



Reducing public debt: Turkey

Abstract

Turkey halved the ratio of public debt to GDP from almost 80 percent in 2001 to less than 40 percent before the global crisis of 2009. Several factors helped. First, a revival of growth spurred by reforms at home, accession talks with the European Union, and seven years of global prosperity. Second, through greater fiscal discipline, Turkey generated primary fiscal surpluses between 2002 and 2005. Third, it granted more independence to the central bank and implemented better monetary policies, increasing the confidence of global markets in the lira. Fourth, it better managed public debt, leading to longer maturity periods and lower interest rates. And fifth, it prudently used privatization proceeds to repay sovereign debt. Turkey's experience in reducing public debt can show others what is needed to bring levels of sovereign debt to levels that are favorable for economic growth.

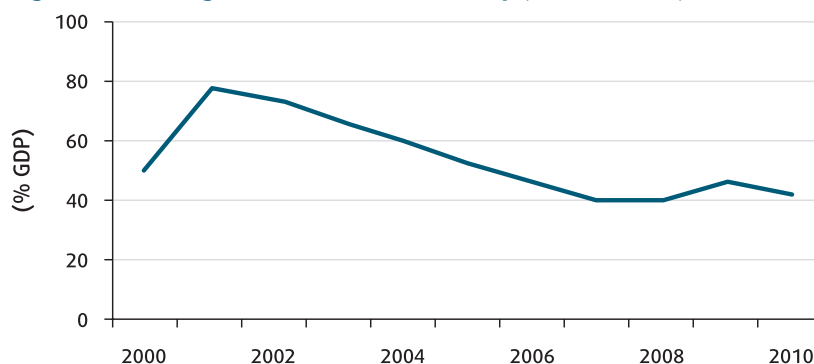
The recent economic crisis has brought the problem of public debt to the forefront of policy discussions. Reinhart and Rogoff (2010) suggest that debt levels above 90 percent of GDP may slow economic growth. But dealing with public debt during times of financial distress is particularly difficult. Turkey may well serve as a good example on how to successfully reduce public debt to levels that are more favorable for growth, i.e., to eliminate a "sovereign debt overhang."¹

What Turkey accomplished

Turkey suffered a serious crisis in 2001 that left it with a high level of public debt. In less than a decade it halved its gross public debt, from 77 percent of GDP to 39 percent in 2008 (figure 76). And even during the global economic crisis of 2009, Turkey's debt rose only marginally to 41 percent of GDP.

The general government deficit fell from 15 percent GDP in 2002 to 3.5 percent in 2010.² Turkey decreased its borrowing requirement from 12 percent of GDP in 2001 to almost zero in 2007. The inflation rate fell from 84 percent in 1998 to 8.6 percent in 2010. Macroeconomic stabilization improved Turkey's credibility abroad: CDS spreads dropped from more than 11.45 basis points in mid-April 2001 to around 3 in January 2004.

Figure 76: Gross government debt in Turkey (share of GDP), 2000–10³

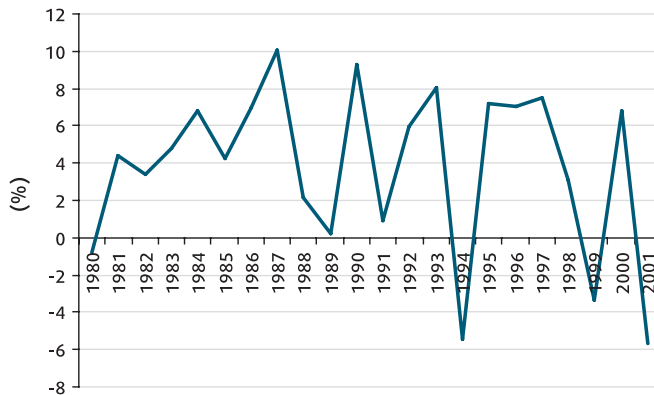


Source: IMF WEO.

The aftermath of the crisis of 2001

In the 1990s, the Turkish economy was weak and volatile. Attempts to curtail rampant inflation by shifting toward domestic borrowing failed. Interest rates were volatile, and so was economic growth (figure 77). Turkey's growth rates have remained among the most turbulent in the world.

Figure 77: Precrisis economic growth was volatile: real GDP growth (percent) in Turkey, 1980–2001



Source: IMF WEO.

For an emerging economy, GDP per capita recorded disappointing growth in the 1990s (1.5 percent annually). A fragile banking sector and increasing indebtedness of the government made Turkey more vulnerable to external shocks. Total external debt grew from 43 percent of GNP in 1997 to 55 percent in 1999, with the private sector mostly responsible for the increase. Gross treasury debt shot up from 40.6 percent of GNP in 1998 to 100.8 percent in just three years (Moghadam 2005). Private banks financed their purchase of public debt with short-term loans from international capital markets.⁴ There were additional pressures in a highly concentrated banking sector: weak banking practices, poor regulation, and lax accounting rules.

To tame growing public debt and high inflation, the Turkish authorities negotiated an IMF Stand-by Arrangement in December 1999. In mid-2000, the government tried to make the Turkish regulatory framework more consistent with the EU regulations. Despite these measures, economic vulnerability remained high. For banks, maturity mismatches contributed to significant losses.⁵ Banks started to report negative return on assets as early as 1999; by 2001 nonperforming loans accounted for nearly a third of total loans. To avoid insolvency, banks started selling government securities. Additional liquidity from the monetary authorities put pressure on exchange rates.⁶

To address these problems, the IMF provided financial assistance of US\$10 billion conditional on the government's actions to tackle problems in the banking sector. The World Bank provided another US\$5 billion. The Turkish treasury together with the Banking and Supervision Agency offered to acquire most troubled banks. Although these interventions temporarily stabilized the economy, disagreements within the government on the scale and nature of fiscal adjustment prompted another surge in interest rates, which at one point almost reached 5,000 percent. Pressure on the exchange rate prompted the government to float the Turkish lira in February 2001. At the same time, public debt peaked at nearly 80 percent of GDP in 2001, due to the



restructuring of the financial crisis as well as the recognition of debt that had built up outside the official statistics.⁷

Deteriorating internal conditions pushed local as well as global authorities to act. The government prepared a set of structural reforms. The IMF revised its program with additional funds, as did the World Bank. First, the new stabilization program addressed the weaknesses of the banking sector. To withstand losses, troubled public banks were provided with additional capital, amounting to US\$19 billion.⁸ The authorities embarked on transparent and true valuations of assets and losses. Shareholders were encouraged to invest in their own resources. The Bank Regulation and Supervision Agency put additional resources in for banks to recapitalize. The IMF and the World Bank assisted with asset management. The ratio of nonperforming loans to total loans dropped from nearly 30 percent in 2001 to 4.9 percent in 2010 (figure 79, in the appendix).

Though successful, the restructuring of the banking sector came at a cost of nearly a third of Turkish GNP.⁹ Government securities accounted, on average, for about 43 percent of private banks assets, making the soundness of government finances crucial for the long-term prospects of the financial sector.

How Turkey reduced its public debt

How did Turkish authorities control the exploding public debt? There were four main factors that helped: (1) renewed economic growth, (2) a primary budget balance, (3) real exchange rate appreciation, and (4) falling interest rates.

First, a well-tailored response to the crisis helped revive economic growth. Growth between 2002 and 2010 averaged about 5 percent. Strong economic performance, fuelled by set of reforms implemented during the crisis, allowed Turkey to grow out of debt.

Second, between 2002 and 2006 Turkey recorded, on average, primary budget surpluses of 3 percent of GDP. Fiscal consolidation adopted by the government addressed mainly the expenditure side of the budget. Embarking on transparency and predictability of public finances proved to be particularly beneficial.

Third, greater confidence in the economy and better monetary policies lead to appreciation of the lira after 2002. Between 1999 and 2007, the real exchange rate in Consumer Price Index (CPI) against the euro gained around 30 percent (Macovei 2009). The central bank, independent since 2001, succeeded in taming rampant inflation from 55 percent in 2000 to 8.6 percent in 2004. As a bulk of the public debt was denominated in or indexed to foreign currencies, the strengthening lira helped to reduce country's indebtedness. Turkey has been also working on improvements in the investment and business climate. It established an advisory body (Investment Advisory Council), comprising of business executives, representatives of international institutions and multinational companies, that cooperates with the government on legislation. Opening of the accession negotiations with the EU further strengthened the confidence in the country's prospects.

Fourth, falling interest rates reduced the cost of debt servicing. The government improved the management of public debt by optimizing the cost of borrowing through, among other avenues, extended maturities of debt issuance and borrowing in domestic currency at fixed rates. Together with the World Bank, it implemented structural reforms that improved transparency, financial

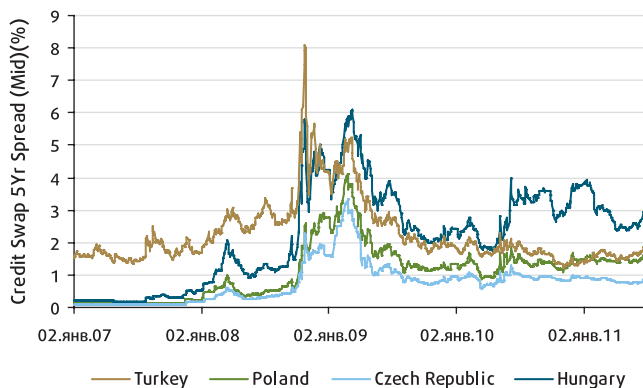
planning, and execution. The World Bank program included changes in taxation, caps on public employment, and rationalization of public investment program. Finally, part of the revenues from privatization process was used to prepay country's liabilities.

Good prospects

In 2009, the Turkish economy contracted by nearly 5 percent, mainly due to falling external demand. The slump in industrial production was greater than in 2001: from January to June 2009 the output of the automotive industry plunged by almost 50 percent. Yet the economy did not suffer as much as in 2001. GDP growth rebounded rapidly, reaching more than 8 percent in 2010, and the economy is forecast to grow by an average of 4 percent between 2011 and 2016.

The macroeconomic and financial indicators showed a new resilience. Banks did not experience the pronounced difficulties they had in 2001. The public debt was stable and is estimated to go down gradually to 33 percent of GDP in 2016. How well Turkey handled the crisis is also reflected in credit default swap (CDS) spreads, which have fallen from 2009 below Hungary's spreads and since 2011 are more or less equal to spreads for Poland (figure 78).

Figure 78 Credit swaps five-year spread in Czech Republic, Hungary, Poland, and Turkey, 2007-11



Source: JP Morgan.

Turkey has many challenges ahead. Volatile GDP growth, low savings rates, growing external imbalances, and persistent unemployment will pose a threat to the economy for some time to come. However, the recent global crisis of 2008–09 showed how much more resilient an economy can become in just a decade and can be treated as a good basis for going forward.



Sources

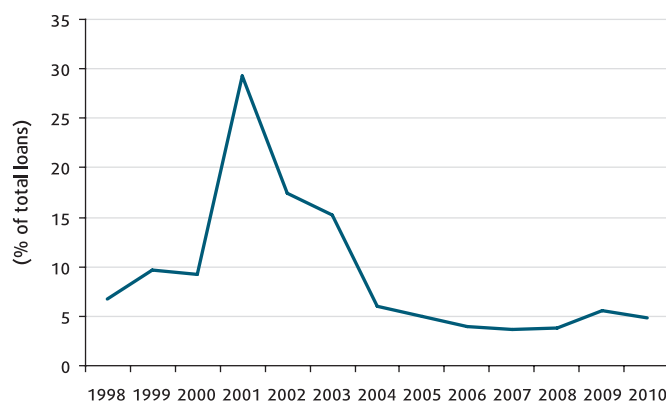
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Notes

- This note will focus on comparing Turkey's performance during two crises: 2001 and 2008 and will not take into account developments after 2009.
- Government budget deficit understood as government structural budget, according to IMF WEO methodology.
- Data on gross government debt as percentage of GDP prior to 2000 are not available at the IMF WEO.
- Turkish banks accumulated a bulk of unhedged foreign exposures that made them vulnerable to exchange rate fluctuations.
- The maturities of bank deposits shortened, and at the same time consumer lending increased (with longer maturities and fixed interest rates).
- As a part of the program, a firm exchange rate commitment was introduced. Additionally, the monetary authorities were not permitted to sterilize capital inflows/outflows.
- An example of debt not covered by official statistics prior to 2001 were exposures of public banks.
- Restructuring of two state banks (Ziraat and Halk) lead to closure of 820 branches and layoffs of 30,000 employees between March 2001 and December 2003. One state bank (Emlak) was liquidated. The Savings Deposit Insurance Fund banks were merged, privatized, or liquidated.
- About US\$47 billion. Source: Moghadam (2005).

Appendix

Figure 79: Nonperforming loans in Turkey have fallen significantly since 2001



Source: IMF FSI.