate. But, with the growing information technology and innovations it became hard to control capital flows. Malaysia with its strict controls was successful in eliminating speculative attacks. But, the FDI in Malaysia was adversely affected by controls. There is an inverse relation between FDI and capital controls. FDI is attracted by the openness of a country, and is measured by the trade/GDP ratio. An increase in the amount of controls lead to a decrease in the FDI.

4.9. Some Experiences of Developing Countries

It is a known fact that, there are both costs and benefits of liberalization. Some countries benefited from it, while others did not. Some countries became integrated with the world markets, whereas others did not. Hence, there seems to be two different outcomes of liberalization that depend on specific cases regarding different countries.

The developing countries face volatile international capital flows. The international financial system has a contagion effect of spreading the crisis in one country to another. Thus, countries should aim to build sound financial systems. The financial system's architecture should depend on a strong infrastructure. Transparency in the financial sector is also crucial for the establishment of an orderly regulated system. The exchange rate regime should also be created according to the country's economic situation.

The income levels of developing countries are less than the income levels of industrialized countries. They have higher inflation, interest rates and unstable exchange

rates when compared with developed countries. The liberalization attempts of emerging countries have positive effects on investors' view about country's growth, and have negative effects on their view of crisis probability.

The last two decades have been a scene for financial instability, especially in emerging markets. Latin America and Asia were two examples of financial instability. Brazil in 1998 faced currency instability as a result of a poorly conducted fiscal policy. Malaysia fixed its currency after the Asian Crises. Korea, Indonesia, Taiwan and Thailand eliminated restrictions during the Asian Crisis of 1997-1998 gradually. Argentina, Mexico, Brazil and Peru also opened their KAs during 1990s. Developing countries have badly structured financial markets, whereas developed countries' financial markets are strong institutionally. Hence, developing countries need to protect themselves from sudden flows of capital, shocks and volatility. They should follow a step-by-step or a gradual liberalization of the KA, rather than setting of for full KAC at the beginning. They should use controls for international capital movements of portfolio, by either applying a certain tax (like the Tobin-tax) to capital flight or directly controlling capital flows. Many countries levied the Tobin tax to control the flows of short-term capital. Raffer (1998) states that;

“ While Mexico liberalized its KA and dismantled most of its previous controls on capital movements, countries such as Brazil, Chile and Columbia have attempted to discourage short-term capital inflows by taxes of various kinds on foreign borrowing and portfolio foreign investment.”

Malaysia preferred to apply a certain tax to the outflows of capital, instead of applying capital controls. The FDI was not affected negatively in the long run, since the tax rates were kept at low levels. The KAC leads to a decrease in returns and volatility. In Malaysian and Chilean cases, the returns were not volatile even after financial liberalization. Malaysia, rather than using outflow controls put a tax to all the capital that exited the country. Taxes are more market friendly instruments when compared with administrative controls. Turkey faced high volatility in the post-liberalization period. Some claim that, Turkey has benefited substantially from liberalization.

Table 4.2
Liberalization of financial markets in emerging economies

<u>Country</u>	<u>Opening date</u>	<u>Degree of openness</u>
Korea	January 1992	10% of capital of listed companies, 25% after July 1992
Malaysia	December 1988	30% for banks and institutions, 100% for remaining stocks
Philippines	October 1989	investable up to 40%
Taiwan	January 1991	investable up to 10%
Thailand	December 1988	investable up to 49%
Turkey	August 1989	fully open
Argentina	October 1991	fully open
Brazil	May 1991	100% of non-voting preferred stock, 49% of voting common stock
Chile	December 1988	25% of shares of listed companies
Mexico	May 1989	30% of banks, 100% for other stocks

Source: Huang, B., and Yang, C., 2000, "The impact of financial liberalization on stock price volatility in emerging markets", *Journal of Comparative Economics*, Table 1, p. 325.

Table 4.2, shows that Malaysia, Thailand, and Chile opened up their financial markets by the beginning of 1989. South Korea liberalized its financial sector in 1992. The degree of KAC differs from one country to the other. FDI is fully allowed in Turkey, Argentina, whereas Taiwan only allows 10% of FDI. Huang and Yang (2000, p. 323) state that;

"PI exceeded FDI after liberalization in all markets except Chile and Malaysia. Furthermore, PI decreased around the period of the Asian financial crisis. The pummeling of the Thai bath on July 2, 1997 started a domino effect in both stock and exchange markets in these countries, and the financial avalanche continued until

March 8, 1998. General sentiment in Asia links capital flight to the Asian economic crisis.”

The high growth rates and increasing income of the host country draws FDI to that country. The prudential and regulatory policies depending on strengthened infrastructure also promote FDI. FDI is negatively affected by exchange rate volatility and inflation. One other major subject to be checked is the country risk. The higher the risk in a country, the lower the amount of FDI it draws.

Liberalization of FDI should be achieved at the beginning, since the flight of PI is much easier than the flight of FDI. Majority of the capital flows are PI. Hence, inward FDI must be allowed. Some countries liberalize other factors. One example is Korea, which restricted inward FDI. Countries should not open up their KAs before the financial system is strengthened. Otherwise, there would be large amounts of PI inflows, which would then disturb the FDIs in that country.

Developing countries controlled their exchange rates until the beginning of 1980. They limited capital movements. There was a slow movement of capital. They pegged their exchange rates, and devalued their currencies from time to time. International transactions were restricted. This led to a decrease in efficiency and increase in crony capitalism and corruption. “Adjustable peg” system did not function smoothly. However, the era between 1980 and 2000 witnessed an increase in capital mobility with reductions in capital controls and new innovations. Adjustable peg system became fragile with speculative attacks. Globalization led to a necessity of free capital mobility and independent monetary policy. Hence, floating exchange rates were used instead of fixed exchange rates after liberalization.

Many countries whether developed or not are moving towards full KA liberalization. The benefits and costs of KA liberalization should be analyzed before moving ahead. The developing countries face the risk of financial and banking crises. Hence, countries should follow a carefully planned reform in their financial system. Transition economies should develop their institutions carefully, and sequence the regulations and policies, which will be applied. If not the KAC benefits might not be seen due to financial crises. Developing countries should strengthen their financial sectors, remove guarantees, apply prudential and regulatory policies, and reconstruct the banking system before moving on with the KAC.

5. CAPITAL ACCOUNT CONVERTIBILITY IN TURKEY: THE TURKISH CASE

5.1. The Development of Financial Liberalization (KAC) in Turkey

The 1980s witnessed a radical and major change in the world. Globalization affected all the countries in the world during that decade and it also led the economies to open up their trade and KA, by decreasing the level of protectionism and barriers to trade between countries. Developed and developing countries quickly were included in the process and the effect of globalization was a rather contagious one. It was during that period that, this infectious effect spread to the Turkish political and economic arena. The newly launched strategy brought a new perspective to the economy, but whether the outcomes were effective and efficient are other questions to be answered. The countries were inclined to open up their economies by sudden liberalizations. Most of the time, developing countries were the ones that were more fragile, than the developed ones.

The development programs executed since 1960s were not able to prevent the economic crises during 1970s. The economic situation of Turkey depended heavily on domestic and foreign economic progress. The political and economic decisions of foreign countries affected Turkey immensely. The economic depression decade of 1970s made the government follow some stability measures together with the continuation of the import strategy.

The development programs were aiming to achieve the so-called “planned growth” during the 1960s and 1970s. The two OPEC crises in 1973 and 1979 worsened the economic situation even more. The development programs were introduced to the economy in 1963. The first development program was put into action during 1963-1967, the second during 1968-1972, the third during 1973-1977, the fourth during 1979-1983, the fifth during 1985-1989, the sixth during 1990-1994, the seventh during 1996-2000, and the latest program which is the eighth is being executed for the 2001-2005 period.

This chapter analyzes the development, reforms and effects of financial liberalization (KAC) in Turkey. The KA legislations and reforms, Capital Markets Law and Board, exchange rate regime, interest rate deregulation and banking sector reforms, regulatory and legislative reforms after the KAC are examined. The effects are analyzed under the

headings of BOP and the allocation of the KA, FDI, PI, domestic saving and investment, foreign exchange rates and the factor influencing economic stability.

5.1.1. The planning (or ISS) period

The history of financial liberalization in Turkey witnessed foreign debt payment difficulties during 1970s under the ISS. The level of exports was low, whereas the level of imports was high. The policies led for economic growth were generally unsuccessful till the beginning of 1980s. The development and disinflation programs aimed to protect the domestic industry. The exchange rate was overvalued and the exports were subject to restrictions. Production and investment goods and raw materials were imported during the ISS. The BOP deficit increased due to the rising CA deficit, and decreasing foreign exchange reserves.

The first three development programs were tailored to back up the ISS. Unfortunately, these three programs were unable to solve the problems of the economy and were also inefficient in finding a way out of the deep recession during 1970s. The unemployment and inflation levels in developed countries also affected the Turkish economy negatively. The problems concerning Cyprus and the above mentioned OPEC crises multiplied the negative effects on the economy. The government intended to increase the domestic production, instead of importing raw materials in the second half of 1970s. The result was another disappointment in terms of the ISS. The labor market was also distorted by the beginning of 1980 and the income inequality had risen. The gap between high and low levels of income had become wider.

Before 1980, the foreign exchange transactions, in other words **capital flows** were restricted. Turkish residents were not allowed to carry foreign exchange. According to **Decree No: 17**, which restricted and controlled the capital flows, the CBRT allocated the foreign exchange and made the payments of invisible transactions. The foreign exchange holdings of the banks were limited. All sorts of materials having financial yield had to be declared at the customs both on arrivals and departures. The sales and real estate income blockage was effective. Foreigners were not allowed to transfer their profit and income to other countries. Turkish residents were restricted in buying and selling foreign securities. Vice versa, the non-residents required the authorization of the Turkish Ministry of Finance,

in order to buy and sell Turkish securities. The earnings acquired from exports were to be transferred to Turkey in three months time. The annual plan set the calendar for imports and the import amount had to be paid solely in foreign exchange (CBRT, 2002, p. 82). The regulations and laws applied to foreign currencies during 1970s did not permit the in and out flows of capital. From 1962 to 1983, Decree No: 17 was in force. Thus, there were **capital controls** before the SSAP.

5.1.2. The liberalization period

The 1979 crisis opened a path towards a totally different strategy, which was the **export led growth and neo-liberal development** phase. The trade and KA liberalization were the major objectives of the next decade. A military government was established in September 1980. The implementation and application of the fourth development program and the ongoing change in policy or politics was a radical move towards an open economy and the liberalization of trade. The new era required close interrelations with the world. It also put extra burdens on the economy by increasing its obligations. The efficiency in production was to be increased in order to catch up with the increasing demand on the side of exports. The exchange rate during 1970s was overvalued in terms of the Turkish Lira (TL). That was also another obstacle to be eliminated, since it was impossible to increase the exports with highly appreciating TL.

The **first economic transformation** of 1980s supported **outward orientation** and anticipated **high inflows of capital** with liberalization. Its aim was to restrict inflation and the public sector involvement in the economy. The stabilization measures also aimed to allow the demand and supply conditions to freely bring the capital and labor markets to equilibrium. The long run growth and unequal distribution of income are other social dimensions related with the issue.

The **second transformation** in the economy happened in **August 1989**. The presentation of the **KAC and full financial liberalization**, both **internally and externally** enhanced the move towards radical changes in the Turkish economy. **Capital** was allowed to **move freely** between Turkey and other countries from then on. The liberalization of the KA empowered Turkish citizens to trade, save and invest freely in foreign currencies. That decade witnessed several reforms in financial and economic markets. The last, but not least

act of the decade was the KA liberalization, which had a far-reaching influence on the economy ever since.

The idea of full opening up of the KA, in other words the KAC or the KA liberalization was solely the decision of Özal. He was in the heyday of his glory, during the 1980s and the phase of neo-liberal development. Hence, the 1980s are recalled as “The Özal Decade” in Turkey. Turkey was one of the many countries that became exposed to **premature capital account liberalization** with the rise of globalization. The results of the full liberalization leave small room for argument. But, country experiences reveal and suggest that, efficient and effective allocation of resources and proper functioning of the economy requires strong institutional infrastructure, prudential laws and regulations.

With the November 1983 general elections, Turgut Özal was elected as the new prime minister of Turkey. Although, Turkish economy was passing through a quick transition period during 1980s, it was him who took the risk and went ahead, knowing that the prerequisites for full liberalization were not met in **August 1989**. The economy lacked strong institutions. The KAC that was enforced in 1989, arrived promptly without the establishment of the required infrastructure. The decade had both positive and negative dimensions. With regard to the positive dimension of the decade, Öniş (undated) argues that;

“...Özal’s influence embodied a strong positive dimension... It played an important role to enhance the credibility of the stabilization-cum-structural adjustment program supported by key international institutions such as the OECD, the IMF and the World Bank, both in domestic and international circles... His bold initiatives helped to accelerate the momentum of the liberalization process in the Turkish economy, notably in the realms of trade and capital account liberalization.”

Consequently, one can state that the transition to neo-liberal economy was a mild one. Thus, optimistic expectations for the future increased during the period. As for the negative dimension of the decade, Öniş (undated) states that;

“...the weakest link in Özal’s economic thinking was the tendency to underestimate the importance of the rule of law and the need to develop a strong legal infrastructure

for a well-functioning market economy. His preference was for ruling by decrees, hence bypassing normal parliamentary procedures and constraints... ”

The corruption and the misuse of export subsidies increased in the Turkish economy during the decade. The 1989 transformation in economic policies should be analyzed thoroughly, in order to reflect a sound view of the impacts of the KAC. Hence, the major characteristics of the transformation, internal and external financial liberalization, and macroeconomic balances are the most important topics for further analysis. The interest rates and savings, and the interest rates and investments are related with the internal financial liberalization and macroeconomic balances. The external, fiscal, investment-savings, and money market balances are related with the external financial liberalization, which was the major characteristic of the KAC.

By the end of the 1970s, the government initiated a new economic policy as of **January 24th, 1980**, as a result of the intense economic crisis. This date was a major turning point, in other words a landmark in terms of the Turkish economy. The fourth development plan or the so-called, **SSAP** of 1979 was created to support the **export promotion strategy**. The program intended to create efficient allocation of resources. Another purpose of the program was to increase the private entrepreneurship in the economy with **full financial liberalization**, carried out with the **KA liberalization** or **convertibility**. It encouraged the external financial liberalization, together with capital in and outflows, FDI and mostly it led the path to PI. The SSAP was based on the notion of the free market economy. This meant that, the free actions of the markets would determine the prices. Hence, the economy at some point in time would reach and find its equilibrium. According to this view, the prices would be determined by the demand and supply in the economy. The government therefore, should control the money supply and the public spending. Thus, it should also ensure that the demand would not offset the supply.

The SSAP suggested measures like **export promotion**, and **devaluation of the TL**. The program proposed to increase the exports by decreasing the wages of the workers, thereby also decreasing the cost of production. The increase in exports would then lower the BOP deficit. The program aimed at influencing the pricing policy in the goods, labor and capital markets. The wages and interest rates were also influenced by the changes in

these policies. The increase in the interest rates would also increase the savings, thereby leading to an increase in the prices and a decrease in the investment levels.

The program did not plan the investments to be capital intensive. But, it set a sight on increasing the interest rates in order to increase the savings in the banking sector. Another important aspect of the SSAP was the depreciation of the TL. **The exchange rate was adjusted everyday as of July 1st, 1981** (Kepenek and Yentürk, 2004, p. 202). From then on, the TL was devalued several times. There were two results of these devaluations. The first was a positive outcome, stating that the devalued TL would lead to an increase in exports, since the Turkish products would become cheaper for foreigners. But, the second outcome was a rather negative one, suggesting that these devaluations would increase the prices of the imported goods, since they would become expensive for domestic buyers. Hence, in the short run devaluations would lead to an increase in the foreign exchange reserves, but in the long run, they would not lead to an increase in exports if the price of the imported raw materials are not decreased.

The SSAP's major aim was to decrease the BOP deficit. It intended to solve the twin problems of BOP deficit and high inflation by bringing the markets to equilibrium, and achieving liberalization and privatization in the economy. Other positive outcomes to be realized were the decrease in BOP deficit and inflation. The program also needed to confront problems like transparency, infrastructure and credibility. It was crucial that the economy became transparent with the liberalization of trade and the KA.

Rodrik (1990, p. 4) indicates that, the SSAP included a large devaluation (from TL 47.1 to TL 70 to the USD), export subsidies, an increase in interest rates, and substantial price increases for state enterprise products and the promise of abolition of most government subsidies. It was an **outward orientation, export promotion and liberalization** program. Other measures that helped to deepen the outward orientation process were, the substantial import liberalization and a relaxation of controls on the KA.

The trade liberalization process contained, the expansion of export subsidies and incentives, import liberalization and protection and the establishment of the Customs Union with the EU. Export incentive schemes included the depreciation of the TL, the exporters received direct payments through tax rebates and cash premia from extra budgetary funds. Subsidized export credits, tax exemptions on imported inputs, and corporate tax allowances were provided (CBRT, 2002, p. 7).

The export promotion strategy depended on **domestic currency's depreciation**, **low wage levels**, and foremost on **bounteous export subsidies**. Hence, the KAC in 1989 was constituted as a way to get out of the impasse that was faced. By the beginning of 1990, the TL was **fully convertible** into other currencies. **Hot money** started to flow into Turkey. The **inflows of capital** remained to be short term in general. Continuous in and out flows of capital left the economy *per se* in a fragile position. Higher interest rates in other countries drew most of the capital to them. The increasing opportunities and rates of arbitrage led to **capital flight**. This vulnerable position of the economy in return, led to **three crises** in the next decade, which were confronted respectively in **1994, 1999 and 2000**. As of today, Turkey still remains to be a net debtor country.

5.2. Major Reforms

The orthodox stabilization policy that began the adjustment process in the Turkish economy after 1980 required reforms in the economy. Other countries backed up the **rapid reforms** in the economy. The internal and external liberalizations that were enforced became the pillars of the whole liberalization stage. With the early liberalization of the domestic financial system, a scandal caused by rising credits and interest rates broke out in 1982. Notoriously known Kastelli and many other bankers and banks were ruined. But, the efforts of full liberalization of the economy were carried on, even after the failure of the early liberalization attempts.

The financial liberalization became an **economic and formative process**, with the ongoing reforms in the Turkish financial system. The **major reforms** that were made during 1980s were:

- **The execution of the Capital Markets Law in 1981,**
- **The establishment of the Capital Markets Board in 1982,**
- **The liberalization of the foreign exchange system in 1984,**
- **The interest rate deregulation,**
- **The beginning of the auctions of Government Securities in 1985,**
- **The re-opening of Istanbul Stock Exchange (ISE) in 1986,**

- **The CBRT reforms which were the establishment of the Interbank Money Market, the introduction of OMO,**
- **The establishment of foreign exchange and banknotes markets, together with major reforms in the banking sector.**
- **But, the KAC in 1989 was the most outstanding of all the reforms.**

The liberalization process for Turkey was not a gradual one. It was sort of a big-bang liberalization with consecutive reforms that lacked the necessary degree of transparency. It was vital for the economy to acquire credibility. But, contrary to expectations the full KAC was also unsuccessful in most ways. It lacked the financial regulatory infrastructure. Thus, the necessary laws and regulations were not efficient enough for the proper functioning of the system. This fact also did not help to increase the credibility of the economy internationally.

It is therefore crucial to analyze these reforms and their effects shortly, before moving on to the consequences and effects of the KA liberalization on the Turkish economy. The following sections provide a brief summary of the above-mentioned reforms.

5.2.1. The execution of Capital Markets Law in 1981 and the establishment of the Capital Markets Board in 1982

The transparency in the capital markets was ensured with the establishment of the securities markets. The prudential regulations and especially the enforcement of the Capital Markets Law sustained the security and stability in the securities markets. The Capital Markets Board manages and regulates the capital markets according to the Capital Markets Law. The financial activities of all the financial intermediaries and banks were bounded by the Capital Markets Law and were controlled by the Capital Markets Board from then on (CBRT, 2002, p. 13).

5.2.2. The liberalization of the foreign exchange system in 1984

The exchange rate system was liberalized after the SSAP. The pendulum of the exchange rate regime moved from fixed to flexible after 1980. The flexible exchange rate

system supported the devaluation of the TL. The export-led stabilization and growth policy was reinforced with these devaluations. The black market was abolished with the single exchange rate. The authorization given to private banks at the end of 1982, to hold foreign exchange aimed to decrease the capital flight or hot money flows from Turkey (CBRT, 2002, p. 11).

5.2.3. The interest rate deregulation

The SSAP eliminated the deposit and lending interest rate ceilings. The objective of the deregulation and re-regulation of the interest rates was to pump up the savings and bolster up the competition in the economy. The deepening of the financial sector was to be achieved through the increase in the levels of savings, investments and efficient allocation of resources. The lack of government control on interest rates after 1980 was the primary reason of the financial failure in 1982. The deposit interest rate determination was once again, left back to the hands of the CBRT in December 1983. With the permission of the CBRT, the deposit interest rates started to be determined up to a certain limit by banks from June 1987 onwards. Finally, on October 12th, 1988 all restrictions on the deposit interest rates were abolished (CBRT, 2002, p. 13). The rise in the rates of interest also leads to an increase in production costs and risks, thereby decreasing the level of investments. Hitherto, the flight of capital remained to be the major risk for Turkey and its economy, due to the speculative attacks that it confronted.

5.2.4. The auctions of Government Securities in 1985

The government did not issue any securities until 1985. The deficits were financed by the CBRT monetization until then. Government securities and bonds started to be issued as of May 1985, with the aim of financing the deficit in the BOP. It was stated by the CBRT (2002, p. 14) that;

“The government securities auctions provided the essential preconditions for the initiation of open market operations at the Central Bank and setting up of a secondary bills and bonds market at ISE. Thus, the government securities auctions provided an attractive alternative investment area for financial and non-financial institutions since

interest rates of these instruments were determined under market conditions and had zero-credit risk.”

5.2.5. The Central Bank reforms

The origin of the establishment of the free market economy relied on the notion that the facility of rediscounting was restricted to medium term credits. ISE's operations began in 1986 and the CBRT launched a new monetary policy in order to control the supply of money. It therefore needed to get a grip on the money supply, through the whole reserves of the system of banking. The prerequisites for the open economy and free market prices were the establishment of an Interbank Money Market, OMO and the founding of the Foreign Exchange and Banknotes Market. The Interbank Money Market began its operations on April 2nd, 1986. It regulates the banking sector effectively. The ad hoc measures in the financial sector were left with the establishment of the Interbank Money Market and comprehension of the importance of the management of cash was developed. The banks, which made Interbank Money Market operations, were required to keep collaterals at the CBRT. In February 1987, the actualization of the monetary policy was set out with the introduction of OMO. The money supply and financial system's liquidity level were to be controlled by OMO. The CBRT fixed the exchange rates everyday as of August 1988 with the establishment of the Foreign Exchange and Banknotes Market. By the beginning of January 2003, the Interbank Money Market, and the Foreign Exchange and Banknotes Market were left to their own devices with the withdrawal of the CBRT from its intermediation obligation (CBRT, 2002, p. 15).

The KA liberalization aimed to bring the economy to equilibrium, increase investments, decrease inflation, stabilize monetary and fiscal positions of the economy and increase the growth rate and adjust the income distribution fairly. The SSAP contained a neo-liberal approach to the KA liberalization, which indicated that the economic growth would increase with the full opening up of the KA. The notion behind the introduction of the KAC to the financial system was to increase the effectiveness and efficiency in the economy against all odds. Whether the expectations were met or not still remains a matter subject to controversy. The ramifications of the KAC are analyzed from a broader

perspective in the next section. It is therefore crucial to examine the macroeconomic developments in the Turkish economy after 1980, before deducting any consequences.

5.2.6. The banking sector reforms

The Turkish banking sector went through a transformation period with the reforms implemented after the export promotion strategy. The establishment of the Savings Deposit Insurance Fund (SDIF) was finalized for the achievement of an effective financial market. The fund aimed to protect the holders of the savings accounts, and therefore, obligated the banks to participate. The last two decades witnessed the implementation of **two Bank Acts**. The enactment of the **first** was effective as of **May 2nd, 1985**, and the enactment of the **second** was effective as of **June 18th, 1999**. The 1985 Bank Act aimed to restructure the banking system. The notion of GAAP and Sworn Bank Auditors were introduced to the financial system. The auditing of the banks was to be made by the independent external auditors. The CBRT requested the banks to present their balance sheets to the institution. After the KAC, and as of **October 1989**, the banks were requested to **adjust their capital** according to their assets' risks. Hence, they were obliged to accept the capital adequacy ratios. The SDIF was restructured in **1994**. The 1999 Bank Act aimed to transfer the weak banks that were a burden to the economic and financial markets to the SDIF. It targeted to operate the markets according to the international standards and the requirements of the European Union. In line with these developments, the Banking Regulation and Supervision Agency (BRSA) was established. The BRSA aimed to create an effective and efficient banking system, to ward off the danger of an economic crisis, and to increase the confidence and competition in the financial sector. The banks were stranded with the implementation of the new Bank Act, which requested that they make internal control and risk management (CBRT, 2002, p. 17-18).

5.2.7. The KA liberalization in 1989

The movement towards the full KAC or liberalization led the authorities to execute the **Decrees No: 28, 30 and 32** after 1980. The so-called decrees accelerated and tied up the KA liberalization process of that decade. Hence, the **Decree No: 17** became ineffective

in 1983 with the increasing liberalization efforts. The **restrictions on capital flows** were eliminated with the **Decrees No: 28, 30 and 32**. The **Decree No: 28** that was first put into force in **December 1983** was followed by, the **Decree No: 30** that was put into force later in **July, 1984**. The **partial KAC** began with the introduction of these decrees. The major points of the **Decree No: 28 and 30** that started up the **partial KA liberalization** were:

- The Undersecretariat of Treasury and Foreign Trade was put in charge of foreign trade and exchange. It later on passed the control and management of foreign exchange to the CBRT.
- The execution of the daily implementation of the fixed exchange rate as of May 1st, 1981 has been carried on.
- Given the CBRT's basic exchange rate, the commercial banks were left free to arrange their own exchange rates between a (+/-) 6% margin.
- The transfer of the foreign exchange, acquired from the sale of a real estate that was purchased with foreign exchange was allowed.
- The banks were free to keep (at maximum) 40% of their short-term commitment as foreign exchange.
- Financial institutions and banks were allowed to make foreign exchange transactions and hold foreign exchange assets.
- It was their obligation to submit 20% of the foreign exchange and earnings from foreign currency notes to the CBRT. They were also required to keep reserve requirements in the CBRT for all the deposits opened in foreign exchange.
- The TL import limitation has been abolished.
- The travel restrictions to foreign countries have been eliminated. After these decrees were put into force, residents were allowed to travel abroad with maximum 3000.- USD (CBRT, 2002, p. 83-84).

The **full financial liberalization** or **liberalization of the KA** was finalized in **August 11th, 1989** with the enforcement of **Decree No: 32**. Hence, the **Decree No: 32** needs to be emphasized for a thorough apprehension of the KA liberalization. It was the application of the **Decree No: 32** that led the way to **full KAC** and **liberalization**. The **full liberalization**

of capital movements was accomplished after the Decree No: 32 was issued. The major points of the Decree No: 32 were:

- The residents were free to buy and keep foreign exchange with no limitations.
- Foreigners or non-residents were free to own and dispose, in other words buy and sell the Stock Exchange securities.
- Turkish residents working with and for foreigners were allowed to bring foreign currency into Turkey.
- Turkish residents were free to buy and sell foreign stock exchange securities and foreign currency bonds denominated by the CBRT. They were also allowed to transfer the purchase value abroad.
- Residents were at ease in issuing, and selling securities to foreign countries. They could bring and take securities, to and out of Turkey.
- They were free to transfer the profit from foreign capital sales to other countries.
- The liberalization of foreign credit obtaining was achieved.
- Non-residents were allowed to open TL accounts and transfer the money out of the country in any currency.
- The real estate sales blockage was abolished and the liberalization of sales income transfer was accomplished.
- Foreigners were free to buy and transfer TL and foreign exchange with no restrictions.
- The transfers more than 500,000.- USD or any other foreign currency equal to the same amount were to be reported by the financial institutions, other than the export, import and invisible transfers.
- Turkish residents were free to establish offices and representations in foreign countries (CBRT, 2002, p. 16-17).

5.3. The Effects of Financial Liberalization (KAC) on the Turkish Economy

The Turkish economy faced major problems during 1980s and 1990s, which had to be solved urgently. These problems were: the high level of inflation, the disproportionate scales of public investment in infrastructure, and of private investment in housing, and the stagnation in the manufacturing industry. Another problem of the economy was the necessity to restore equilibrium in the current account balances. The public sector borrowing requirement was to be reduced for the private sector to use of the favorable balance created between private savings and private investment. Yet, another problem of the Turkish economy was ensuring economic balances that will never be disrupted by the implementation of new policies.

Like most of the earlier plan strategies, the Fifth Five-Year Development Plan (1985-1989) strategy was based on the issue of BOP deficits. During the first Four Five-Year Plans (1963-1984) this aim was to be reached through a strategy centering on the expansion of the internal market to build a large production capacity. During the Fifth Five-Year Plan (1985-1989) the strategy for overcoming the BOP deficit was changed to export orientation. The implementation of the KAC highlighted that the internal and external balances of the economy should be achieved and sustained for macroeconomic stability.

The analysis of the statistical data in this section will be useful in understanding the effects of the KAC on the Turkish economy, towards the end of 1980s and throughout 1990s. The BOP, capital in and outflows, growth rates, FDI and PI, domestic saving-investment difference, together with the public sector borrowing requirement, foreign exchange, unemployment and inflation rates, income distribution, OMO and money supply changes of the economy will be analyzed in the following pages.

5.3.1. The BOP and the trend of the KA

Table 5.1 (p. 76) gives an annual summary presentation of the BOP as of the initiation of the KAC. At the beginning of the KAC the CAB gave surplus. But, by the end of 2003 the CAB reflects the second highest deficit amount after the year 2000. The amount of exports has increased steadily, except the years 1998-2000 when there had been a slight

decline. The analysis of the imported amount of goods shows that there has been a large increase in imports especially after 2000, and the end year result remains to be a high amount of imported goods. The KAC has been favorable in terms of the increase in the exported goods. It also led the imports to increase tremendously, and hence is unfavorable in terms of the imported goods. The first sub-account of the CA (goods account) gives a negative balance, since the imported goods' amount is higher than the exported goods' amount. The services account, which is the second sub-account of the CA gave surplus all throughout the years as of 1989 and the KAC. The tourism and travel services reflect a steady increase in the overall balance of the services account. The third sub-account (income) of the CA reflects an increasing negative balance during the years after the KAC. The CA's last sub-account's (current transfers) surplus is caused by the increasing workers' remittances (although the end result achieved at 2003 reflects the lowest current transfers for the analyzed period).

The KAB is calculated by taking, both the capital and the financial account into consideration. The only small positive balance seen in the capital account through migrant's transfers is in the year of KAC. The years after that including 2003 all ended with a zero balance. The analysis of the financial account is important in terms of the outcomes of the KAC. As of 1989, the DI in Turkey decreased and reached its lowest level in 2003. The PI when compared to the DI increased throughout the interval. Other investment also increased, whereas the reserve assets decreased from 1989 to 2003. The capital and financial account balance reflects that the highest two results were achieved in 1993 and 2000 (right one year before both the 1994 and 2001 crises).

At the beginning of the KAC the capital and financial account gave deficit, whereas by the end of 2003 the account reflects a positive balance, indicating a surplus. The net errors and omissions balance also increased to its highest level in 2003.

The BOP year-end results indicate that it gave deficit in general when compared to minor surpluses. Although the exports seem to be increased, the amount of imports outweighs them for the analyzed years.

Figure 5.1(p.79) shows the evolution of the KA, taking CA and reserve accumulation into account. The rising CA deficit remained high over the years when compared to capital inflows. The crises of 1994, 1999 and 2001 in the Turkish economy led to sudden outflows of capital shown by the severely declining KA balance in those years.

Table 5.1 - Balance of payments summary presentation (annual) (Million US \$)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
I - CURRENT ACCOUNT	938	-2,625	250	-974	-6,433	2,631	-2,339	-2,437	-2,638	1,984	-1,360	-9,819	3,390	-1,540	-6,850
Goods, Services and Income (A+B+C)	-2,597	-7,118	-4,819	-5,033	-10,201	-461	-6,835	-6,884	-7,504	-3,743	-6,535	-15,044	-413	-5,036	-8,956
Goods and Services (A+B)	-270	-4,610	-2,186	-2,408	-7,457	2,803	-3,630	-3,957	-4,491	-758	-2,998	-11,042	4,587	-487	-3,529
A. GOODS	-4,298	-9,576	-7,350	-8,215	-14,197	-4,249	-13,250	-10,614	-15,403	-14,264	-10,484	-22,410	-4,543	-8,367	-14,034
Exports	11,625	12,959	13,593	14,715	15,345	18,106	21,636	32,067	32,110	30,662	28,842	30,721	34,373	39,827	51,206
Imports	-15,923	-22,535	-20,943	-22,930	-29,542	-22,355	-34,886	-42,681	-47,513	-44,926	-39,326	-53,131	-38,916	-48,194	-65,240
General Merchandise	-3,240	-8,044	-6,189	-6,785	-12,316	-3,769	-11,928	-8,942	-13,536	-12,503	-9,405	-20,510	-3,580	-8,315	-11,512
Exports f.o.b.	11,625	12,959	13,593	14,715	15,345	18,106	21,636	32,067	32,110	30,662	28,842	30,721	34,347	30,430	51,130
Exports f.o.b.	11,625	12,959	13,593	14,715	15,345	18,106	21,636	23,225	26,261	26,973	26,587	27,775	31,334	35,762	47,253
Shuttle trade	0	0	0	0	0	0	0	8,842	5,849	3,689	2,255	2,946	3,039	4,065	3,953
Adjustment: Classification	0	0	0	0	0	0	0	0	0	0	0	0	-26	-9,397	-76
Imports f.o.b.	-14,865	-21,003	-19,782	-21,500	-27,661	-21,875	-33,564	-41,009	-45,646	-43,165	-38,247	-51,231	-37,927	-38,745	-62,642
Imports c.i.f.	-15,792	-22,302	-21,047	-22,871	-29,428	-23,270	-35,709	-43,627	-48,559	-45,922	-40,687	-54,503	-41,399	-51,270	-69,340
Adjustment: Coverage	927	1,299	1,265	1,371	1,767	1,395	2,145	2,618	2,913	2,757	2,440	3,272	2,483	3,076	4,100
Adjustment: Classification	0	0	0	0	0	0	0	0	0	0	0	0	0	989	9,449
Goods for Processing	0	0	0	0	0	0	0	0	0	0	0	0	0	1,303	0
Repairs on Goods	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Non Monetary Gold (net)	-1,058	-1,532	-1,161	-1,430	-1,881	-480	-1,322	-1,672	-1,867	-1,761	-1,079	-1,900	-963	-1,355	-2,522
B. SERVICES	4,028	4,966	5,164	5,807	6,740	7,052	9,620	6,657	10,912	13,506	7,486	11,368	9,130	7,880	10,505
Transportation	299	20	235	170	47	270	302	15	323	755	799	492	833	867	-523
Freight	300	156	282	208	87	320	320	65	267	698	663	246	731	537	-712
Other Transportation	-1	-136	-47	-38	-40	-50	-18	-50	56	57	136	246	102	330	189
Travel	1,992	2,705	2,062	2,863	3,025	3,455	4,046	4,385	5,286	5,423	3,732	5,923	6,352	6,600	11,090
Construction Services	582	741	713	936	1,142	1,254	1,857	1,941	2,285	2,311	1,095	968	654	830	682
Financial Services	0	0	0	-283	-286	-259	-274	-191	-290	-112	-312	-303	-391	-400	-83
Other Business Services	1,289	1,643	2,232	1,362	1,532	1,903	3,181	1,796	4,314	5,562	3,368	4,082	1,693	-68	-25
Government Services	-134	-143	-78	-203	-223	-286	-239	-236	-241	-259	-290	-277	-319	-572	-715
Other Services	0	0	0	962	1,503	715	747	-1,053	-765	-174	-906	483	308	623	79
C. INCOME	-2,327	-2,508	-2,663	-2,625	-2,744	-3,264	-3,205	-2,927	-3,013	-2,985	-3,537	-4,002	-5,000	-4,549	-5,427
Direct Investment	-104	-161	-158	-145	-243	-102	-272	-175	-142	-227	-167	89	52	-86	-268
Portfolio Investment	0	0	0	-36	264	-542	-741	-517	-53	15	89	-434	-694	-830	-1,207
Other Investment	-2,223	-2,347	-2,505	-2,444	-2,765	-2,620	-2,192	-2,235	-2,818	-2,773	-3,459	-3,657	-4,358	-3,633	-3,952
Interest Income	684	917	935	771	697	691	1,208	1,166	977	1,096	1,074	1,168	1,139	784	634

	Interest Expenditure	-2,907	-3,264	-3,440	-3,215	-3,462	-3,311	-3,400	-3,401	-3,795	-3,869	-4,533	-4,825	-5,497	-4,417	-4,586
	<i>Long Term</i>	-2,517	-2,748	-2,778	-2,711	-2,900	-2,700	-2,908	-2,769	-2,840	-3,053	-3,431	-3,785	-4,271	-4,053	-4,278
	<i>Short Term</i>	-390	-516	-662	-504	-562	-611	-492	-632	-955	-816	-1,102	-1,040	-1,226	-364	-308
D.	CURRENT TRANSFERS	3,535	4,493	5,099	4,059	3,768	3,092	4,496	4,447	4,866	5,727	5,175	5,225	3,803	3,496	2,106
	Workers' Remittances	3,040	3,246	2,819	3,008	2,919	2,627	3,327	3,542	4,197	5,356	4,529	4,560	2,786	1,936	729
	Imports with Waiver	108	128	60	139	116	82	98	350	355	212	284	451	810	1,054	1,079
	Official Transfers	423	1,144	2,245	912	733	383	1,071	555	314	159	362	214	207	506	298
	Other Private Transfers	-36	-25	-25	0	0	0	0	0	0	0	0	0	0	0	0
	CAPITAL AND FINANCIAL															
II -	ACCOUNT	-1,909	3,093	-1,198	2,164	8,595	-4,463	-93	938	3,625	-1,287	-377	12,581	-1,719	1,668	1,875
A.	CAPITAL ACCOUNT	23	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	Migrants' transfers	23	0	0	0	0	0	0	0	0	0	0	0	0	0	0
B.	FINANCIAL ACCOUNT	-1,932	3,093	-1,198	2,164	8,595	-4,463	-93	938	3,625	-1,287	-377	12,581	-1,719	1,668	1,875
	Direct Investment	663	700	783	779	622	559	772	612	554	573	138	112	2,769	862	76
	Abroad	0	16	-27	-65	-14	-49	-113	-110	-251	-367	-645	-870	-497	-175	-499
	In Turkey	663	684	810	844	636	608	885	722	805	940	783	982	3,266	1,038	575
	Equity Capital	0	0	810	844	636	608	885	722	805	940	783	982	3,266	585	406
	Other Capital (Net)	0	0	0	0	0	0	0	0	0	0	0	0	0	452	169
	Portfolio Investment	1,386	547	623	2,411	3,917	1,158	237	570	1,634	-6,711	3,429	1,022	-4,515	-590	2,569
	Assets	-59	-134	-91	-754	-563	35	-466	-1,380	-710	-1,622	-759	-593	-788	-2,093	-1,386
	General Government	0	0	0	0	330	52	-33	-19	-41	-21	-46	-33	-36	-42	-33
	Banks	0	0	0	-754	-754	-37	-391	-1,395	-667	-1,791	-812	-680	-281	-1,437	-932
	Other Sectors	0	0	0	0	-139	20	-42	34	-2	190	99	120	-471	-614	-421
	Liabilities	1,445	681	714	3,165	4,480	1,123	703	1,950	2,344	-5,089	4,188	1,615	-3,727	1,503	3,955
	Equity Securities	17	89	147	350	570	989	195	191	8	-518	428	489	-79	-16	1,009
	Debt Securities	1,428	592	567	2,815	3,910	134	508	1,759	2,336	-4,571	3,760	1,126	-3,648	1,519	2,946
	Monetary Authority	0	0	0	-216	0	0	-213	0	0	0	0	0	0	0	0
	General Government	1,043	572	593	2,988	3,903	446	933	1,919	1,915	-4,253	3,677	984	-3,645	1,958	3,123
	Banks	385	20	-26	43	7	-312	-212	-160	421	-318	83	142	-3	-439	-177
	Other Investment	-1,509	2,742	-3,803	458	4,364	-5,634	3,903	4,301	4,753	-3,067	1,782	11,801	2,667	7,549	3,277
	Assets	371	-409	-2,563	-2,438	-3,291	2,423	-383	331	-1,750	-1,464	-2,304	-1,939	-601	-652	-986
	Trade Credits	0	0	0	0	0	0	0	0	0	0	-106	-26	-445	-793	-910
	Loans	390	156	-811	-327	-289	-38	1,101	-125	-358	-261	-453	116	-734	17	-404
	Currency and Deposits	-187	-567	-1,760	-2,142	-2,894	2,451	-1,430	1,510	-678	-752	-1,454	-1,690	927	593	724
	Other Assets	168	2	8	31	-108	10	-54	-1,054	-714	-451	-291	-339	-349	-469	-396
	Liabilities	-1,880	3,151	-1,240	2,896	7,655	-8,057	4,286	3,970	6,503	6,531	4,086	13,740	-2,066	8,201	4,263

Trade Credits	67	361	433	1,526	2,378	-979	1,486	328	572	-40	719	805	-1,930	2,432	2,181
Long Term	0	0	0	-119	194	-100	-107	189	256	77	-52	8	11	5,322	966
Short Term	67	361	433	1,645	2,184	-879	1,593	139	316	-117	771	797	-1,941	350	1,215
Loans	-2,574	1,714	-91	1,171	3,639	-8,391	160	950	4,836	3,505	3,057	12,868	614	5,105	606
Monetary Authority	-562	-509	-310	-210	-33	272	340	-81	-30	-234	518	3,348	10,229	-6,138	-1479
Use of Fund Credits and Loans	-240	-48	0	0	0	340	347	0	-28	-231	520	3,351	10,230	-6,138	-1479
Long Term	-322	-466	-241	-210	-33	-68	-7	-81	-2	-3	-2	-3	-1	0	0
Short Term	0	5	-69	0	0	0	0	0	0	0	0	0	0	0	0
General Government	-2,317	-393	-201	-1,645	-2,177	-2,962	-2,131	-2,108	-1,456	-1,655	-1,932	117	-1,977	11,834	-765
Use of Fund Credits and Loans	0	0	0	0	0	0	0	0	0	0	0	0	0	12,503	1429
Long Term	-1,288	-393	-201	-1,645	-2,177	-2,962	-2,131	-2,108	-1,456	-1,655	-1,932	-883	-977	-669	-2194
Short Term	-1,029	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Banks	-78	1,245	1,199	2,411	3,975	-6,883	1,074	1,815	2,384	892	2,187	4,378	-8,076	-1,027	1975
Long Term	-49	231	536	7	193	-282	273	1,046	1,660	829	117	-363	-1,024	-297	-40
Short Term	-29	1,014	663	2,404	3,782	-6,601	801	769	724	63	2,070	4,741	-7,052	-730	2015
Other Sectors	383	1,371	-779	615	1,874	1,182	877	1,324	3,938	4,502	2,284	5,025	438	653	875
Long Term	456	369	-380	619	2,268	1,313	431	1,317	3,352	4,083	2,344	4,897	255	1,381	587
Short Term	-73	1,002	-399	-4	-394	-131	446	7	586	419	-60	128	183	-728	288
Currency and Deposits	796	960	-1,432	154	1,589	1,260	2,462	2,567	876	2,877	239	-20	-832	348	1,368
Monetary Authority	478	-74	-629	465	1,069	1,430	1,563	1,336	1,028	574	-229	622	736	1,336	497
Long Term	518	49	-497	410	925	1,315	1,462	1,273	978	654	-131	620	605	616	-275
Short Term	-40	-123	-132	55	144	115	101	63	50	-80	-98	2	131	720	772
Banks	318	1,034	-803	-311	520	-170	899	1,231	-152	2,303	468	-642	-1,568	-986	871
Other Sectors	0	0	0	-215	226	-65	-2,087	0	0	1,187	2	182	-1,748	-1,104	562
Other Liabilities	0	0	0	-96	294	-105	2,986	1,231	-152	1,116	466	-824	180	118	309
Other Assets	-169	116	-150	45	49	53	178	125	219	189	71	87	82	97	108
Reserve Assets	2,472	896	1,199	1,484	308	546	5,005	4,345	3,216	216	5,726	354	2,694	6,153	2,047
Reserve Position in the Fund	0	0	0	0	0	0	0	0	0	0	-112	0	0	0	0
Foreign Exchange	-2,485	-781	1,223	-1,484	-314	-625	-5,032	-4,545	-3,316	-216	-5,614	-354	2,694	-6,153	-4,047
Currency and Deposits	-2,485	-781	1,223	-1,484	-314	-625	-5,032	-4,545	-3,316	4,784	-2,003	-1,545	404	1,763	-99
Securities	0	0	0	0	0	0	0	0	0	-5,000	-3,611	1,191	2,290	-7,916	-3,948
Other Reserve Assets	13	-115	-24	0	6	79	27	0	0	0	0	0	0	0	0
III - NET ERRORS AND OMISSIONS	971	-468	948	-1,190	-2,162	1,832	2,432	1,499	-987	-697	1,737	-2,762	-1,671	-128	4,975

Source: UT.

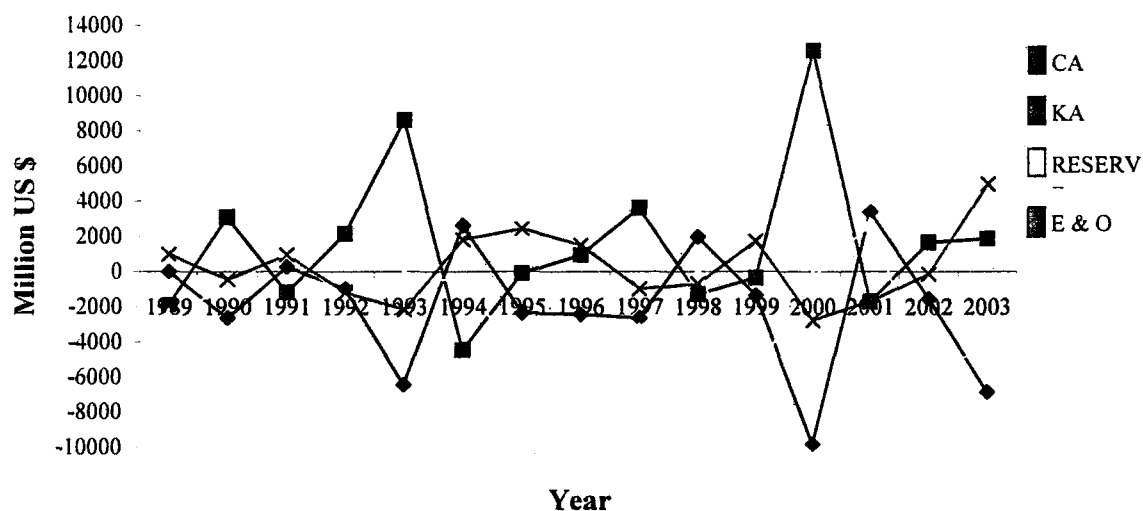


Figure 5.1 Trend of KA

Source: UT BOP Statistics.

5.3.2. The KAC and GDP growth

The decade after the KAC witnessed major fluctuations in the capital in and outflows of capital. The increasing capital inflows also led to an increase in the growth rate of the economy. Hence, there was a one to one relation between the growth rate and the inflows of capital. The acceleration of growth is supported with the overvalued TL, and the PI in the economy is increased due to the ongoing speculations. Figure 5.2 illustrates the crises in 1994, 1999 and 2001 clearly, which were mainly caused by the growth of the economy based on speculations. During these years the GDP has dropped severely when compared to the GDP of the previous year.

The increasing inflows of foreign capital are considered as a positive outcome in terms of the growth of the economy. Hence, the economy aims to attract and draw foreign capital in the form of FDI preferably into Turkey. Therefore, high arbitrage gains are provided to foreigners through high interest rates.

The years after the KAC led to business cycles in the financial sector, thereby also increasing the volatility and stagnation in the economy. The maturities of the capital flows changed from medium and long-term to short-term with the KAC, and the increasing BOP deficit and public expenditures were made through these short-term inflows of capital.

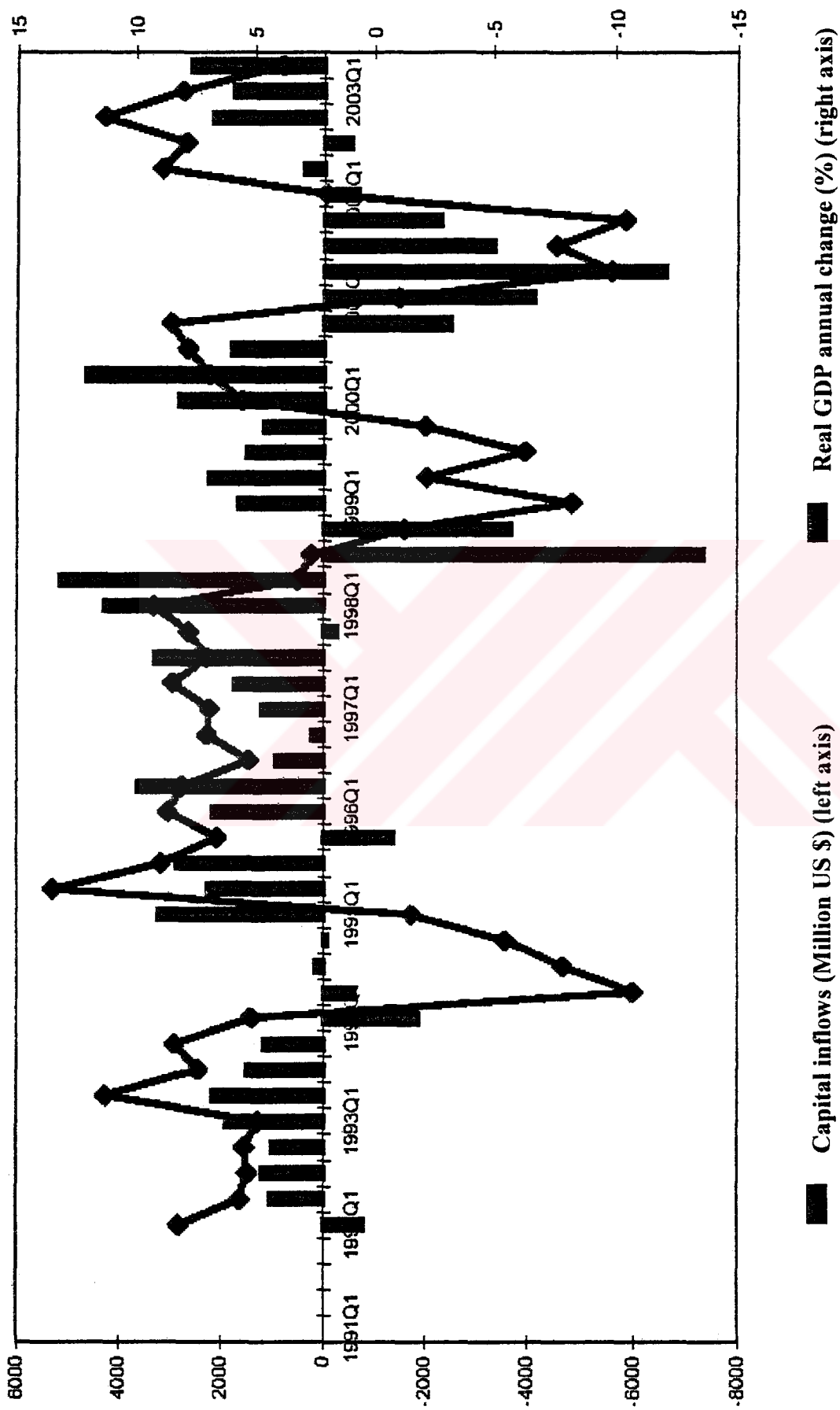


Figure 5.2 BOP Finance Account + Net Errors & Omissions (Million US \$) and GDP Annual Change (%)

Source: <http://www.gpn.org/data/turkey/turkey-analysis.pdf>

5.3.3. Characteristics of capital flows in Turkey

With the introduction of the KAC to the Turkish financial system in 1989, the economy was attacked by speculative short-term flows of capital, namely hot money. Hence, in analyzing the characteristics of capital flows in Turkey, one needs to study the FDI, PI, and short-term capital movements carefully. Table 5.2 details the PI investment in terms of the assets and liabilities, and separates the sales and purchases of securities made by residents and non-residents.

The net FDI amount that was 663 million US \$ in 1989 fluctuated throughout the 1985 – 2001 period, and it increased suddenly from 112 million US \$ in 2000 to 2,769 million US \$ in 2001.

The net PI amount that was 1,386 million US \$ in 1989, decreased until 1992. It then increased to 2,411 million US \$ in 1992, and 3,917 million US \$ in 1993. The net PI decreased from 1994 till 1998, reaching –6,711 million US \$, that was the highest capital outflows for 1985 – 2001 period. Although, the net PI increased in 1999, the 2001 (–4,515 million US \$) balance showed a rapid decrease in PI once again. The inflows of capital led to the appreciation of the domestic currency, thereby also leading to an increase in imports, mainly due to the cheapening of the foreign goods. Some of the public expenditures were also financed by the short-term flows of capital. The assets side, reflecting the residents' net flow of securities shows that the outflows of securities outweighed the inflows, except for 1994 when 35 million US \$ was recorded as inflows. The inflows of securities outweighed the outflows on the liabilities side until 1997. In 1998, the outflows of securities suddenly increased (–14,647 million US \$) and surpassed the inflows (10,137 million US \$). In 1999, the inflows were higher than the outflows. But, the crises of 2000 and 2001 had an adverse impact on the inflows once again, leading to increases in capital outflows. The total of the resident and non-resident net flows of securities on both the assets and liabilities side from 1992 to 2001 indicate a high amount of flight of capital from Turkey.

The short-term capital movements refer to the banking sector credits received from foreigners. The loans received after the KAC illustrates a rapid increase (122,053 million US \$) in 1993, followed by sudden decreases (8,824 million US \$) until 1996. From then on, the amount of the loans received increased up to 122,673 million US \$ in 1999.

Table 5.2 Characteristics of capital flows in Turkey

(Million US \$)	1985	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
1- FDI (Net)	99	354	663	700	783	779	622	559	772	612	554	573	138	112	2.769
2- PORTFOLIO INVESTMENT (Net)	0	1.178	1.386	547	623	2.411	3.917	1.158	237	570	1.634	-6.711	3.429	1.022	-4.515
a- ASSETS															
SECURITIES															
INFLOW(Security sales of residents abroad)	0	-6	-59	-134	-91	-754	-563	35	-466	-1.380	-710	-1.622	-759	-593	-788
OUTFLOW(Security purchases of residents abroad)	0	-6	-59	-134	-91	-754	-563	35	-466	-1.380	-710	-1.622	-759	-593	-788
b- LIABILITIES															
SECURITIES															
INFLOW(Security purchases of non-residents in Turkey)	0	1.184	1.445	681	714	3.165	4.480	1.123	703	1.950	2.344	-5.089	4.188	1.615	-3.727
OUTFLOW(Security sales of non-residents in Turkey)	0	0	17	89	147	359	753	1.024	317	619	570	-4.510	968	-4.637	-3.823
3- SHORT-TERM CAPITAL MOVEMENTS															
BANKS															
Loans Received	296	-43	-29	1.014	663	2.404	3.782	-6.601	801	769	724	63	2.070	4.741	-7.052
Repayments	0	0	0	0	43.186	64.767	122.053	75.439	76.427	8.824	19.110	19.288	122.673	209.432	110.270
4- NET ERRORS AND OMISSIONS															
MEMO ITEMS (As a % of the GNP)															
CAB	-1,9	1,8	0,9	-1,7	0,2	-0,6	-3,6	2,0	-1,4	-1,3	-1,4	1,0	-0,7	-4,8	1,4
PSBR	3,6	4,8	5,3	7,4	10,2	10,6	12,0	7,9	5,0	8,6	7,7	9,4	15,6	12,5	16,4
OUTSTANDING DOMESTIC DEBT	3,5	5,7	6,3	7,0	8,1	11,7	12,8	14,0	14,6	18,8	21,4	22,5	29,3	28,7	68,1
TOTAL ASSETS ISSUED	5,5	7,8	8,7	6,5	8,5	17,6	20,6	24,8	21,9	36,3	23,9	30,4	39,8	42,1	74,3
Public Sector	5,1	6,9	7,7	5,5	7,4	15,9	16,8	22,7	19,8	35,3	22,9	29,4	38,7	37,5	68,5
Private Sector	0,4	0,9	1,0	1,0	1,0	1,7	3,8	2,1	2,1	1,0	1,0	1,0	1,1	4,6	5,8
BANKING SECTOR CREDITS	10,9	17,6	16,1	16,5	12,4	12,7	14,0	13,3	16,5	18,5	21,7	19,4	20,1	20,4	20,1
Real rate of growth of GNP (%)	4,3	1,5	1,6	9,4	0,3	6,4	8,1	-6,1	8,0	7,1	8,3	3,9	-6,1	6,3	-9,4

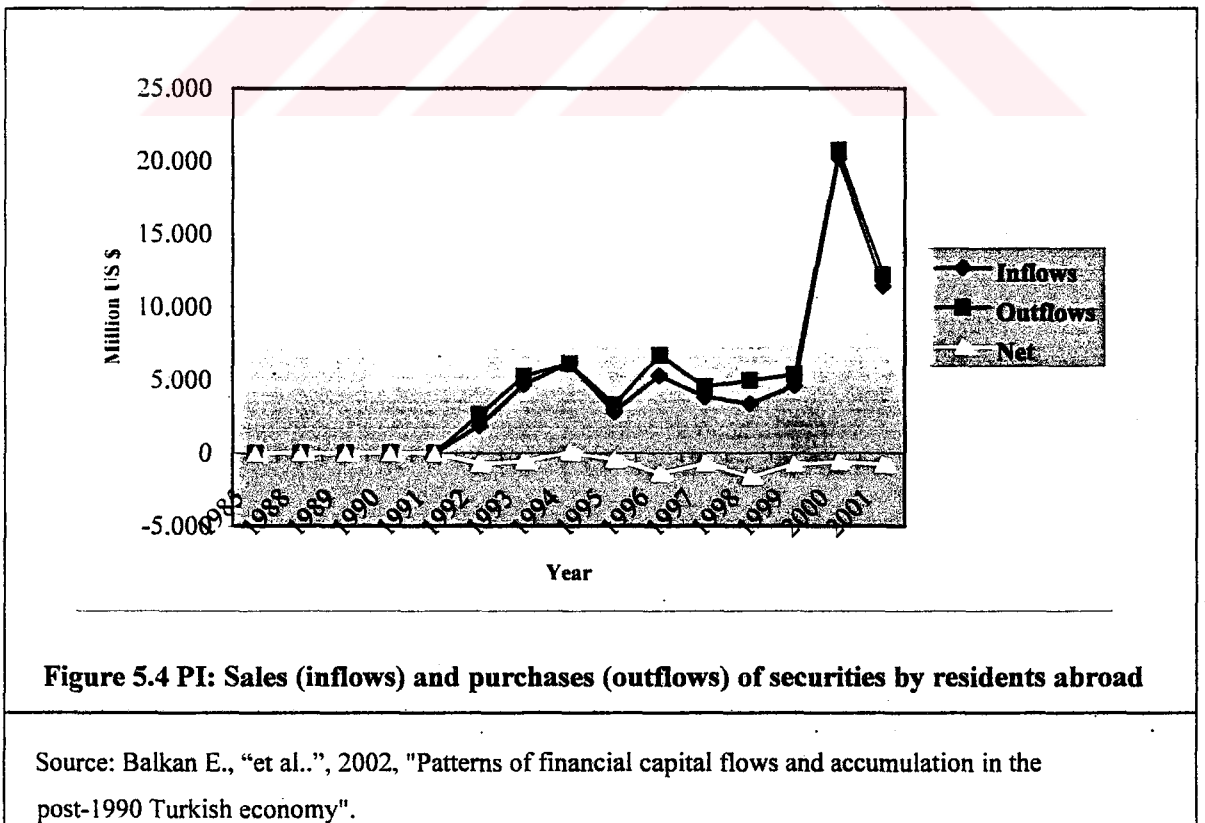
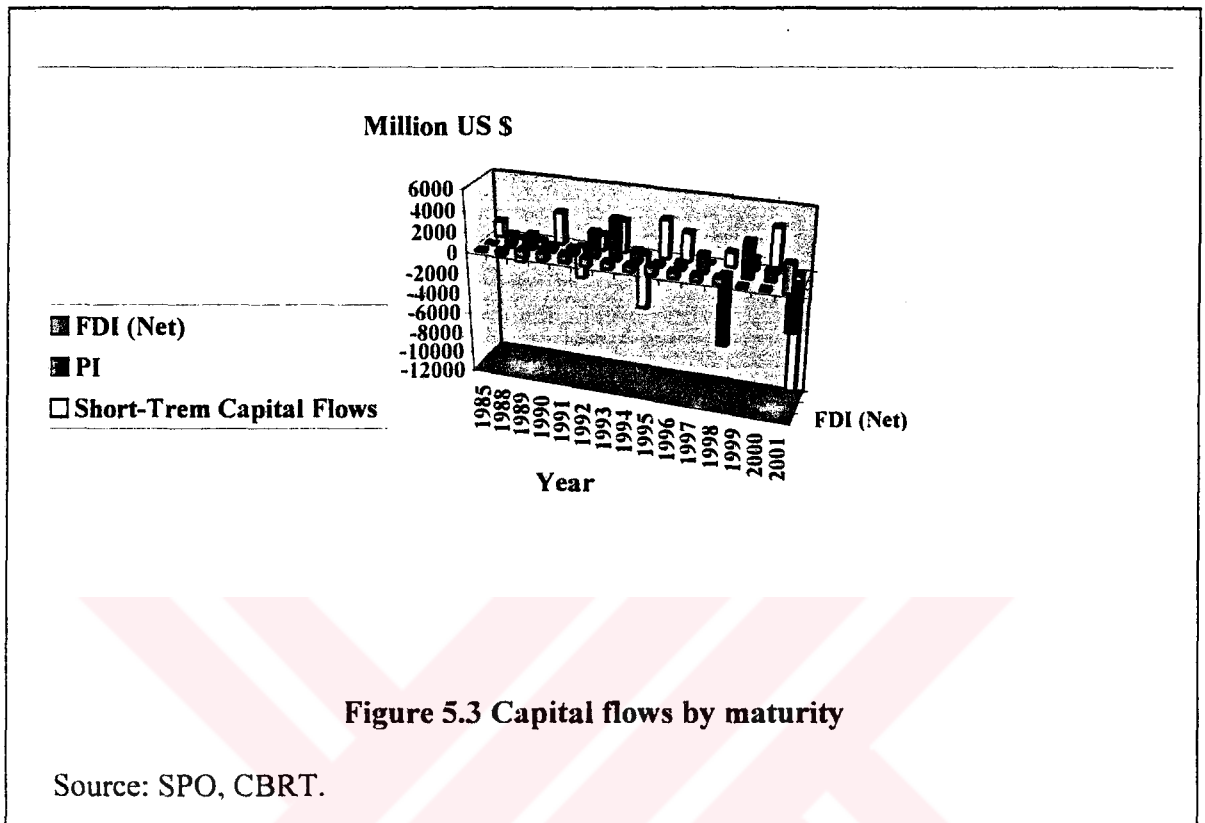
Source: Balkan E., "et al.", 2002, "Patterns of financial capital flows and accumulation in the post-1990 Turkish economy".

In 2000, the loans received reach up to the highest level of 209,432 million US \$, thereby decreasing in 2001 back to 110,270 million US \$. The amount of the loans received, exceeded the repayments for all the years during 1991 – 2001, with the exception of the crises years 1994 and 2001. The highest amount of repayment was made in 2000 (-204,691 US \$). The volatility of the short-term capital in and outflows, the increased amounts of the loans received in 1993 and 2000 led to the worsening of the economy, and the crises of 1994 and 2001 became inevitable.

The analysis of the memo items as a percentage of the GNP shows negative balances for the CA in general. These figures were rather small with the exception of pre crises years of 1993 and 2000 when they reached -3.6% and -4.8% consecutively. The financial markets were sensitive to the CAB in the sense that, the CAB deficits were followed by outflows of capital and crises in 1994 and 2001. The 1985-2001 CAB deficits show that, except for the crises years, the saving – investment difference in the public and private sector was not the major factor that influenced the economy. The PSBR as a percentage of the GNP shows that the PSBR increased through the years, with the exception of 1994, 1995, 1997 and 2000. The increase in the PSBR left the economy in a vulnerable position. The outstanding domestic debt also increased steadily. In 2001, it reached 68.1% and more than doubled last year's value of 28.7%. The total assets issued as a percentage of the GNP increased rapidly, with the exception of years 1990, 1995 and 1997. It finally reached 74.3% in 2001. It should be noted that the public sector was the major source of the increase with the issues of new bills throughout the period. The KAC opened the path for the public sector to use the inflows of hot money to cover up the CAB deficit and bring the distorted saving-investment gap into balance. The banking sector credits increased, and the banks became exposed to exchange rate fluctuations and risks with the KAC. The banks gained from trading in the financial markets. These gains were in high amounts in general, but at times of sudden speculative outflows of capital the gains decreased severely, and the banking sectors confronted the approaching crisis inevitably. The real rate of growth of GNP however, fluctuated throughout the 1985-2001 period due to speculative in and outflows of capital.

Figure 5.3 illustrates the capital flows by their maturities, by taking the net FDI, PI and short-term capital movements into account. The fluctuations in the short-term capital flows are notable. The FDI amount in the period between 1989 and 1998 was fluctuating

around the interval of 500-800 million US \$. The decrease in the PI is obviously observed in 2001.



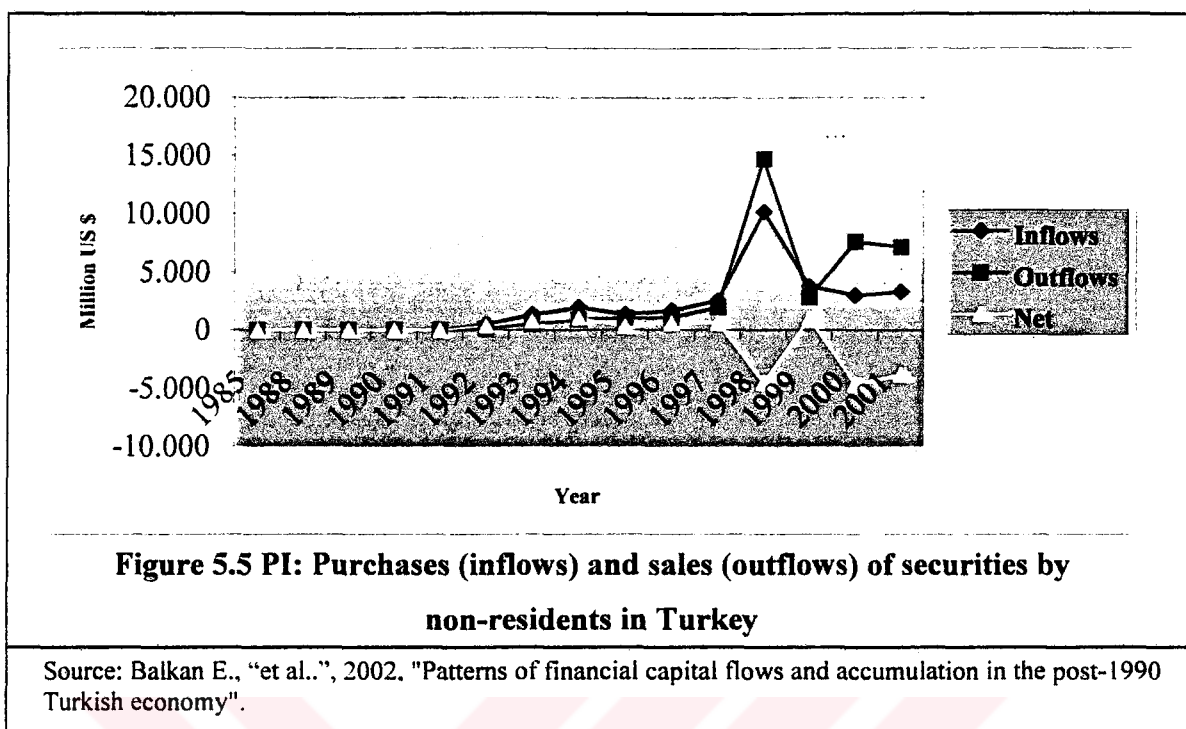


Figure 5.4 shows the sales and purchases of securities by residents abroad. Note that, the sales of securities by residents abroad create inflows of capital, whereas the purchases of securities by residents abroad create outflows.

Figure 5.5 shows the purchases and sales of securities by non-residents in Turkey. Note that, the purchases of securities by non-residents in Turkey create inflows, whereas the sales of securities by non-residents in Turkey create outflows.

5.3.4. FDI

5.3.4.1 FDI in Turkey between 1989-2002

Table 5.3 shows an increase in the amount of the capital inflows. The inflows reach their peaks (amounting up to 33288 million USD) in 2001, but after that year suddenly start to decrease. The outflows of capital start two years after the KAC. The outflows reach their highest level (725 million USD) in 2000, and just like the inflows they decrease after that year. The decrease in the outflows of capital indicates that the TL is appreciating, whereas the decrease in the inflows indicates that the level of FDI is affected adversely. The realized net capital flows reach their highest level (3,266 million USD) due to the

increase in inflows in 2001, but after that year drop severely. It should be noted that the realized amounts of net capital flows have only exceeded the permitted annual amount in year 2001.

<i>Million US\$</i>	Permits		Realized		
	Cumulative	Annual			
1989	4.466	1.512	663	0	663
1990	6.327	1.861	684	0	684
1991	8.294	1.967	907	97	810
1992	10.114	1.820	911	67	844
1993	12.178	2.063	746	110	636
1994	13.655	1.477	636	28	608
1995	16.593	2.938	934	49	885
1996	20.429	3.836	914	192	722
1997	22.107	1.678	852	47	805
1998	23.754	1.647	953	13	940
1999	25.454	1.700	813	30	783
2000	28.931	3.477	1.707	725	982
2001	31.656	2.725	3.288	22	3.266
2002	33.899	2.243	590	5	585
2003	35.107	(1)1208	(2)417	(2)8	(2)409
Total					

Source: SPO and UT.

(1):January-June. (2): Jan.-December

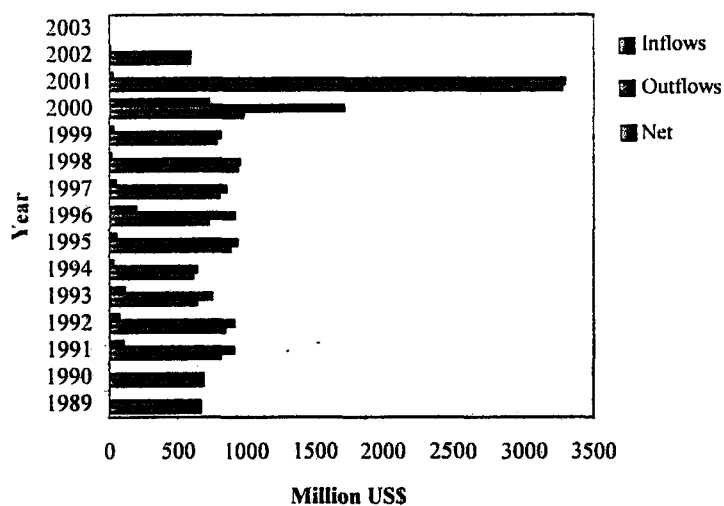


Figure 5.6 FDI by years

Source: SPO and UT.

Figure 5.6 illustrates the realized capital in and outflows, together with the net flows.

Table 5.4 shows that total permitted investment amount of foreign firms are not realized for the analyzed period. Hence, the total capital of firms was lower than the permitted amount of investment each year, except 1994. Only in year 1994, the total capital of firms approximately doubled the total permitted investment amount of foreign firms. In 1996, although the total permitted investment amount of foreign firms was very high (1,250,652 billion TL), the total capital of firms for 1996 was very low (235,971 billion TL). Between 1997 and 2003, investment of foreign firms never exceeded the permitted amount in Turkey. The FDI permitted amounted up to 30,944 million US \$ in total between 1989 and 2002. The inflow of capital only summed 15,050 million US \$ for the same period. Hence, the permitted amount was approximately twice the amount of capital inflows. Hitherto, FDI still remained to be an open sore in terms of the Turkish economy.

Table 5.4 Foreign investment in Turkey in 1989-2002					
Years	Foreign Investment Permitted (Million US\$)	Total Permitted Investment Amount (Million US\$)	Number of Firms (Accumulated)	Total Capital of Firms (Billion TL) (Accumulated)	Inflow (Million US\$)
1989	1.512		1.525	4.848	663
1990	1.861		1.856	7.944	684
1991	1.967		2.123	13.181	907
1992	1.820		2.330	23.441	911
1993	2.063		2.554	36.757	746
1994	1.477		2.830	62.450	636
1995	2.938		3.161	113.014	934
1996(*)	3.836		3.582	235.971	914
1997	1.678		4.068	350.968	852
1998	1.647		4.533	322.601	953
1999	1.700		4.950	1.446.818	813
2000	3.477		5.328	1.663.462	1.707
2001	2.725		5.841	6.181.412	3.288
2002	2.243		6.280	10.027.758	1.042
TOPLAM	30.944				15.050
(*) Includes the approval of 2.3 billion US\$ for the French Project on Metropolitan Area of Silivri-İstanbul.					
Source: UT.					

5.3.4.2. FDI by sectors

The classification of FDI approvals by sectors in terms of percentage share of the sector in total as of the year of KAC's implementation illustrates that the manufacturing sector's share was quite high until 1996 (between 62%-76%). The manufacturing sector drew more than half of the total FDI approvals at the mentioned period. The share severely declined to 16,7% in 1996 (a year after the Customs Union Agreement with the EU), and remained between 52%-66%, during 1997 and 1999. From 2000 till the end of 2003, the share of manufacturing was below the 50% threshold (between 32%-40%). The services share in total FDI approvals remained low until 1996 (between 22%-42%) when compared to the manufacturing share for the same period. In 1996, the services share increased tremendously to 81%, followed by a decrease back to a level below 50% (between 32%-46%, during 1997-1999) of the total. Between 2000-2003, there was a rise in the services share (between 48%-66%), mainly due to the decrease in the manufacturing share. The mining and agricultural sectors' FDI approvals remained very low, when compared with the other two sectors (Figure 5.7).

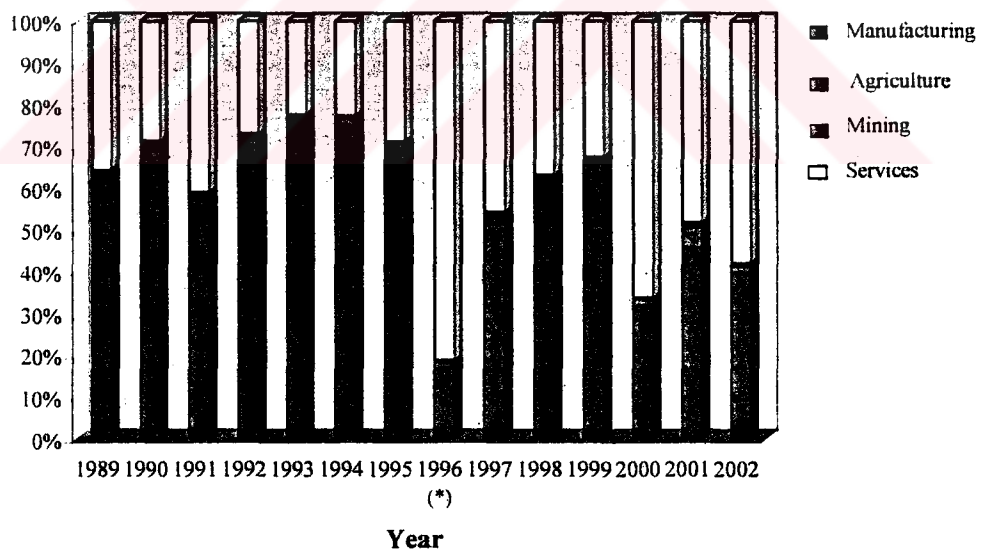


Figure 5.7 Classification of FDI approvals by sectors (%)

Source: UT.

(*) Includes the approval of 2.3 billion US\$ for the French Project on Metropolitan Area of Silivri.

(%) share of the sector in total.

5.3.4.3. FDI by countries

France's FDI approval was the highest total amount (5,522 million US \$) for the years between 1989-2002. Netherlands (5,195 million US \$) and Germany (3,908 million US \$) followed France in terms of the FDI approvals. The lowest total amounts were 27, 48, and 78 million US \$ recorded by U. A. E., Syria and Iran. The highest amount of approval (3,833 million US \$) was given in 1996, which included the approval of 2,3 billion US \$ for the French project. Other countries' total amounted to 2,830 million US \$. The end total of all the countries' totals for the period between 1989 and 2002 was 25,976 million US \$. The total permitted investment amount stated as 30,944 million US \$ in Table 5.3 was not realized for the analyzed period (Table 5.5).

5.3.5. PI

5.3.5.1. Financial deepening in Turkey

The PI rather than the FDI increased due to speculative attacks on the Turkish economy. The volatility of hot money flows (that were short-term flows) gained momentum and these types of flows left the economy in a vulnerable and fragile position. FDI consisted a small amount in the total capital flows. The short-term flows and arbitrage opportunities consisted the larger amount in terms of the economy.

Table 5.6 shows the financial assets and monetary indicators in Turkey between 1988 and 2000 as a percentage of the GNP. The analysis of the securities by issuing sectors shows that the private sector's share remains very low, when compared to the public sector's shares for the 1988 - 2000 period. Thus, the total of the securities by issuing sectors as a percentage of the GNP increased as a result of the increasing issues of public sector government bonds and treasury bills. The monetary indicators illustrate that the total deposits increased throughout the period, reaching their highest level in 1999 (39.5%). After the KAC and with the new issues of government bonds and treasury bills, the deposit rates and the real interest rates increased. Hence, the time deposits as a percentage of the GNP increased after 1996. The FX deposits also increased as a result of the financial deepening, increasing interest rates and mostly as an outcome of the implementation of the

COUNTRIES	Table 5.5 Distribution of FDI approvals by countries (Million US \$)												TOTAL		
	1989	1990	1991	1992	1993	1994	1995	1996(*)	1997	1998	1999	2000		2001	2002
France	233	669	249	354	223	255	476	2,370	104	136	147	34	138	134	5,522
USA	137	128	461	198	248	158	231	179	174	297	293	291	316	311	3,422
Netherlands	149	34	280	273	179	194	559	339	206	352	235	1,381	635	379	5,195
Germany	131	146	196	202	145	223	392	226	282	330	407	637	319	272	3,908
Switzerland	167	128	109	204	136	54	328	157	50	102	51	35	86	149	1,756
UK	281	286	81	109	120	47	161	165	122	44	88	98	507	248	2,357
Italy	74	66	181	120	419	164	99	43	125	129	95	18	34	244	1,811
Japan	74	103	55	37	237	126	284	21	127	18	14	151	259	129	1,635
S. Arabia	11	5	44	34	15	8	12	9	10	17	14	9	14	8	210
Canada	6	2	51	23	58	37	41	1	0	13	2	3	1	4	242
Belgium	30	18	8	20	21	13	36	70	8	18	23	162	8	10	445
S. Korea	1	17	1	10	93	1	16	31	18	3	14	114	2	4	325
Bahrain	1	4	7	50	26	12	6	18	4	25	0	0	0	1	154
Denmark	32	16	5	4	5	9	4	0	14	4	11	10	70	5	189
Singapore	30	26	10	14	15	1	18	6	8	0	0	3	0	0	131
Sweden	12	16	14	14	6	9	12	22	8	19	7	9	2	8	158
Iran	12	5	3	9	6	4	6	5	10	5	2	2	5	4	78
I.F.C.	6	9	6	10	2	21	10	7	4	3	0	0	10	0	88
Panama	4	3	2	3	4	2	18	0	0	1	0	51	133	28	249
Austria	8	7	8	9	6	4	33	11	8	6	16	28	2	20	166
U. A. E.	4	6	8	0	3	0	0	1	1	0	0	0	3	1	27
Syria	4	11	4	1	3	2	1	10	5	1	2	1	1	2	48
Other countries	105	157	185	123	91	132	195	142	392	125	279	440	182	282	2,830
TOTAL	1,512	1,862	1,968	1,821	2,061	1,476	2,938	3,333	1,680	1,648	1,700	3,477	2,727	2,243	25,976

(*) Includes the approval of 2.3 billion US\$ for the French Project on Metropolitan Area of Siliври-Istanbul.

Source: UT.

Table 5.6 Financial deepening in Turkey: Financial assets and monetary indicators (% of GNP)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
I. Securities by issuing sectors														
Public Sector	6,9	7,7	5,5	7,4	15,9	16,8	22,7	19,8	35,3	22,9	29,4	38,7	37,5	
Government Bonds	3,0	3,9	3,2	1,8	6,8	7,5	4,8	4,4	8,3	8,0	2,5	27,3	32,3	
Treasury Bills	4,0	3,3	2,1	5,4	8,7	9,0	16,7	15,4	24,8	14,9	26,9	11,3	5,2	
Private Sector	0,9	1,0	1,0	1,0	1,7	3,8	2,1	2,1	1,0	1,0	1,0	1,1	4,6	
Shares	0,3	0,4	0,5	0,7	0,5	0,5	1,0	0,5	0,6	0,7	0,8	0,9	2,4	
TOTAL	7,8	8,7	6,5	8,5	17,6	20,6	24,8	21,9	36,3	23,9	30,4	39,8	42,1	
II. Monetary Indicators														
Currency in circulation	2,7	3,0	2,9	2,7	2,7	2,6	2,6	2,4	2,1	2,2	2,1	2,6	2,6	
M1	8,8	8,5	7,9	7,4	7,1	6,5	5,9	5,0	5,6	4,7	4,3	6,3	6,5	
M2	21,1	20,5	18,0	18,5	17,3	14,1	16,2	16,0	18,7	17,9	20,3	28,9	26,0	
M2Y	28,4	26,6	23,5	26,5	26,6	23,7	30,7	30,7	36,8	34,5	36,3	51,3	45,4	
Total Deposits	15,7	16,6	15,7	15,9	18,3	19,0	24,6	26,0	29,3	27,0	27,7	39,5	33,6	
Demand Deposits	3,4	3,4	3,3	2,8	2,5	1,0	0,9	0,7	0,7	0,7	0,5	0,8	0,7	
Time Deposits	7,2	8,8	8,3	8,1	8,1	5,3	7,6	8,1	10,5	9,8	11,2	16,3	13,6	
FX Deposits	4,2	3,8	3,6	4,7	7,3	12,7	16,2	17,3	18,0	16,5	16,0	22,4	19,3	
Banking Sector Credits	17,6	16,1	16,5	12,4	12,7	14,0	13,3	16,5	18,5	21,7	19,4	20,1	20,4	
III. Securities Markets														
Stock Exchange Trading Volume (a)						115	773	5.854	8.502	8.567	21.771	23.202	52.311	36.696
Government Securities Direct														
Transactions Trading Volume (a)									312	2.403	8.828	16.509	32.736	
Repo-Reverse Repo Trading Vol.(a)										4.794	23.704	123.254	221.405	

(a) Millions US\$.

Source: Boratav K. and Yeldan, E. 2001, "Turkey, 1980-2000: Financial liberalization, macroeconomic (in-)stability, and patterns of distribution".

KAC. The KAC led to a decline in the total banking credits between its implementation in 1989 and 1995. From 1996 on, the credits increased. The data about the securities market's Repo – Reverse Repo trading volume goes back to 1997 and was 4,794 million US \$ for that year. It made a tremendous increase and reached 221,405 million US \$ by the end of year 2000. The banking system marketed the treasury bills to customers through *repo transactions*. Hence, the securities issued by the public sector and the increasing FX deposits increased the financial depth of the Turkish economy.

5.3.5.2. Outstanding securities

Table 5.7 illustrates the outstanding securities in terms of billions of TL and percentage change from previous period for years 1989 – 2002. The analysis of the total amounts for the period shows that the total amount of outstanding securities increased rapidly from 23, 478 billion TL to 164,115,343 billion TL throughout the years. The shares also increased within the same period (from 6,727 to 13,176,817).

The outstanding corporate bonds increased till 1998 (other than the decrease in 1994), and from then on started to decrease and finally reached zero balance in 2002. The outstanding commercial papers increased up to 1,198 billion TL until 1993, and decreased to 213 billion TL in 1994. A rapid increase was recorded until 1997, and from then on the outstanding commercial papers balance remained zero till the end of 2002. The outstanding ABS remained zero till 1992, and suddenly peaked in 1992 (9,043 billion TL) and 1993 (36,583 billion TL). In 1994 it decreased to 19,950 billion TL and rapidly reached 66,785 billion TL in 1995. From 1996 onwards it declined and finally reached zero balance in 1999. As of 2002, the balance remained the same.

The outstanding government bonds made a remarkable progress and continuously increased from 10,863 billion TL in 1989 to 112,849,835 billion TL in 2002. The outstanding treasury bills also made the same remarkable progress as the government bonds by reaching 37,019,856 billion TL in 2002 from 3,537 billion TL in 1989. The outstanding revenue share certificates reached its highest level in 1994 and decreased rapidly until it reached zero balance in 1997. The balance remained the same as of 2002.

The outstanding FX indexed bonds increased up to 38,469 billion TL in 1994, and then onwards started to decrease. The zero balance reached in 1997 remained the same as

Table 5.7 Outstanding securities

	(Billion TL)											(% Change From Previous Period)							
	Shares	Corp. Bonds	Comm. Paper	ABS	Gov't Bonds	Treasury Bills	Rev.Sh. Cert.	FX Ind. Bonds	Privatization Bonds	Total	Shares	Corp. Bonds	Comm. Paper	ABS	Gov't Bonds	Treasury Bills	Rev.Sh. Cert.	FX Ind. Bonds	Privatization Bonds
1989	6.727	776	490	0	10.863	3.537	685	400	0	23.478	114,8	43,9	190,9	0	122,6	39,2	17,1	0,0	0
1990	14.476	1.391	209	0	18.801	5.469	800	300	0	41.446	115,2	79,3	-57,4	0	73,1	54,6	16,8	-25,0	0
1991	32.304	1.656	532	0	24.678	18.258	100	1.663	0	79.191	123,2	19,0	155,0	0	31,3	233,9	-87,5	454,5	0
1992	49.139	1.671	756	9.043	86.388	42.247	0	6.240	0	195.484	52,1	0,9	42,2	0	250,1	131,4	-100,0	275,1	0
1993	71.286	1.668	1.198	36.583	190.506	64.488	0	15.886	0	381.615	45,1	-0,2	58,4	304,6	120,5	52,6	0	154,6	0
1994	109.239	1.412	213	19.950	232.825	304.230	20.380	38.469	0	726.718	53,2	-15,3	-82,2	-45,5	22,2	371,8	0	142,2	0
1995	223.804	2.355	1.533	66.785	511.769	631.298	12.419	21.847	25.000	1.496.810	104,9	66,8	619,0	234,8	119,8	107,5	-39,1	-43,2	0
1996	242.725	2.719	2.880	8.011	1.250.154	1.527.837	4.457	13.660	52.802	3.105.245	8,5	15,5	87,9	-88,0	144,3	142,0	-64,1	-37,5	111,2
1997	909.295	3.897	2.200	13.150	3.570.811	2.374.990	0	0	147.426	7.021.769	274,6	43,4	-23,6	64,1	185,6	55,4	-100,0	-100,0	179,2
1998	1.885.946	5.494	0	7.305	5.771.980	5.840.906	0	0	176.801	13.688.432	107,4	41,0	-100,0	-44,4	61,6	145,9	0,0	0,0	19,9
1999	3.793.195	2.533	0	0	19.683.393	3.236.753	0	0	382.708	27.098.582	101,1	-53,9	0,0	-100,0	241,0	-44,6	0,0	0,0	116,5
2000	6.866.817	1.163	0	0	34.362.937	2.057.684	0	0	381.593	43.670.194	81,0	-54,1	1,0	0,0	74,6	-36,4	0,0	0,0	-0,3
2001	10.515.933	1.163	0	0	102.169.784	20.029.334	0	0	730.892	133.447.105	53,1	0,0	1,0	0,0	197,3	873,4	0,0	0,0	91,5
2002	13.176.817	0	0	0	112.849.835	37.019.856	0	0	1.068.835	164.115.333	25,3	-100,0	1,0	0,0	10,5	84,8	0,0	0,0	46,2

Source: UT.

of 2002. The outstanding privatization bonds increased rapidly from zero balance in 1989 to 25,000 billion TL in 1995, and continued to increase at the same pace till a balance of 1,068,835 was reached in 2002.

The analysis of the percentage change from previous period indicates that, due to the zero balance of the outstanding ABS, revenue share certificate, and FX indexed bonds the percentage change of these securities for 2000-2002 remained zero. The outstanding shares and corporate bonds percentage change decreased rapidly during the 1989 – 2002 period. The outstanding commercial papers percentage change decreased to 1% in 2002, from 190,9% in 1989. The outstanding government bonds percentage change increased from 122,6% in 1989 to 197,3% in 2001, and suddenly decreased to 10,5% in 2002. The outstanding treasury bills percentage change increased from 39,2% in 1989 to 873,4% in 2001, and suddenly decreased to 84,8% change from the previous year in 2002. The outstanding privatization bonds percentage share decreased to 46,2% in 2002 from 111,2 in 1996. Hence, the highest percentage of change was realized with the government bonds and treasury bills in 2001. Therefore, the major marketable securities by the commercial banks remained as the government bonds and treasury bills, during 1989 – 2002.

5.3.5.3. Speculative short-term flows of capital (hot money)

Table 5.8 illustrates the hot money flows and financial indicators of the economy. Other than the years 1988, 1991 and 1994, the return on hot money is positive between 1988 and 2000. The return on hot money shows the net return gained by switching to TL and back, in other words the arbitrage return, which increases the vulnerability of the economy to exchange rate changes. The inflows of the banking sector foreign credits increased and reached 209,432 million US \$ in 2000, with the exception of the year 1994. The net short-term capital outflows are recorded for the same years and 1989. The highest outflow of -5,127 million US \$ was realized in 1994, and coincided with the crisis of that year. The sign of the return on hot money and the in and outflows of the foreign credits of the banking sector are in correspondence with each other, except for the year 1991. Although the inflows outweighed the outflows that year, the sign of the return on hot money was negative, indicating a decrease in arbitrage gains. The CAB mostly reported deficit for the 1988–2000 period. The CAB deficit amounted up to its highest level (-9,765

Table 5.8 Speculative short-term capital (hot money) flows and financial indicators (Millions US \$)

	Banking Sector		III BOP Errors & Omissions (b)	Net Short Term Capital Flows (b)	CAB (b)	Reserves at CB	Currency Substitution (c)	ISE Composite Index (d)	ISE Trading Volume
	Return on Hot Money (a)	Foreign Credits							
	I Inflows	II Outflows							
1988	-0,073		515	-2.281	1.596	2.480	27,0	374	105
1989	0,236		971	-584	961	4.537	23,0	2.217	817
1990	0,293		-468	3.000	-2.625	5.759	22,5	3.255	5.854
1991	-0,038	43.186	948	-3.020	250	4.813	29,5	4.369	8.504
1992	0,154	64.767	-1.190	1.396	-974	6.107	39,9	4.004	8.567
1993	0,045	122.053	-2.222	3.054	-6.433	6.277	50,2	20.682	21.771
1994	-0,315	75.439	1.769	-5.127	2.631	6.906	53,0	27.257	23.202
1995	0,197	76.427	2.354	3.713	-2.339	12.043	54,8	40.024	52.311
1996	0,329	8.824	-1.787	5.945	-2.437	16.386	50,9	97.588	36.698
1997	0,278	19.110	-2.755	1.761	-2.638	18.610	48,6	345.100	57.178
1998	0,254	19.288	-1.985	2.601	1.984	19.718	45,1	259.800	69.696
1999	0,298	122.673	1.899	759	-1.364	23.587	45,2	1.502.900	82.931
2000	0,073	209.432	-2.677	4.035	-9.765	22.172	44,1	943.700	180.183

(a) $((1+R) / (1+E) - 1)$; R: The highest rate of return offered in the domestic market; E: TL Rate of depreciation.

(b) Inclusive of luggage trade after 1996.

(c) FX Deposits / Total Deposits of residents.

(d) Composite index at closing prices, end of year values based on TL. (1986 Jan=100).

Source: <http://www.bilkent.edu.tr/~yeldane/hotmoney.pdf>

million US \$) for the mentioned period in 2000. The increasing amount of capital inflows as an outcome of the increasing interest rates led to the appreciation of the domestic currency. The inflows of capital increased the growth in the economy, and the foreign currency was undervalued, while the TL was overvalued. The imports increased as a result of the appreciation, and Turkey was lending to other countries at the period. The rising imports and decreasing exports due to the overvaluation of the TL widened the CAB deficit even further. The reserves at the CBRT increased and reached 22,172 million US \$ in 2000. The ratio of the currency substitution (although fluctuating) increased from 27 in 1988 to 44.1 in 2000. The ISE composite index increased tremendously from 374 based on the TL end of year values, and closing prices (1986 Jan=100), to 1,502,900 in 1999, and 943,700 in 2000. The ISE trading volume also increased rapidly from 105 in 1988 to 180,183 in 2000. Hence, the overvalued TL and the high interest rates, the capital inflow generating private sector create a vicious circle, which the economy cannot break. The risk of capital flight is eliminated by; increasing the interest rates even higher, thereby triggering the inflows of capital, appreciation of the currency, and the increase in the CAB deficit once again.

5.3.6. KAC and domestic saving and investment

The macroeconomic balance at current prices show that, the GNP increased steadily from 1989 to 2002. The analysis of the 1989-2002 period shows that, the foreign deficit amount also increased in 1994 (57,323 billion TL), and severely in 2001 (-2,360,709 billion TL). The total investment which was 51,526 billion TL in 1989, increased rapidly until it came to a halt in 2001. It decreased from 31,176,799 billion TL in 2000 to 28,379,906 billion TL in 2001. In 2002, the total investment increased to 54,385,139 billion TL. The total consumption increased from 179,385 billion TL in 1989 to 226,314,374 billion TL in 2002 (Table 5.9).

The public disposable income also increased at the same period, until it suddenly decreased from 9,066,682 billion TL in 2000, to 5,760,829 billion TL in 2001. It increased to 17,014,973 billion TL in 2002 suddenly. The public consumption also increased from 1989 (18,372 billion TL) till the end of 2002 (35,030,157 billion TL). The 10,854 billion TL amount of public savings in 1989 decreased severely up until 2002, when it

Table 5.9 Macroeconomic balance (at current prices)

(Billion TL.)

	Estimate													
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Gross National Product	230.371	397.178	634.393	1.103.843	1.997.323	3.887.903	7.854.887	14.978.067	29.393.263	53.518.332	78.282.967	125.596.129	176.483.953	271.406.000
Foreign Deficit	541	12.710	13.328	22.049	96.906	-57.323	253.729	722.322	1.117.089	566.538	1.961.393	8.312.875	-2.360.709	9.293.512
Total Resources	230.911	409.888	647.721	1.125.654	2.094.229	3.830.580	8.108.617	15.700.389	30.510.351	54.084.869	80.244.360	133.909.004	174.123.244	280.699.512
Total Investment	1.526	100.195	148.779	259.976	551.136	839.695	1.988.499	3.690.310	7.389.747	12.703.289	18.554.616	31.176.999	28.179.906	54.385.139
Fixed Investment	51.836	89.892	150.156	258.406	525.506	952.322	1.882.225	3.757.812	7.728.372	13.022.212	17.328.839	28.573.893	33.470.391	47.080.557
<i>Public</i>	17.346	27.684	47.585	81.295	143.977	192.052	329.515	764.426	1.733.050	3.359.435	5.130.996	8.709.004	11.108.742	16.066.143
<i>Private</i>	34.490	62.208	102.571	177.111	381.529	760.270	1.552.710	2.993.386	5.995.322	9.662.778	12.197.844	19.864.889	22.361.649	31.014.414
Changes in Stocks	-310	10.303	-1.377	1.569	25.630	-112.627	106.274	-67.502	-338.625	-317.923	1.225.776	2.602.906	-5.090.485	7.304.582
<i>Public</i>	-393	8.580	673	-6.652	1.561	-50.632	-29.940	32.549	132.971	278.899	27.673	65.171	-1.475.148	-364.381
<i>Private</i>	83	3.723	-2.050	8.222	24.069	-61.995	136.214	-100.051	-471.596	-596.823	1.198.103	2.537.734	-3.615.337	7.668.962
Total Consumption	19.385	309.693	498.942	865.678	1.543.092	2.990.886	6.120.117	12.010.079	23.120.603	41.380.580	61.689.744	102.732.205	145.743.338	226.314.374
Public Disposable Income	30.226	53.390	75.504	125.533	191.330	372.154	743.955	1.211.481	3.383.094	4.912.167	5.202.223	9.066.682	5.760.829	17.014.973
<i>Public Consumption</i>	18.372	39.774	70.964	134.576	244.926	414.743	750.619	1.466.843	3.140.449	5.922.692	10.480.836	15.593.737	23.213.529	35.030.157
<i>Public Savings</i>	10.854	13.616	4.540	-9.043	-53.596	-42.589	-6.664	-255.362	242.645	-1.010.525	-5.278.613	-6.527.055	-17.452.700	-18.015.184
Public Investment	16.953	34.264	48.258	74.643	145.538	141.420	299.575	796.975	1.866.021	3.638.334	5.158.669	8.774.175	9.633.594	15.701.762
Private Disposable Income	200.144	343.787	558.889	976.072	1.805.993	3.515.749	7.110.932	13.766.587	26.010.168	48.606.165	73.080.744	116.529.446	170.723.124	254.391.027
<i>Private Consumption</i>	160.013	269.919	427.977	731.103	1.298.166	2.576.142	5.369.498	10.543.236	19.980.154	35.457.888	51.208.908	87.138.468	122.529.809	191.284.217
<i>Private Savings</i>	40.131	73.868	130.911	246.970	507.827	939.606	1.741.434	3.223.350	6.030.013	13.148.277	21.871.836	29.390.979	48.193.315	63.106.810
Private Investment	34.573	65.931	100.522	185.333	405.598	698.274	1.688.924	2.893.335	5.523.726	9.065.955	13.395.947	22.402.623	18.746.312	38.683.376
Private Savings Ratio	20.1	21.5	23.4	25.3	28.1	26.7	24.5	23.4	23.2	27.1	29.9	25.2	28.2	24.8
Total Domestic Savings	50.985	87.485	135.451	237.926	454.230	897.017	1.734.770	2.967.988	6.272.669	12.137.751	16.593.223	22.863.924	30.740.615	45.091.626
Fixed Investment / GNP	22.5	22.6	23.7	23.4	26.3	24.5	24.0	25.1	26.3	24.3	22.1	22.8	19	17.3
Domestic Savings / GNP	22.1	22.0	21.4	21.6	22.7	23.1	22.1	19.8	21.3	22.7	21.2	18.2	17.4	16.6

Source: UT.

finally reached -18,015,184 billion TL. The public investment amount (other than the slight decrease in 1994) increased in the mentioned period. The public savings - investment difference indicates a tremendous increase, and the negative sign indicates that the savings are lower than the investment for the public sector. The -6,099 billion TL difference in 1989, increased to -33,716,946 billion TL in 2002, with the exception of the decreases in 1994 (-184,009 billion TL) and 1997 (-623,376 billion TL).

The private disposable income increased rapidly between 1989 and 2002 from 200,144 billion TL to 254,391,027 billion TL. The private consumption followed the same trend, and increased from 160,013 billion TL in 1989 to 191,284,217 billion TL in 2002. The increase in the private savings however is remarkable and one should note that, 40,131 billion TL in 1989 reached 63,106,810 billion TL in 2002. The increase in private investment was also another notable figure in analyzing the private saving - investment difference. The private investment increased after the implementation of KAC, from 34,573 billion TL in 1989 to 38,683,376 billion TL in 2002. The private saving - investment difference due to the increase in the savings of the private sector reflected a positive sign, indicating that the both the savings and investment increased throughout the period.

The private savings ratio although fluctuating through the period increased from 20,1 in 1989 to 24,8 in 2002. The total domestic savings also increased steadily during those years. However, the fixed investment / GNP and domestic savings / GNP ratios demonstrate decreases from 22,5 and 22,1 consecutively in 1989, to 17,3 and 16,6 in 2002.

The increase in the interest rates, in order to attract foreign capital increases the savings, but has an inverse affect on the investments. Table 5.9 shows that, although, the private sector was able to increase its savings and investment due to rising capital inflows after the liberalization of the KA and in relation with the increase in private consumption, the public sector was not successful in doing the same. The saving - investment balance of the public sector was distorted as a result of the capital in and outflows. Hence, the negative public saving - investment differences, and the rising public consumption in 1989 -2002 period were covered by the hot money flows.

5.3.7. KAC and foreign exchange rates

Table 5.10 shows the foreign exchange buying rates between 1988 and 2002 for the US \$, DM, FF, Pound, Japanese Yen, Swiss Franc, Italian Lire and Netherland Guilder.

The percentage change results for the crises years 1994 and 2001 indicate severe depreciations of the TL against foreign currencies. The intensities and degrees of these crises differed from one another. The US \$ appreciated against the TL by approximately 170% in 1994, whereas the appreciation of the Swiss Franc reached 195% for the period.

The percentage change of the depreciation of the TL (from previous period) against the foreign currencies fluctuated between 74% (Japanese Yen) and 97% (Swiss Franc) in 2001.

A remarkable decrease in the depreciation, (indicating an appreciation in reality) against the US \$ (22.8%) and the Japanese Yen (18%) was recorded in 1990. The percentage changes for the years between 2000 and 2002 show that, (with the exception of 2001) the TL was on the appreciation trend in 2000. The degree of appreciation increased especially in 2002. In other words, when compared to 2001 percentage change rates it could be stated that, the high rate of appreciation of the TL was recorded against foreign currencies. The TL percentage change against the DM, FF, Italian Lire and Netherland Guilder was 17.2% in 2002, when compared with the previous period. The TL percentage change against the Japanese Yen was 20.2%, the US \$ was 22.9%, and the Swiss Franc was 34.2% in 2002. A significant appreciation of the TL against the Pound is observed in 2002. The TL appreciated from 1,761,310.40 against Pound in 2001 to 1,168,903.90 in 2002. The percentage change from the previous period reflects the appreciation of the TL against the Pound in 2002 with the negative sign (-33.6%).

Figure 5.8 graphs the changes in the real exchange rate taking 1987 as the base year. An appreciation is shown with an increase, and other than the crises years of 1994 and 2001, in which the TL depreciation is observed clearly, the appreciation of the domestic currency is visible. This path of appreciation is a serious outcome of the early KAC and inflows of speculation based hot money. Hence, it should be noted that the TL appreciation was observed as of the initialization of the KAC till 2002.

The full KAC or the deregulation of the KA led the domestic currency to follow the path of appreciation in general after 1989. The devaluations of 1994 and 2001 were

Table 5.10 Exchange Rates

(*)

<i>(Buying Rate)</i>								
	US Dollar	Deutsche Mark	French Franc	Pound Sterling	Japanese Yen	Swiss Franc	Italian Lira	Netherland Guilder
1988	1.431,1	812.9	239,6	2.546.8	11,1	974.8	1,1	722.3
1989	2.121,8	1.130.2	333,3	3.456.7	15,4	1.417.4	1,5	1.002.5
1990	2.606,3	1.621.1	481,4	4.671.1	18,1	1.893.2	2,2	1.439.6
1991	4.175,3	2.515.6	739,8	7.352.7	31,1	2.906.1	3,4	2.233.4
1992	6.874,4	4.428.2	1.306,4	12.089.2	54,4	4.927.2	5,6	3.933.0
1993	11.035,7	6.659.8	1.941,8	16.573.5	100,2	7.483.3	7,0	5.930.2
1994	29.788,3	18.567.4	5.425,9	45.858.0	294,2	22.062.4	18,6	16.564.5
1995	45.738,5	31.953.5	9.183,3	72.148.2	484,8	38.831.6	28,2	28.534.8
1996	81.386,2	53.981.2	15.890,8	127.709.9	742,3	65.655.6	52,9	48.182.2
1997	152.071,3	87.368.1	25.944,5	249.162.2	1.254,4	104.633.7	88,5	77.520.0
1998	261.045,3	149.135.0	44.440,5	432.653.8	2.003,3	180.692.4	150,1	132.117.1
1999	420.126,2	227.870.8	67.943,0	679.192.7	3.727,6	278.005.2	230,2	202.239.3
2000	623.704,0	293.452.2	87.496,9	942.157.4	5.780,5	368.200.6	296,4	260.443.8
2001	1.225.411,8	559.191.5	166.731,0	1.761.310.4	10.042,3	725.346.4	564,8	496.291.9
2002	1.505.839,5	655.111.0	195.331,0	1.168.903.9	12.071,3	973.316.9	661,7	581.423.0
<i>(% Change From Previous Period) (**)</i>								
	US Dollar	Deutsche Mark	French Franc	Pound Sterling	Japanese Yen	Swiss Franc	Italian Lira	Netherland Guilder
1988	66,9	69.6	67,3	80.2	86,4	68.4	65,3	69.8
1989	48,3	39.0	39,1	35.7	38,3	45.4	41,2	38.8
1990	22,8	43.4	44,4	35.1	18,0	33.6	41,1	43.6
1991	60,2	55.2	53,7	57.4	71,2	53.5	53,9	55.1
1992	64,6	76.0	76,6	64.4	75,2	69.5	66,2	76.1
1993	60,5	50.4	48,6	37.1	84,2	51.9	25,2	50.8
1994	169,9	178.8	179,4	176.7	193,6	194.8	165,9	179.3
1995	53,5	72.1	69,2	57.3	64,8	76.0	51,3	72.3
1996	77,9	68.9	73,0	77.0	53,1	69.1	87,9	68.9
1997	86,9	61.8	63,3	95.1	69,0	59.4	67,4	60.9
1998	71,7	70.7	71,3	73.6	59,7	72.7	69,5	70.4
1999	60,9	52.8	52,9	57.0	86,1	53.9	53,4	53.1
2000	48,5	28.8	28,8	38.7	55,1	32.4	28,8	28.8
2001	96,5	90.6	90,6	86.9	73,7	97.0	90,5	90.6
2002	22,9	17.2	17,2	-33.6	20,2	34.2	17,2	17.2

(*) Average buying rates. (**) Devaluation or revaluation of foreign exchange /TL parity.

Source: UT.

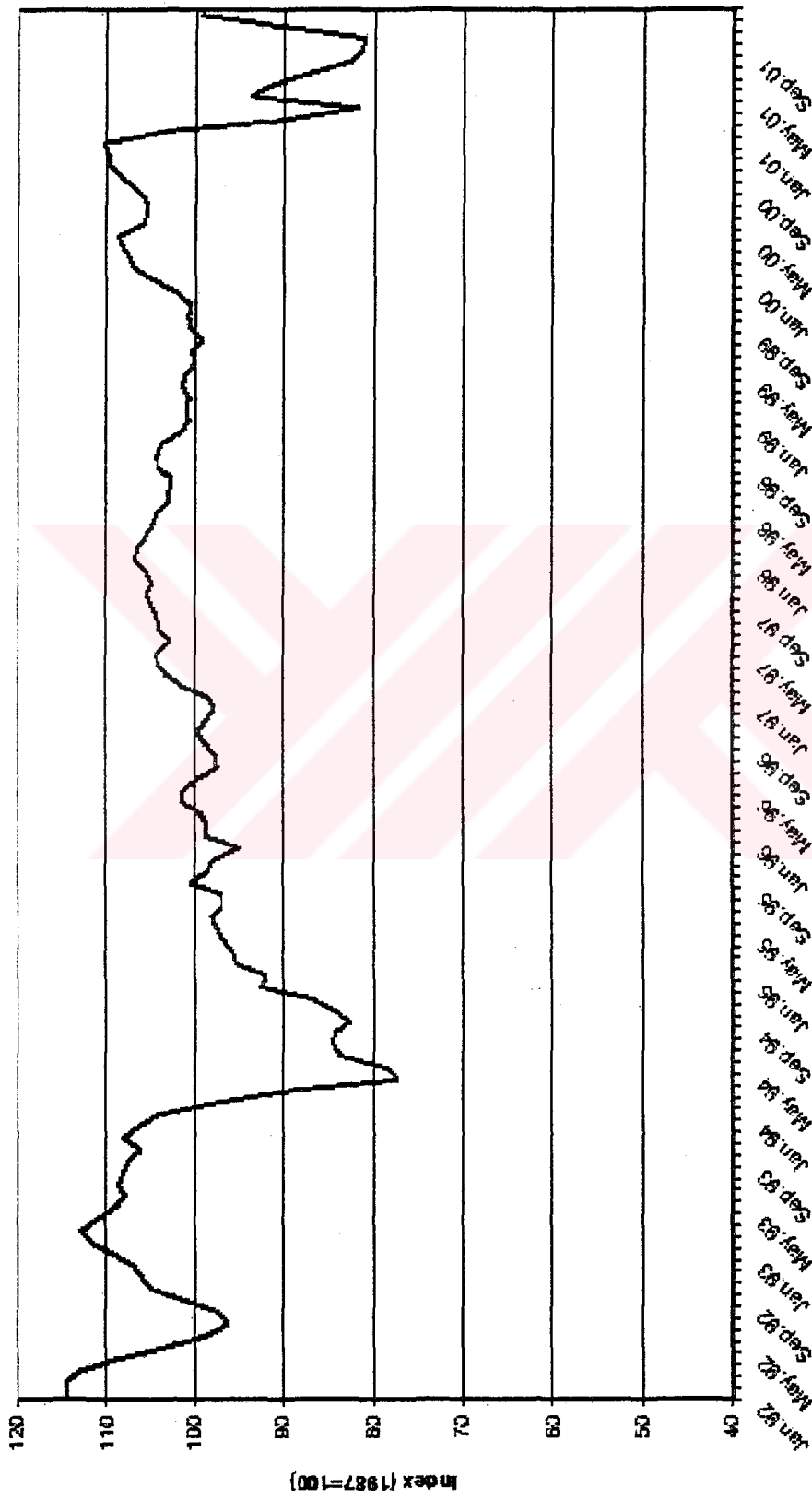


Figure 5.8 Real exchange rate, Turkey (1987=100)

Note: An increase indicates appreciation of TL.

Source: Balkan E., "et al.", 2002, "Patterns of financial capital flows and accumulation in the post-1990 Turkish economy."

exceptional, since their major aim was to bring the economy to balance and to decrease the BOP deficit.

The capital inflows after the full liberalization of the KA led to the appreciation of the domestic currency, thereby also increasing the amount of imports and the rate of growth of the economy. High interest rates were offered in order to withdraw foreign capital inflows. But, these flows were in the form of hot money and not FDI. Hence, PI provoked the capital to fly to other countries that offered higher interest rates, leaving the Turkish economy in a vulnerable position. The years 1994, 1999 and 2001 witnessed the growth (based on speculations) to come to a halt with severe crises.

Figure 5.9 demonstrates the exchange rate volatility in Turkey. The 1994 and 2001 crises are clearly visualized in the figure. But, the volatility observed in the remaining years is quite low for the period.

The usage of capital inflows to cover the public expenditures provided a relief for the economy, and thereby also increased the appreciation of the TL. The appreciation of the domestic currency led the CAB deficit to widen further, since the exports of Turkish goods became expensive for foreigners. The public sector's dominance in the economy and the high interest rates were two major problems faced.

Figure 5.10 depicts the changes in the CPI and WPI based (1995=100) real effective exchange rate indexes. It illustrates the depreciation in 2001 once again with a severe decrease.

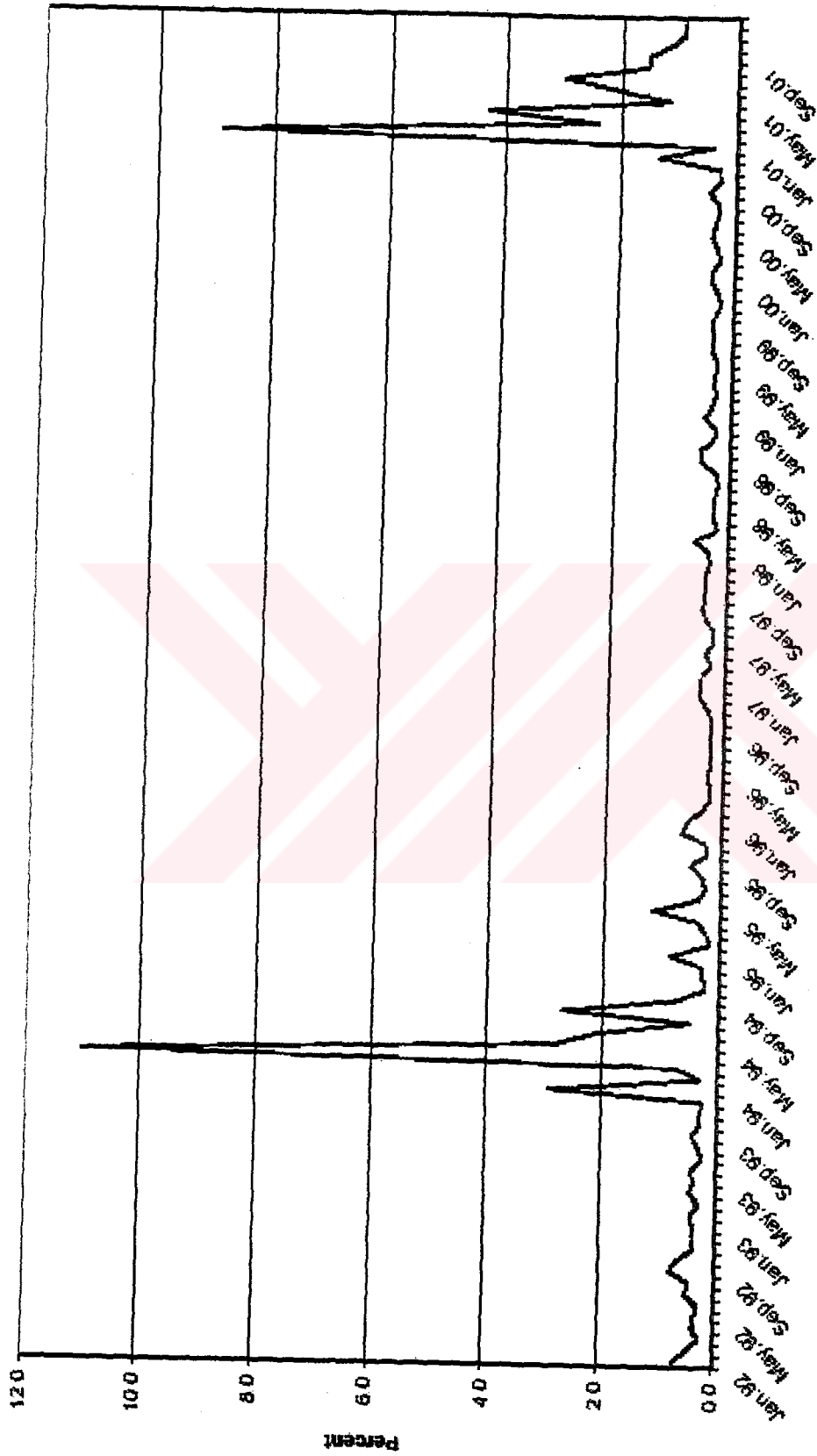


Figure 5.9 Exchange rate volatility in Turkey

Note: Exchange rate volatility is estimated as the standard deviation of 22 working day of a month.
 Source: Balkan E., "et al.", 2002, "Patterns of financial capital flows and accumulation in the post-1990 Turkish economy."

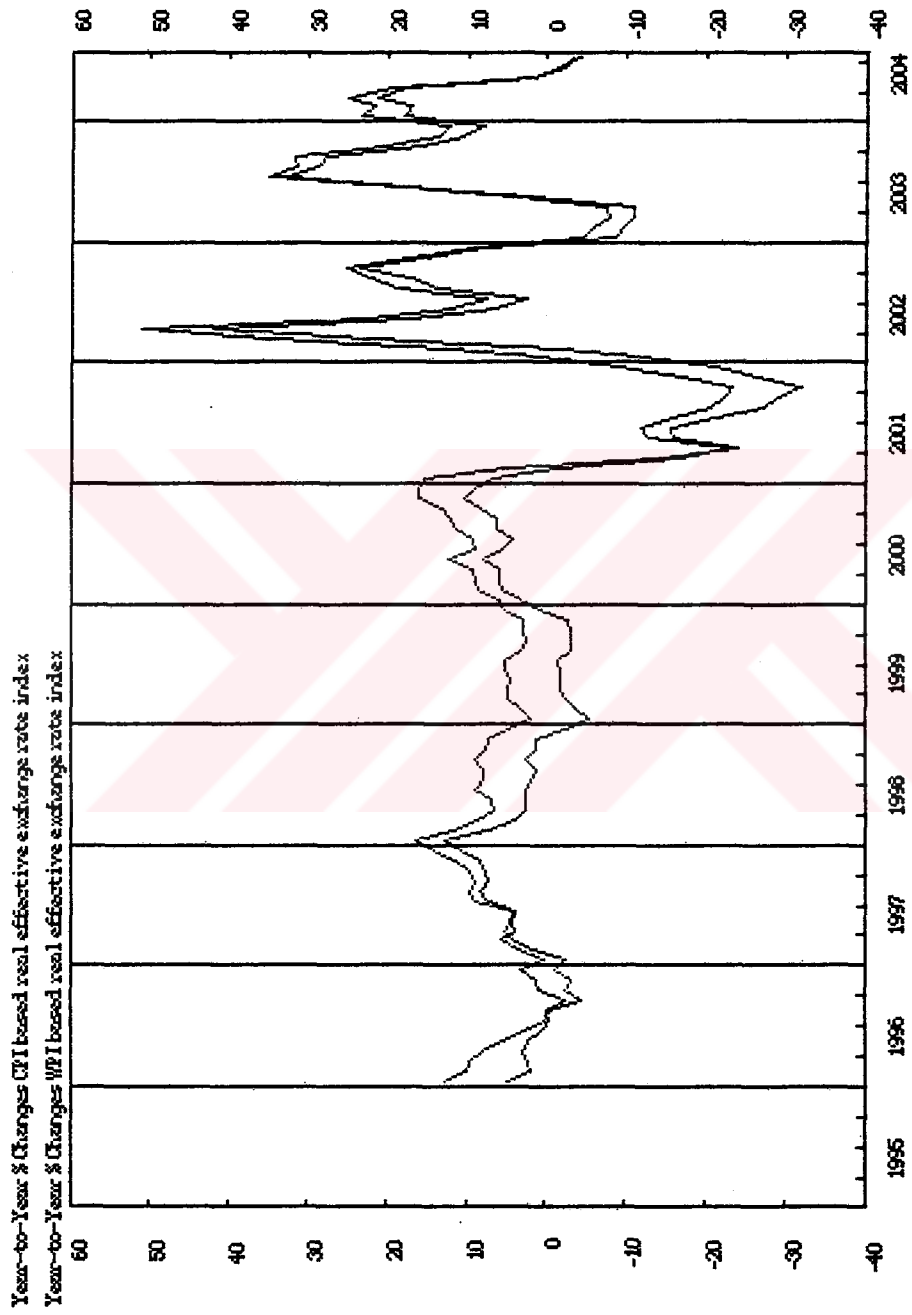
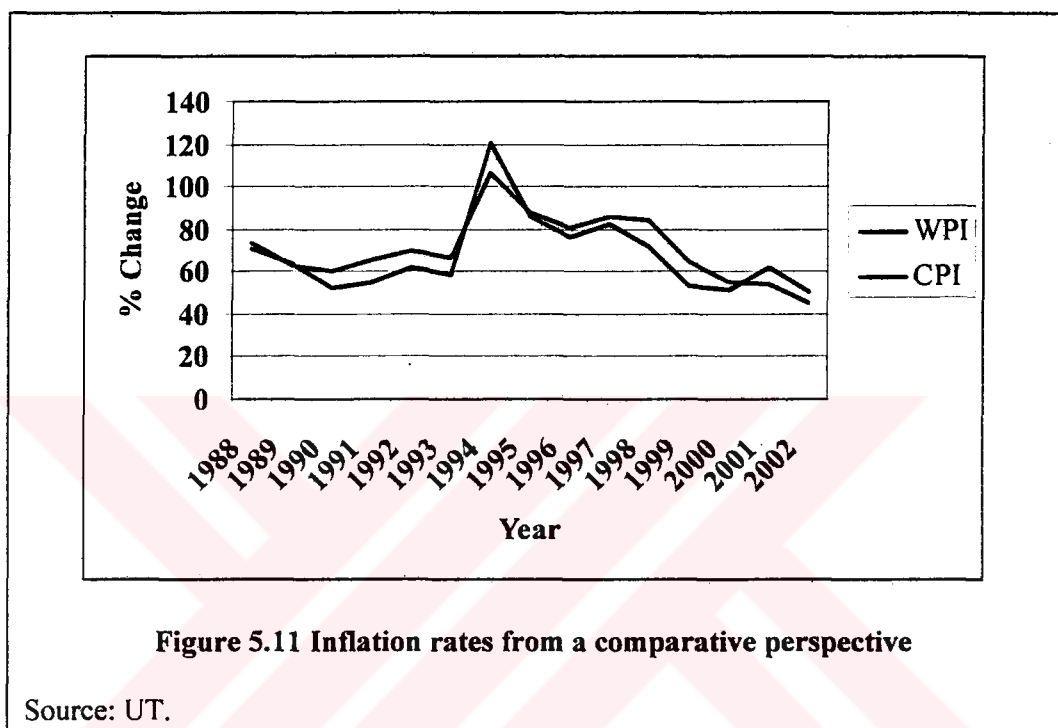


Figure 5.10 Real effective exchange rate (1995=100) (monthly)

Source: CBRT.

5.3.8. KAC and economic stability

5.3.8.1. KAC and inflation rates



Inflation rates are one of the factors affecting the stability and macroeconomic balance of the economy. Figure 5.11 shows the percentage changes in the WPI and CPI between 1988 and 2002. Table 5.11 details the percentage changes for both of the indexes, together with the annual values calculated according to the indicated base years.

The percentage changes in the inflation rates, taking the base year 1987 into account reflect high rates of inflation in terms of the WPI (120.7%) and CPI (106.3%) in 1994. Although, there seems to be a slight decrease in inflation after the KAC, one should note that the increase in inflation went approximately back to the same level for the WPI (62.2%), and exceeded the former level of CPI (63.3%) in 1992 (70.1%).

The appreciation of the TL, together with the increasing CAB deficit and aggregate demand in the economy led to inflationary pressures after the KAC. Hence, the percentage changes in the inflation rates, taking the base year 1994 into account once again reflected high rates of inflation in terms of the WPI (86%) and CPI (88%) in 1995. In 1997, the percentage change of inflation rates in terms of the WPI increased to 82%, whereas the

Table 5.11 Inflation rates					
Years	WPI	WPI	Years	CPI	CPI
(1987=100)	(% change)		(1987=100)	(% change)	
1988	71	171	1988	73,7	174
1989	63,7	280	1989	63,3	284
1990	52,1	426	1990	60,3	455
1991	55,1	661	1991	66,0	754
1992	62,2	1.072	1992	70,1	1.283
1993	58,4	1.698	1993	66,1	2.131
1994	120,7	3.747	1994	106,3	4.396
(1994=100)			(1994=100)		
1995	86	186	1995	88	188
1996	75,8	327	1996	80,4	339
1997	82	595	1997	85,8	630
1998	71,8	1.022	1998	84,6	1.163
1999	53,1	1.565	1999	64,9	1.918
2000	51,4	2.370	2000	54,9	2.970
2001	61,6	3.830	2001	54,4	4.586
2002	50,1	5.750	2002	45	6.649

Source: UT.

percentage change in the CPI increased to approximately 86%. From then on, the inflation rates steadily declined both for the WPI (50.1%) and the CPI (45%) up until 2002.

The appreciation of the domestic currency caused by the inflows of capital (which are attracted with high interest rates) after the 1994 crisis led to deflationary pressures in the economy, thereby decreasing the inflation rates through the years.

5.3.8.2. KAC and unemployment rate

Figure 5.12 (p. 108) shows the annual changes in the unemployment rates. Table 5.12 indicates that, the 8.7% unemployment rate in 1989 decreased by 1% in the following years and reached 7.7% in 1993. It slightly increased in 1994 to 8.1%, and decreased in the following two years until it reached 6% in 1996. From 1997 onwards, it increased steadily, with the exception of the year 2000, until it reached 8.4% in 2001. The outbreak of the 2001 crisis worsened the situation even further, by leading the unemployment rate to

Table 5.12 Total labor force and unemployment rate

	Total Labor Force (Thousand)	Unemployed Persons (Thousand)	Rate (%)
1989	20,620,10	1,803,60	8,7
1990	20,847,30	1,701,40	8,2
1991	21,438,00	1,703,00	7,8
1992	21,503,00	1,735,00	8
1993	21,469,00	1,665,00	7,7
1994	22,158,00	1,802,00	8,1
1995	22,673,00	1,568,00	6,9
1996	22,919,00	1,382,00	6
1997	21,824,50	1,463,50	6,7
1998	22,399,00	1,527,00	6,8
1999	23,187,00	1,773,50	7,6
2000	22,031,00	1,452,00	6,6
2001	23,491,00	1,967,00	8,4
2002	23,818,00	2,464,00	10,3
2003	23,640,00	2,493,00	10,5

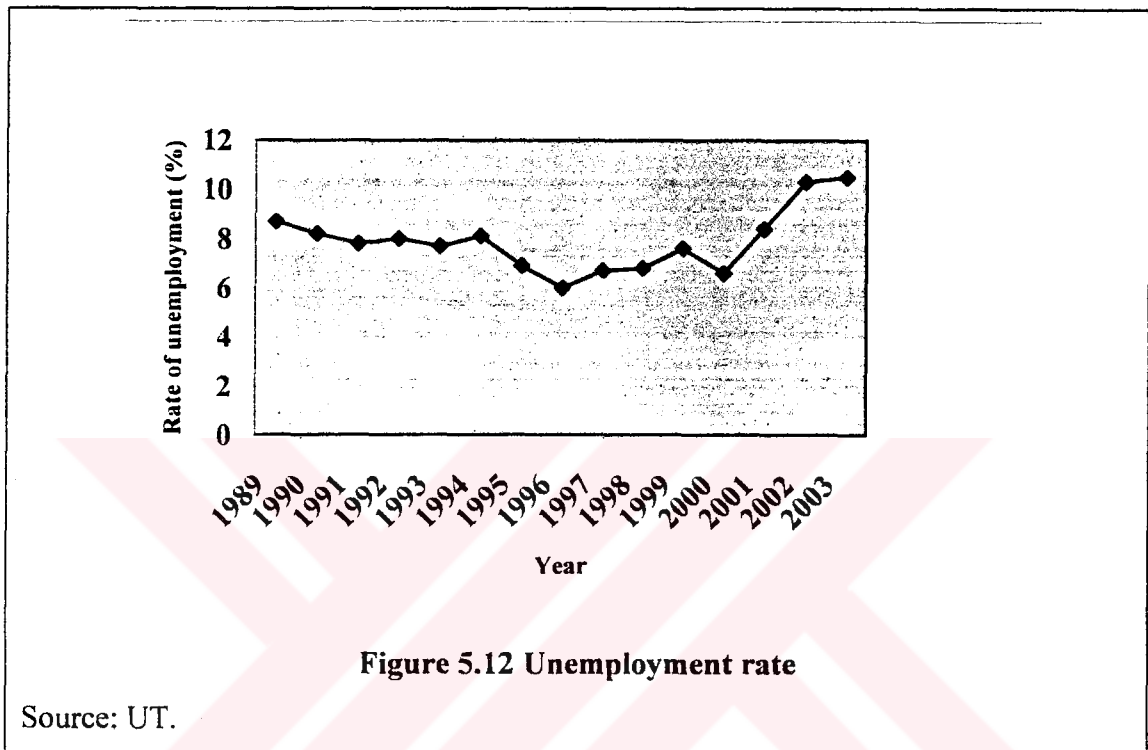
	Total Labor Force (Thousand)	Unemployed Persons (Thousand)	Rate (%)
2002 1st Quarter	21,917,00	2,531,00	11,5
2nd Quarter	24,233,00	2,259,00	9,3
3rd Quarter	25,247,00	2,414,00	9,6
4th Quarter	24,347,00	2,689,00	11
2003 1st Quarter	23,088,00	2,844,00	12,3
2nd Quarter	24,115,00	2,418,00	10
3rd Quarter	24,739,00	2,328,00	9,4
4th Quarter	23,206,00	2,396,00	10,3
2004 1st Quarter	22,732,00	2,830,00	12,4

Note: 1-) 1998-1999 figures are the weighted results of April and October Household Labour Force Survey (SIS).

2-) Since the year 2000, labour statistics have been announced quarterly.

Source: UT.

increase to its highest level, for the 1989-2003 period (10.5%). The first quarter of 2002 and 2003 reflect the highest unemployment rates (11.5% and 12.3%) for those years. But, the highest overall unemployment rate (12.4%) was recorded in the first quarter of 2004, for the period between 1989 and 2003.



The KAC was not able to decrease the unemployment rate, since the foreign investments were in the form of PI and not FDI. The FDI received by Turkey remained low for the period, and therefore the increase in the creation of employment that was expected to be one of the positive outcomes of the KAC was never achieved.

5.3.8.3. KAC and income distribution

Table 5.13 shows the distribution of annual household disposable income by types. The highest share in the disposable income for Turkey was observed in total entrepreneur (42.4%) in 1994, followed by salary and wages (23.7%) as the second highest share. Other shares included in the disposable income were the property income (19.3%), transfer (10%) and daily wage (4.6%) in 1994. The observation of the 2002 shares reflects that the total entrepreneur and salary and wages switched places. The salary and wages increased to

35.8%, followed by a decrease in the total entrepreneur share (34.5%) in 2002. Another switch in the ranking of the shares was recorded between the property income and transfer in 2002. The property income share decreased to 9.3%, whereas the transfer share increased to 17.5%. The last share's position remained the same, with a decrease to 2.9%.

The urban and rural areas' analysis show that, the urban area's shares behaved in the same way as the analysis stated above for Turkey in general. The total entrepreneur composed the highest share (33.3%) in 1994, and salary and wages constituted the highest share (41.9%) in 2002. The daily wage and property income shares decreased, whereas the transfer share increased from 1994 to 2002 for the urban area. The rural area's shares also acted in the same direction, with the exception of total entrepreneur share (52.7%) settling to the top of the list, unlike the shares of total entrepreneur that ranked second for the urban area and Turkey in 2002. Total entrepreneur recorded the highest share as 62.5% for 1994. The daily wage and property income shares decreased, whereas the transfer share increased from 1994 to 2002 for the rural area.

(%)	Turkey		Urban Area		Rural Area	
Types of Income	1994	2002	1994	2002	1994	2002
Total	100	100	100	100	100	100
Salary and Wages	23,7	35,8	27,4	41,9	15,7	23,1
Daily Wage	4,6	2,9	4,6	2,6	4,7	3,5
Total Entrepreneur	42,4	34,5	33,3	25,7	62,5	52,7
<i>Agriculture</i>	39,3	38,2	7,7	7,4	76,5	69,6
<i>Manufacturing</i>	10,4	9,7	16,4	13,1	3,3	6,2
<i>Construction</i>	4,1	3,8	7,1	6	0,7	1,5
<i>Trade</i>	33,9	28,3	50,6	44,7	14,3	11,7
<i>Services</i>	12,2	20,1	18,2	28,8	5,2	11,1
Property Income (1)	19,3	9,3	24,5	11,4	7,7	4,7
<i>Real Estate</i>	60,2	47,3	56,6	45,8	84,9	54,9
<i>Stocks and Shares</i>	39,8	52,7	43,4	54,2	15,1	45,1
Transfer	10	17,5	10,3	18,3	9,5	16
<i>Government</i>	69,2	81,3	72,1	82,1	62,3	79,4
<i>Abroad</i>	14,2	5,1	11	3,9	21,9	7,9
<i>Other</i>	16,5	13,6	16,9	14	15,7	12,7

(1) With the change of methodology that was made in the year 2002, "property income" has not been included by "personel income" since that year.

Source: UT and SIS.

The full liberalization of the KA led to an increase in the amount of transfers from the government, and a decrease in the daily wages in general. The salary and wages share approximately stayed equal to the total entrepreneur share for Turkey in 2002. The results for urban and rural areas are significant in the sense that, the share of the salary and wages increased for the urban area, whereas the increase in the rural area was observed in total entrepreneur's share. The entrepreneurs made a move towards the rural areas, where the salary and wages were low, in order to decrease their cost of capital.

Segmentation by 20%	Turkey			Urban Area			Rural Area		
	1987	1994	2002	1987	1994	2002	1987	1994	2002
First 20%	5,2	4,9	5,3	5,4	4,8	5,5	5,2	5,6	5,2
Second 20%	9,6	8,6	9,8	9,3	8,2	9,7	10	10,1	10,3
Third 20%	14,1	12,6	14	13,6	11,9	13,9	15	14,8	14,7
Fourth 20%	21,2	19	20,8	20,7	17,9	20,5	22	21,8	21,7
Fifth 20%	49,9	54,9	50,1	50,9	57,2	50,4	47,8	47,7	48
Gini Coefficient	0,44	0,49	0,44	0,44	0,51	0,44	0,42	0,41	0,42

Source: UT and SIS.

Table 5.14 depicts the annual household income segmentation by 20% for urban and rural areas and Turkey in general. It is remarkable to observe that, the distribution of annual household income segmentation by 20% for urban and rural areas and Turkey in general reflected the same results before KAC 1987 and in 2002. The fifth 20% of the annual household income constituted half of the total income segmentation, indicating that the payment of the incomes' of the employed persons were made according to the lowest income segmentation. However, the fifth 20%'s share of the income distribution increased by exactly 5% in 1994, for the urban area and Turkey in general. In the aftermath of the 1994, 1999 and 2001 crises, the share of the fifth 20% for the urban area and Turkey in general decreased back to the level before the KAC. The share of the rural area remained unchanged throughout 1987, 1994 and 2002. Unfortunately, the expectations of a higher standard of living and the solution of the problem of fairly equal income distribution were stemmed by the early and full liberalization of the KA.

5.3.8.4. KAC and money supply

The intervention of the CBRT to the financial markets became history as of the full liberalization of the KA. The money and financial markets solely determined the exchange and interest rates after the liberalization of the KA. The appreciation of the TL, in other words the decrease in the depreciation amount of the domestic currency was affected by the OMO or sterilization operations, since the CBRT used OMO as an indirect tool to influence the interest rates.

The CBRT applied expansionary OMO from 1993 to 1999. Hence, it increased the currency issued, reserve money, M1, M2 and M2Y money supplies substantially. The highest annual rate of change (115.9%) for M1 was observed in 1999. The highest annual rate of change (120.5%) for M2 was recorded in 1996, whereas the highest annual rate of change (125.5%) for M2Y was achieved in 1994. The annual rate of change for the currency issued fluctuated from 71% to 94% between the period of 1993 and 1999. The annual rate of change for the reserve money fluctuated from 66% to 93% between the period of 1993 and 1999.

The year 2000 was a turning point, in terms of the OMO and changes in the money supplies. The CBRT applied contractionary OMO and decreased the money supplies, the currency issued and the reserve money immensely. It sold bonds in order to decrease the inflation and its pressures. The prices decreased and the rates of interest increased. The increase in the rates of interest led to capital inflows and the depreciation amount of the domestic currency slowed down. Another aim behind the 2000 OMO was to increase the inflows of capital and uplift the growth rate of the economy after the crisis of 1999. The changes in the money supplies for 1999 reflect the tremendous increase in the money supplies in that year. The CBRT started to apply expansionary OMO once again from 2001 till 2003. In order to increase the money supplies, it bought bonds, led to a decrease in the deflationary pressures and interest rates. The results were observed as net outflows of capital between 2001 and 2003. The flight of capital led to the depreciation of the domestic currency, thereby leading the exports to increase and CAB deficit to decrease (Table 5.15).

Table 5.15 Money supplies (1)

(Billions TL)

	Currency Issued		Reserve Money		M1 Money Supply		M2 Money Supply		M2Y Money Supply(2)	
	Total	12 Month % Change	Total	12 Month % Change	Total	12 Month % Change	Total	12 Month % Change	Total	12 Month % Change
1993	63.104	80.1	101.721	66.2	129.087	83.0	291.976	59.6	533.048	84.1
1994	120.212	90.5	185.738	82.6	238.981	85.1	642.490	120.0	1.202.032	125.5
1995	223.935	86.3	343.484	84.9	396.047	65.7	1.270.423	97.7	2.424.609	101.7
1996	395.018	76.4	618.329	80.0	831.415	109.9	2.801.675	120.5	5.081.437	109.6
1997	719.328	82.1	1.142.167	84.7	1.378.604	65.8	5.264.529	87.9	10.128.836	99.3
1998	1.232.331	71.3	2.040.981	78.7	2.284.174	65.7	10.856.763	106.2	19.425.576	91.8
1999	2.390.748	94.0	3.932.065	92.7	4.931.262	115.9	22.596.061	108.1	40.119.310	106.5
2000	3772411	57.8	5948675	51.3	8209624	66.5	32812563	45.2	57167429	42.5
2001	5328876	41.3	7931613	33.3	11073270	34.9	46985987	43.2	104132803	82.2
2002	7707082	44.6	10662123	34.4	14258860	28.8	61195275	30.2	133450273	28.2
2003	10844508	40.7	15442662	44.8	21564149	51.2	80922936	32.2	149854800	12.3

Sources: SPO.

(1) Provisional figures.

It was taken from weekly CB Bulletin.

By the last Friday of the Month.

(2) In May 1998, M2X series changed by CB.

The outcome of KAC, in terms of the money supplies and the usage of OMO to influence the interest rates was the application of the expansionary OMO (with the exception of year 2000) in general. The CBRT used the OMO against inflationary and deflationary pressures in the economy. It applied expansionary OMO during deflationary pressures and contractionary OMO in the opposite cases, in other words inflationary pressures. The capital in and outflows were influenced by the degree and intensity of the sterilization operations.

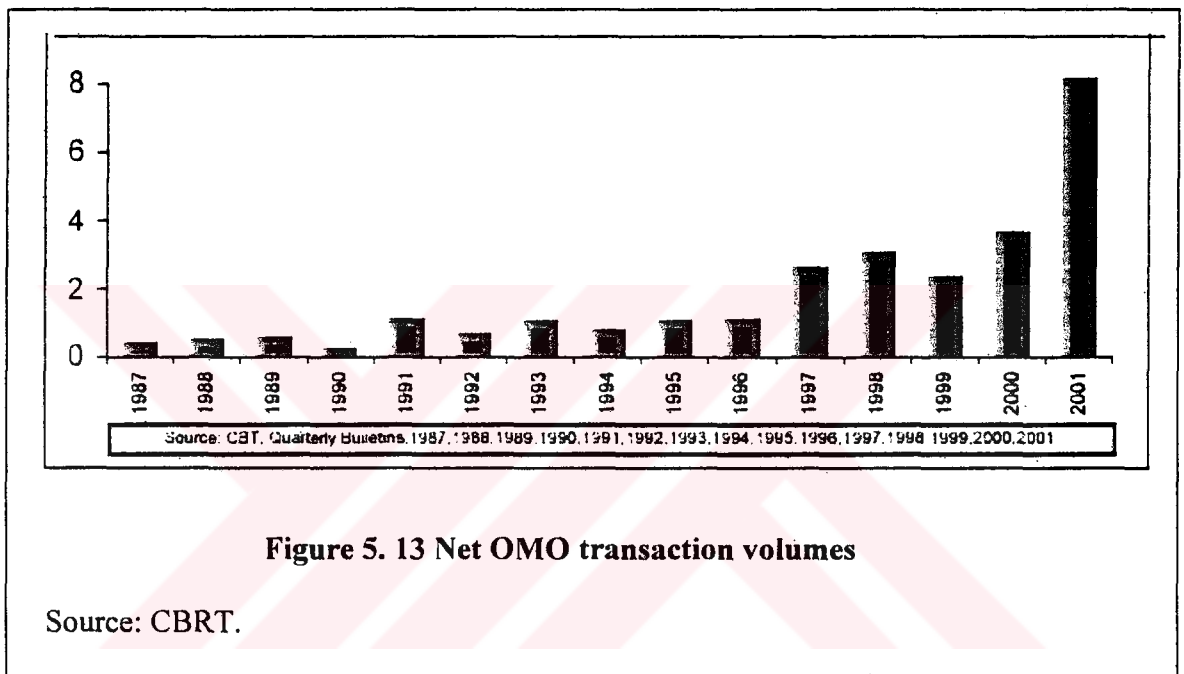


Figure 5.13 depicts the net OMO transaction volumes of the CBRT. The sterilization operations of the CBRT demonstrate a significant increase in 2001.

6. CONCLUSION

The KAC is a learning process and it leads to a decrease in liquidity restrictions. Looking back at Turkish experience and after the analysis of KAC in terms of the Turkish case, it is hard to suggest that the results are favorable for Turkey.

Turkey had its share from KAC's risks like the asymmetric information, herd psychology, moral hazard, crony capitalism, excess volatility, and contagion. These factors eventually led to financial crises in the Turkish economy. Although, the necessary reforms were made rapidly, the regulatory laws and prudential controls were not successfully set in order to decrease the risk of moral hazard, herd psychology and financial crisis. The reforms in the financial and banking sector were not carried on with continuous reforms in all other economic sectors in order to achieve a successful development.

The increased liquidity and systematic risks through contagion affected the economy after KAC. The capital controls were lifted before the strengths of financial institutions increased, and the full opening up of the CA was not finalized when the KAC was implemented. The volatility of flows was triggered by the full KAC.

The major requirement of full KAC being the macroeconomic stability under flexible exchange rates was not fulfilled in the Turkish case. The expectations of the FDI to increase due to decreasing capital controls ended in disappointment. Hence, incentives that promote FDI should be introduced in order to attract new foreign investment to Turkey.

The weaknesses of the economy were reflected with the KAC. The required successful construction of financial architecture, monitoring and control of international capital movements were not finalized at the implementation of the KAC. Hence, the financial institutions were not strong in terms of financial and institutional capacity in order to hedge the risks. The improvements in the structural framework and transparency which were expected to draw inflows and decrease the degree of risk, by increasing the credibility of the economy were a failure, and the developments in monitoring and controlling the financial sector were not made with caution. The calendar of the pacing and sequencing of the KAC was not prepared in advance, and the full KAC was witnessed as a big-bang or **premature liberalization** in Turkey.

The 1980-2003 period has been a rapid growth period for Turkey. Thus, it also had some burdens on the economy. The first decade has been a new policy implementation to

transfer technology to Turkey. The period of export orientation was formed under the new industrialization policy. All other policies like incentives, technology, infrastructure, organization, education and training, labor market and employment, employers', have affected the growth of the economy. The policy makers have thought of technology as an easy way for import substitution. This suggestion led to a neglect of optimization in the use of resources. With the introduction of export oriented policies the distribution of factors of production in the economy has become balanced. The newly increasing share of the private sector in the economy was influenced and was a by-product of the efforts of privatization.

There was an urgent need for close cooperation between the private sector and the government; for the establishment of an industrialization strategy; for the implementation of diverse incentives to be provided for a selected number of specific commodities. The growth of the capital stock of private businesses was to be reduced by the shift in the composition of investment away from manufacturing.

Another serious problem faced by the Turkish economy was the migration from rural lands to the urban centers. Therefore, in large centers, the unemployment rate has gone up and cities have become polluted and crowded. The open unemployment concept sets targets for the economy to create employment, which would be highly productive. Liberalization of the labor market, in order to increase welfare was not achieved in Turkey.

While observing the KAC and its effects on the Turkish economy, one can state that the structural change of the Turkish economy to become an industrialized society has still not been achieved fully. In the 1980's, more emphasis has been given to creating an outward looking, and more efficient economy. During 1980s, the economic growth was moderately high, and the export performance was impressive before the KAC. The inflation decreased, and the stability was increased until the KAC. The FDI improved slightly. The investment made by the public and private sectors were high, although the problem of unequal income distribution was not solved.

In 1990s, the economic growth remained high, with fluctuations in 1994, 1999 and 2001. The macroeconomic stability was a forgotten issue. The amount of exports decreased. The declining wages increased capacity utilization, through foreign trade liberalization, and interest rate reform. The KAC was unsuccessful in correcting the imbalance in the income distribution. The FDI and employment opportunities did not increase as expected. Rational distribution of factors of production among sectors and

sectoral relations was not achieved. It is observed that there must be more integration between industrial, incentives and technology policies.

The years after KAC and the decade of the 1990s witnessed, ongoing BOP deficits, severe outflows of capital followed by crises in the following years, together with severe decreases in the growth rates during the crises years. The net FDI and capital flows remained at low levels, with the exception of 2001 when they increased notably, followed by a severe decrease after the 2001 crisis. Only, half of the total permitted FDI between 1989 and 2002 was realized as inflows of capital. There was a heavy concentration in manufacturing and services, together with a decrease of investment intentions in agriculture, mining, and in services other than tourism, transportation, and trade. A better balance between infrastructure, housing and manufacturing should be established. The competitiveness and technological growth of the Turkish economy and industry should be improved.

In 1990s, the public sector issued treasury bills in large amounts, whereas the private sector shares remained low. The total deposits increased, due to the financial deepening created by public sector securities and FX deposits. The trading volume in the securities market also increased immensely as an expected result of the KAC. The amount of outstanding securities in terms of the government bonds and treasury bills also increased in total. The characteristics of capital flows in Turkey demonstrated that, the short-term capital flows led the capital movements. These flows were not awaited, since they put the economy under a burden. The PI amount was higher than FDI amount. The return on hot money increased leading to an increase in short-term capital flows. The currency substitution as a major result of the KAC increased, due to increases in FX deposits. The total outstanding domestic debt and the banking sector credits also increased. The appreciation of the TL against other currencies was a significant result of the premature KA liberalization, especially being noteworthy towards the end of the millennium.

One other effort was to, reduce the PSBR so that the private sector could balance private savings and private investment. The anticipated increase in private investment and output was realized, thereby creating a positive saving - investment balance in the private sector. But, the public savings remained very low and the PSBR remained high. The saving-investment gap in the public sector increased. Hence, the private sector was not able to make better use of the favourable balance between the private savings and

investment, since the capital inflows were transferred to the public sector to cover the expenditures.

The inflation rate increased tremendously in 1994, and from then on fluctuated and decreased due to the appreciation of the domestic currency. The money supplies increased till 1999, and suddenly decreased in 2000, indicating a change of policy made by the CBRT.

During the period between 1980-2003, it has been very hard to control the rising costs and inflation. Economic growth was very volatile during 1994-2001, with periods of overheating and three sharp recessions in 1994, 1999 and 2001. Key structural reforms have been adopted, which are likely to contribute to future macroeconomic stabilization. From 1998 onwards, the Turkish authorities have made repeated efforts to stabilize the economy. The financial sector is still in the process of consolidation and does not yet channel sufficient savings towards productive investment. A major banking crisis erupted in 2000-2001.

In May 2001, measures were taken to reduce uncertainty in the financial markets, to stabilize the money and the foreign exchange markets, and to establish macroeconomic balances, together with long-term sustainability of the fiscal adjustment, and public sector governance with the so-called 'Turkey's Program for Transition to a Strong Economy'. Top priority among all these problems and efforts to solve them, must be given to the fight against inflation, reduction of the BOP deficit, and controls on short-term capital flows. Macroeconomic stability should be achieved through successful implementation of economic programs, which would lead to an increase in capital inflows or a decrease in capital outflows, thereby also leading to an increase in the FDI in the long-run.

The major aim of the last section was to draw attention to the problems that were not solved even after KAC. It has not been possible to provide definite answers to these problems throughout the years. Although, the demonstration of these data only constitutes a part of the work in this field, it is believed that, these data would be helpful for further analysis of some of the problems faced. But, more emphasis should be given to new ideas.

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