

EXTERNAL DEBTS SUSTAINABILITY, IMF POLICIES EFFECT AND TURKEY SAMPLE

Faik ÇELİK- /Kocaeli University-Turkey¹
Yaman Ö. ERZURUMLU /Doğuş University-Turkey²

Abstract

It is generally recognized that developing countries need substantial amounts of net transfer of resources at early stages of development in order to close their savings and foreign exchange gaps. External³ borrowing is a core element in nearly all developing countries' development strategies. Foreign loans can be used to finance public spending aimed at increasing growth, development, and security. Debt sustainability and holding the debt burden at a reasonable level are the two main cornerstones of achieving macroeconomic stability. Solvency is derived from the intertemporal budget constraint which shows sustainability of current policies. Generally, when the expected value of the future resources devoted to debt service equals the current debt stock, solvency condition is satisfied. Developing countries' debt is external debt incurred by Third World countries, generally in quantities beyond that country's ability to repay. Unpayable debt is a term used to describe external debt where the interest on the debt exceeds the amount that the country produces, thus preventing the debt ever being repaid.

IMF' policies through to the World Economy have been changed in the globalization processes. Those policies have been applied in different countries When Turkish economy is taken into consideration it is seen that; it has high debt stocks, the need of external debt continues to increase and the external debt indicators give rise to the anxieties about the issue of external debt sustainability. This paper responds to take forward on external debt-related vulnerabilities and balance sheet risks.

Key words: *External debt, IMF policies, debt sustainability, debt burden, Turkey debt*

1. INTRODUCTION

Throughout their history developing countries have been subject to repeated economic crises, with serious consequences for their long-term growth prospects. The links of these crises to the external sector performance, including the problems of external debt and its sustainability, have been the subject of prolonged debate. While the issue of debt was always present, particularly in relation to the increased availability of investable resources, the relevance of this topic has been heightened in recent years. Increasing capital mobility and greater use of market borrowing by emerging economies may well have helped to improve economic performance and growth prospects, but with low levels of bilateral and multilateral lending the vulnerability of the developing countries' economies has increased.

As developing countries became more integrated into the world economy and a wider universe of private investors have come into the picture, the volatility of capital flows has risen sharply and aggravated the effects of both internal and external shocks. More dramatically, developing countries have seen their debt burden remain high as a proportion of

¹ Assistant Professor Dr.

² Assistant Professor Dr.

³ is defined as the total public and private debt owed to nonresidents repayable in foreign currency, goods, or services (IMF define, external financing to borrowing in foreign currency from nonresident creditors.)

GDP with the possible exception of East Asia; and their rate of growth has lagged behind that of the industrialized world, most dramatically in Latin America and Sub-Saharan Africa. The high debt burden, low growth rates, and considerable resource outflows has put in serious doubt the premise that foreign borrowing on current terms is an appropriate mechanism to enhance growth (Loser 2004). The amount of developing countries external debt in 2004 was 2.5 trillions of dollars, this amount represents 34 per cent of the Third World Gross National Product (GNP). Taking into account that in 1968 the Third World debt represented nearly 50 thousand millions dollars, the amount has increased by 50 times.(Choike 2008)

2. LITERATURE REVIEW

In some countries, debt places such a burden on the economy that it cannot correctly function. Some see this as an argument against maintaining such a debt. In this context, most heavily debated topic is sustainable deficit, keeping deficits at some acceptable level. In an incidence that current deficits exceed sustainable deficit, revising budgetary targets or undertaking alterations in fiscal policy is required. The theoretical literature emphasizes the intertemporal budget constraint as well as the flow-budget constraint of the government, and focuses on whether current fiscal policy can be continued into the distant future without threatening government solvency. Yet, at the level of empirical policy analysis, the term “fiscal sustainability” remains highly controversial, and each empirical study often develops its own definition of the concept and derive its conclusions accordingly. (Voyvoda and Yeldan 2005)

Theoretical discussions of external sustainability reference is often made to the trade balance as the key determinant of the evolution of the external debt ratio, in practice, the relevant variable is the primary current account balance, including current transfers and non-interest net income payments.

External sustainability refers to the ability of a country to meet the current and future external obligations of both private and public sectors without running into arrears, recourse to debt-rescheduling and eventually a -drastic balance-of-payments adjustment. In theory the conditions for external sustainability are analogous to those for fiscal sustainability. (Akyuz 2007). Although external debt provides additional source during the term they were acquired, it requires the transfer of a part of import income as principal and interest payment at the following terms. Moreover, since external debt is acquired in foreign currency, it poses serious impact on the balance of payments. During the period of repayments, the quantity of foreign exchange reserves plays a key role on the balance of foreign deficit. In economies that such balance could not be achieved, additional borrowing becomes necessary for debt-rescheduling. At such situations, domestic debt seems to be easier to reschedule since it usually is much easier to manage old domestic debt with new domestic debt acquired (Özkan 2006).

The rationale behind the creation of a domestic market for government securities in poor countries is that it could stimulate the development of deep and liquid internal financial markets and protect countries from adverse external shocks. When a country is heavily indebted, the prospect of a decline in net inflows, and a possible net resource outflow makes the management of the economy very demanding, as it transfers the cost of lower aid to the borrowing country, and hampers growth.

A rising external debt tends to weaken the economy. First, foreign borrowing increases vulnerability to external conditions. When debt is contracted at a floating rate, higher foreign interest rates lead to an increase in debt-servicing costs. This raises budgetary outlays, which may translate into a larger deficit or a reduction of nondebt outlays. Likewise, a depreciation

of the currency leads to increased debt servicing (in domestic currency terms), and has the same effects as those mentioned earlier. Second, when the government borrows to cover a growing deficit, foreign borrowing leads to an unsustainable level of debt, an excessive share of debt service in overall government expenditure, and substantial use of foreign exchange to service the debt. In the long run, this may lead to a debt crisis (Bcaugrand et al. 2002). Moreover, the recent literature on debt intolerance emphasizes that developing countries historically have run into problems at much lower debt-to-output ratios than advanced countries. (IMF 2004)

Critics of the practical point in this argument question whether or not unpayable debt truly exists, since governments can refinance their debt via the IMF or World Bank, or come to a negotiated settlement with their creditors. However, this international debt problem has become such a crisis that many poor countries pay more money to the World Bank and the IMF each year than they receive in loans. The World Bank's own figures indicate that the IMF extracted a net US\$1 billion from Africa in 1997 and 1998 more than they loaned to the continent.

The problem has been greatly increased by the multilateral institutions' conditionalities, since the IMF determines the creditworthiness of countries: i.e., until the IMF gives its stamp of approval (which usually requires adherence to the economic policies it recommends), poor countries generally cannot get credit or capital from other sources. In the last few years, the World Bank and the IMF have agreed to help countries that are heavily suffering from major debt burdens by creating the Heavily Indebted Poor Countries (HIPC) Initiative of 1996. This facility seeks debt reduction by official creditors, including multilateral agencies, in the context of comprehensive programs of structural reform monitored by the IMF and the IBRD. However, even for the poor countries, the debt burden still remains high at some 50 percent of GDP and 180 percent of exports (Loser 2004). Even after qualifying for HIPC, a country must complete three years under an IMF-designed Structural Adjustment Program. Even after that hurdle, the country must fulfil a further three years bound by another SAP before relief is granted on its multilateral debt. The cruel paradox here is that the SAP requires them to cut spending on health care, food subsidies, and education.

3. EXTERNAL DEBT AND SUSTAINABILITY

3.1. SOURCES OF VULNERABILITY

This section covers the principles involving the sustainability of external debt, and the implications for debt management. External sustainability refers to the ability of a country to meet the current and future external obligations of both private and public sectors without running into arrears, recourse to debt-rescheduling and eventually a drastic balance-of-payments adjustment. In theory the conditions for external sustainability are analogous to those for fiscal sustainability (Akyuz 2007).

A common practice in evaluating debt sustainability is to focus on (gross or net) government debt as a share of the country's GDP. A sustainable government debt is one in which that debt ratio is stable or falling over time; a rising debt ratio denotes unsustainability. To determine what the debt ratio will be next year, the analyst makes (year ahead) projections for the economy's real growth rate, the real interest on the debt, and the noninterest component of the government budget expressed as a share of GDP (the so-called "primary surplus" or primary deficit).

Sustainability will depend among others on developments in the domestic economy and those related to the external environment, as well as the initial level and structure of external debt. The path to sustainability depends on a number of other conditions: the initial stock of debt, the availability of concessional financing, and the level of possible aid. This conclusion is important; while many countries have benefited from major debt reduction exercises, a country's success is still dependent on future availability of resources (Loser 2004). A domestic policy imbalance will have different implications depending on the nature of the external debt, e.g. whether it is market related or official, and whether it has a short- or long-term maturity structure, together with the overall conditions of the economy. While the long term effects of controls on outflows have been shown to have generally a negative impact, there may be short-term benefits at a time of a major crisis, like a bank run, or contagion. By its very nature, external debt sustainability entails the need to pursue a time-consistent path that will allow that the debt-servicing burden over time, as a minimum, does not hamper economic growth, and in more general circumstances enhances growth. (Loser2004).

For the external debt ratio to remain stable or to fall between two periods there should be an adequate amount of trade surplus; that is, a net transfer of resources abroad equal to the difference between net capital inflows and interest payments on external debt. The amount of surplus needed increases with the external debt ratio and the growth-adjusted real interest rate on external debt (Akyuz 2007).

Preventing a debt crisis is a crucial policy concern in a sustainable debt strategy. Ultimately, external debt crisis prevention hinges on one condition, that the debt payment capacity of debtor countries is fully supported by its export capacity. Unlike the primary budget balance the trade surplus needed is not directly linked to policy, but influenced by a host of variables operating on imports and exports, particularly the exchange rate and the rate of growth. (Akyuz 2007)

This brings us to the point that external debt has to be repaid in foreign exchange; hence trade plays a critical role. Exchange rate changes too can have asymmetric effects on fiscal and external sustainability. While a decline in the currency invariably makes it more difficult to maintain a stable public debt ratio, its effect on external sustainability can be benign. Although it increases the external debt ratio and the real interest rate, it also improves the current account by reducing imports and encouraging exports. These asymmetric effects imply that there can be a precarious link between external financial conditions and sovereign debt sustainability. A combination of lower international interest rates, increased appetites for emerging-market risks, surges in capital inflows and currency appreciations reduces the real effective interest rate and improves fiscal sustainability (Akyuz 2007).

However, whether foreign investors can increase competition and market efficiency, they can also bring risks, in terms of market volatility, since they could withdraw their investment if they have expectations of financial crisis, contagion, or deterioration of the macroeconomic framework (Arnone and Presbitero 2006).

3.2.THE ROLE OF DOMESTIC DEBT IN POOR COUNTRIES

Domestic debt, when well managed, can also reduce the government's exposure to interest rates and currency risks. However, domestic bond markets are expected to provide these possible benefits, only if some prerequisites are satisfied. In particular the World Bank and the IMF underline the importance of some key elements:

1. A stable macroeconomic environment;
2. An efficient money market

3. Broad investor participation;
4. The presence of a sound legal, regulatory and supervisory framework;
5. A non distortionary tax system;
6. An updated settlement infrastructure.

Domestic public debt is defined as the Central Government securitized debt: this is represented mainly by Treasury Bills, Bonds, notes and government stocks, even if in some countries there are other special securities and consolidated debt. For reasons of comparability across countries, the definition of domestic debt excludes loans, advances, local government debt and contingent liabilities – which are relevant in a number of countries – so that, in some cases, we are probably underestimating the real burden of domestic debt. (Arnone and Presbitero 2006).

The share of domestically issued public debt has risen, outpacing the rise in external debt in most regions. The growth of domestic debt markets reflects the success of many emerging economies in reducing inflation and deepening financial markets, though, as noted above, in several cases, the placement of large domestic bond issues for bank recapitalization in the wake of financial crises contributed as well (IMF 2004)

However, in developing countries, policy makers and international institutions have given to domestic debt far less attention than to external indebtedness. Even if the large concern on external imbalances is justified by a number of reasons and by the huge stocks of debt accumulated in the last decades, nonetheless a fully fledged macroeconomic analysis has to include domestic debt dynamics. In fact, domestic financing is becoming more and more important in many countries and there are reasons to believe that this trend will not revert, especially if donors' willingness to lend will decline over time. Such trend carries the probability of a domestic shock. Domestic policy shocks are likely to be the most sensitive source of vulnerability, most often resulting from inappropriate macro policies. The initial impact may be similar to those resulting from a real external shock, e.g. balance of payments pressures, inflation, and problems with economic activity. However, the mix between domestic adjustment and financing may well be different than when a country faces an external shock (Loser 2004).

3.3. EXTERNAL DEBT AMOUNT IN THE WORLD

The external debt still remains a heavy burden on underdeveloped economies and its regional distribution has changed in recent years. Various factors have had an influence on the new trends that can be observed regarding the total external debt accumulated by regions, among which the following are included: the financial instability of emerging markets, the deteriorated socio-economic situation in Africa, and the appeal of regions such as Eastern Europe, the Middle East and Asia for foreign investment.

According to International Monetary Fund figures from September 2006, the external debt amount of underdeveloped countries has remained unaltered around 2.1 trillion dollars.

By 2006, the regions were participating in the total debt amount in the following manner: Africa 7.7%; Asia 28.3%; the Middle East 7.8%; Eastern Europe 21.1%; the Community of Independent States 11.5%, and Latin America 23.6% (WEO, 2006).

According to estimates, underdeveloped countries paid 5.1 trillion dollars by way of debt service, that is, an annual average of 256 billion dollars, in the 1986-2006 period. (WEO, 2006).

Table 1. Other Emerging Market and Developing Countries: Ratio of External Debt to GDP 1

Years	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Other emerging markets and developing countries	42.0	37.3	37.0	37.2	35.9	33.1	28.5	27.0	25.7	24.7
<i>Regional groups</i>										
Africa	66.3	62.9	61.3	60.6	54.0	46.9	36.1	26.7	23.4	19.6
Sub-Saharan	70.2	67.4	66.6	65.8	58.4	51.0	39.2	28.9	24.9	20.3
Central and eastern Europe	47.7	50.0	52.5	52.3	53.2	53.3	49.4	55.7	51.8	52.1
Commonwealth of Independent States	75.1	56.4	45.8	43.1	41.8	36.2	33.4	32.5	33.4	31.8
Developing Asia	32.2	28.3	27.8	25.7	23.7	22.1	20.1	18.9	16.9	16.8
Middle East	32.6	28.2	27.4	28.0	27.0	26.3	23.4	25.3	26.0	25.1
Western Hemisphere	43.4	37.8	39.5	44.1	43.9	38.3	29.7	25.5	24.7	23.2

Years	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<i>Billions of U.S. dollars external debt</i>										
Other emerging markets and developing countries	2,454.4	2,372.6	2,388.6	2,460.9	2,687.8	2,931.5	3,013.3	3,342.4	3,762.7	4,118.0
<i>Regional groups</i>										
Africa	291.4	283.2	275.0	288.7	312.5	328.3	295.4	245.6	243.5	255.6
Central and eastern Europe	277.0	299.5	305.1	353.5	441.7	539.8	588.5	745.6	843.6	929.9
Commonwealth of Independent States	218.8	200.6	189.4	199.5	239.4	280.9	335.1	420.2	534.0	610.5
Developing Asia	692.0	652.8	674.7	678.3	711.5	767.9	805.3	882.3	952.8	1,070.9
Middle East	182.5	177.0	173.2	178.0	192.1	217.0	237.7	299.8	354.0	387.6
Western Hemisphere	792.7	759.5	771.3	762.8	790.6	797.6	751.3	748.8	834.8	863

Source: IMF, World Economic Outlook, Globalization and Inequality, October 2007

3.4. SHORT-TERM EXTERNAL DEBT AND FOREIGN CURRENCIES

In the nonfinancial private sector, as elsewhere, domestic debt has been replacing external debt. The average external debt level across regions more than halved from 40 to less than 20 percent of GDP, falling markedly in all regions except in the Middle East, Africa, and Turkey group. At the same time, loans from the domestic banking sector rose from 30 to 45 percent of GDP, leaving the average overall debt level almost unchanged.

Because a high share of domestic debt is denominated in foreign currency, the sector's exposure to various market risks remains substantial. In 2001, the average amount of foreign-currency debt still amounted to over 30 percent of GDP—somewhat more than in 1994—of which only two-thirds constituted debt owed to nonresidents. This foreign-currency denominated domestic debt, which is the flipside of the rise in banks' foreign-currency loans described earlier, creates a vulnerability to currency risk among indebted households and firms (IMF 2004). Moreover, in the event of devaluation, holders of foreign-exchange linked debt may switch to foreign exchange denominated assets as they question the government's solvency. As the government services foreign-exchange-linked debt, it has to generate liquidity. In both cases, there will be pressures on reserves and/or the exchange rate. This type of debt is therefore included under foreign-currency debt (IMF 2004)

Dollarization implies that the banking system can be the source of large foreign-currency liquidity needs in a crisis. Banks that undertake maturity transformation in foreign currency—offsetting short-term funding from domestic dollar deposits with less liquid domestic dollar-denominated loans—are vulnerable both to a run and to the risk that exchange rate fluctuations will lead to a sharp deterioration in the quality of a bank's loan portfolio (credit risk). Large positions of liquid foreign-currency assets can increase the resilience of dollarized banking systems both because they may be a source of emergency liquidity.

Since commercial banks' own foreign exchange resources are often not sufficient, central banks have in many cases acted as lender of last resort—with moral hazard implications. This relates potential short-term foreign exchange claims (including deposits) to available liquidity buffers, including from the public sector's balance sheet. The build-up of official reserves has generally improved the ability to cover potential drains. Latin America is again the exception.

4. BALANCE SHEET DEVELOPMENTS IN RECENT FINANCIAL CRISES: SOME COUNTRY EXAMPLES AND IMF POLICIES

The IMF strategy for low-income countries requires more work in the following areas: (i) focus and flexibility—the Fund should focus on macrocritical issues tailored to individual country circumstances, broaden its division of labor with the World Bank, and offer more flexible lending facilities; (ii) aid and the MDGs—the Fund needs to assess whether projected aid flows are consistent with macroeconomic stability and the estimated costs of achieving countries' development goals, and also be more forthcoming with donors; and (iii) debt relief—the Fund needs to ensure that the beneficiaries of debt relief do not again accumulate excessive debt. Countries' public expenditure management systems need to be strengthened. (Arnone and Presbitero 2006)

4.1. ARGENTINA: DEBT AS A MECHANISM IN ECONOMIC CRISIS

An example of debt playing a role in economic crisis was the Argentine economic crisis. During the 1980s, Argentina, like many Latin American economies, experienced hyperinflation. As a part of the process put in place to bring inflation under control, a fixed

exchange rate was put into place between Argentina's new currency and the US Dollar. Of course a fixed exchange rate was incompatible with a structural (i.e. recurrent) budget deficit, as the government needed to borrow more US Dollars every year to finance its budget deficit; eventually leading to an unsustainable amount of US Dollar debt.

Argentina's debt grew continuously during the 1990s, climbing above \$120 billion USD. As a structural budget deficit continued, the government kept borrowing more, creditors continued to lend money, while the IMF suggested less state spending to stop the government's ongoing need to keep borrowing more and more. As the debt pile grew, it became increasingly obvious the government's structural budget deficit was simply not compatible with a low inflation fixed exchange rate - either the government had to start earning as much as it spent, or it had to start (inflationary) printing of money (and thus abandoning the fixed exchange rate as it would not be able to borrow the needed amounts of US Dollars to keep the exchange rate stable). The crisis exploded in December 2001. In 2002, a default on about \$93 billion of the debt was declared. Investment fled the country, and capital flow towards Argentina ceased almost completely.

The Argentine government met severe challenges trying to refinance the debt. Some creditors denounced the default as sheer robbery. Vulture funds who had acquired debt bonds during the crisis, at very low prices, asked to be repaid immediately. For four years, Argentina was effectively shut out of the international financial markets.

4.2. IMPLICATIONS OF DEBT SUSTAINABILITY ISSUES FOR THE IMF AND THE G-7

When the debt profile doesn't look like it's going to stabilize at a reasonable level under the most likely scenarios, not restructuring is going to be an even more costly policy—just like not devaluing a highly overvalued exchange rate leads to a larger and even more costly adjustment down the road.

If the Fund makes very large loans to countries with unsustainable debts, it's ultimately going to run into large arrears, it's going to jeopardize its relations with its key creditors, it's going to be restricted from helping other debtor countries in need, and the debt restructurings it sought to avoid are going to come anyway—albeit later at even larger cost. Just add up the Fund's current exposure to say, Argentina, Brazil, Indonesia, and Turkey—to say nothing of a highly questionable smaller case like Uruguay—and ask what happens if say, Brazil and Turkey don't make it without major debt restructurings. (Goldstein 2003)

Although, the countries that experienced the Asian crisis had high savings and investment levels, they adopted restrictive fiscal policies in order to maintain the financial liberalism and regain the trust of the international financial world. Although one may attempt to discuss the Asian crises from the neo-political view, the crises remains to be a clear failure of international associations. Including IMF but not limited to, international financial associations failure to foresee the approaching crises and wrong policy suggestions that did not take the economic facts of the countries that fell into the crises into consideration caused a significant loss of trust to these associations. However, although Turkey experienced one of its deepest economic crises during 2000-2001 while it was following an IMF managed program, Turkey still managed to reach a more comprehensive plan with the IMF. This could be interpreted as an evidence of the lack of alternative the country was dragged into. (Celik 2007)

What do these debt sustainability issues imply about the appropriate policies of the IMF and the G-7. First, IMF surveillance has to pay much greater attention than in the past to the build-up of vulnerable external and domestic debt positions in emerging economies. Second, the Fund has to be much tougher than in the past on making debt sustainability a key condition for IMF lending. The trouble with Fund conditionality over the past decade is that

too much emphasis has been placed on things not so central—like very detailed structural policy conditions in Indonesia—and not enough emphasis has been paid to what ought to be the Fund’s bread and butter—namely, realistic real exchange rates, sustainable debt positions, and sensible macroeconomic policies. (Goldstein 2003)

5. TURKISH EXPERINCE

Table 2 Selected Indicators of External Debt of Turkey (1996-2005) (%)

Years	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Financial Indicators (%)										
Total External Debt / GDP	43,2	43,8	46,6	55,7	59,3	77,9	77	60,6	54,2	47,3
Public Debt / GDP	21,9	20,2	19,2	23	24,3	31,6	35,2	29	24,6	18,9
Private Sector Debt / GDP	14,6	17,4	21,1	26,8	27,9	29,6	24,6	21,4	22,4	24,1
Total External Debt / Export (FOB)	341,8	320,8	387,9	426,7	426,7	362,4	362	306,9	256,9	232,2
External debt Payment / GDP	6,2	6,5	8	9,9	11	16,9	15,9	11,6	10,2	10,1

(Source: Ozkan 2006)

Since 1996 talks with IMF has been going on in a friendly environment. By implementing IMF prescriptions the Turkish authorities utilized the credibility of the IMF as well as its credits. In addition to the previous credits the IMF extended 12 billion US\$ in 2001 and it is expected this amount to grow in the near future.

Therefore it was also not unrealistic to expect that any likely future problems in the banking sector would be treated by sources other than taxes. The recent IMF rescue packages actually give some support to this argument. Thirdly, the expectation of this event should have not been associated with an expectation of radical fiscal policy. (Ozdemir 2004)

At the same time, private banks ran large currency mismatches as they exploited the arbitrage opportunity of borrowing at low cost abroad and investing in high-yield local-currency sovereign debt. The high real interest rates on lira paper offered a lucrative carry trade, given banks’ expectation that under the existing managed float the exchange rate would depreciate more or less at the rate of inflation, while the central bank would provide banks with sufficient liquidity through open market operations to ensure the roll-over of government debt. This moral hazard resulted in a substantial currency mismatch on banks’ balance sheets. Indeed, the two largest state banks eventually became insolvent, and a fundamental restructuring of state banks became necessary.

As enforcement of regulatory limits was tightened in 2000 under the IMF-supported program, banks extended foreign-currency indexed loans and bought forwards, which under prudential rules they were permitted to net out from their on-balance sheet foreign-currency position. While the quality of these hedges has been subject to debate, weak banking supervision, poor corporate governance, and the abuse of banks by their owners all contributed to the weakness of the banking sector (IMF 2004).

The banking crisis in the first half of 2001 raised great concern for the sustainability of public debt in Turkey. Following the crisis the Turkish government took ownership of 4 private banks. To rehabilitate them extra bonds equivalent in value to 13 percent of GDP were issued by the government during the crisis period. A similar operation took place for the public banks as well. In this case the issued extra bonds amounted to 8 percent of GDP to compensate their losses. As a result of those operation public debt stock increased to the

record level, which was above 60 percent of GDP in the aftermath of these operations and it is still on increasing trend. In addition to those operations 30 percent of the public debt denominated in Turkish lira (TL) was converted into foreign exchange in the same period.

Related to this event are the questions whether creditors expected such a banking crisis and if it was expected when they perceived this possibility. Did they expect a change in the government's taxation policy including inflation tax, some kind of compensation through privatization or IMF rescue packages? If we search for answers to those questions, the following information should prove useful in the process: Firstly, the fragility of the banking sector in Turkey has been frequently expressed in the reports of international financial institutions.

The 2001 program, hailed as the Turkey's Program for Transition to a Strong Economy (TSEP) included the conventional IMF austerity measures: drastic cuts in public spending, monetary contraction, flexible exchange rate management, and reductions in wage remunerations and in public employment. In particular, the TSEP has targeted a primary fiscal surplus of 6.5% to the GNP every year until 2006, and aimed at reducing the outstanding net stock of debt to 63.9%, by the end of that year. It has foreseen a real rate of growth of 5% for 2003, 2004, and 2005, and assumed an operative nominal rate of interest of 46% for 2003, 32.4% for 2004, and 27.4% for 2005. The targeted end-of-year inflation of the wholesale prices has been set at 16.2%, 12%, and 8% for the same years, respectively. Thus, the Program implicitly assumes a significant real rate of interest through its implementation.

Traditionally, the Fund's stabilization policy advice is criticized based on its implementation of an inappropriate mix of austerity measures to correct for balance of payments difficulties. Often the Fund comes under criticism that it has a dogmatic preference for fiscal prudence, often ignoring the likely negative implications for economic growth, as well as the deterioration of income distribution, regressing the living conditions of the poor and the marginalized. The current program put into operation in Turkey, on the other hand, claims a pro-growth twist. Accordingly, the severe cuts in non-interest expenditures would reduce the interest rates and would be expected to generate growth through the above narrated mechanisms of crowding-out in reverse, a mechanism which can be identified with a non-conventional phrase: *expansionary fiscal contraction*. Thus, the current IMF-led austerity program in Turkey provides a crucial test on the expansionary attributes of such fiscal contraction, and will likely have a major impact on the Fund's credibility in its capacity as a policy advisor (and as the international lender of last resort) in the age of new financial architecture. (Voyvodaa and Yeldanb 2005)

5.2. THE IMF'S VISION OF FISCAL SUSTAINABILITY AND SOLVENCY IN THE TURKISH CONTEXT

Exposures in the public and financial sector, and tight financial links between them, contributed to, and amplified, Turkey's twin banking-currency crises of 2000–01. When Turkey experienced capital account pressures in November 2000, it was about ten months into an exchange rate-based disinflation program that had shown some initial success. The reasons for these pressures—which eventually led to the floating of the currency in February 2001 and a severe output contraction—are manifold and are discussed elsewhere. A significant share of public debt was 20 denominated in foreign currency, and, in the wake of the Russian and Brazilian crises, the maturity of this debt was progressively shortening.

The banking sector balance sheet clearly reflected this worsening economic environment. First, high inflation eroded the public's confidence in the local currency and led agents to adopt a short-term perspective. Both were evident on the liability side of banks' balance sheets: the average maturity of local-currency deposits was extremely short, and over

half of the deposits were held in foreign currency. Second, on the asset side, the public sector's large borrowing needs caused the crowding-out of private sector credit in favor of Treasury paper

Under these circumstances, an interest rate defense of the exchange rate peg could not be sustained and sharp fiscal adjustment became the only available option to stem the crisis. The initial surge in interest rates in November 2000 caused a drop in the value of banks' holdings of fixed-rate government securities and simultaneously increased their short-term funding costs. The subsequent exchange rate depreciation in February 2001 fully exposed banks' negative net open foreign-currency positions. In light of the banking sector's financial distress, foreign investors' confidence dwindled, adding to capital flight and associated pressures on the exchange and interest rates. Given the choice of exchange rate regime, only a sharp fiscal adjustment could alleviate these pressures. (IMF 2004)

5.3. TURKISH ECONOMY

When financial sources Turkey utilized in closing budget deficits are analysed, it is observed that borrowing is the main source in public financing. In this context domestic debt constitutes the main axis in domestic finance. We observe a rising trend in the ratio of domestic debt used in financing public sector consolidated budget to GNP. Such that the ratio of domestic debt to GNP is 0.28% in 1980 and the same ratio rises to 3.9% in 1989, 20-30% in 1990's and finally to 70% in 2000's. When overall debt stock/GNP is observed, this ratio happens to be 42.9% in 1997 and rise to 101% in 2001.

In the post-1980 period, setting aside the year of coup d'état, public sector deficit has increased in all years. In the post-1980 process, financing of public sector expenditures is achieved by domestic borrowing and Turkish economy did not experience severe difficulties in the first ten years since the deficits had not exceeded sustainable levels. Besides, by moderate increases in overall domestic price levels, seignorage revenue is transferred to public sector and expenditures are financed by these means.

In the post 1990 process, income redistributive policies has increased the deficits and public sector bonds are used in financing these deficits. This has been the major reason that short-term speculative capital enters Turkey since the borrowing policy of the treasury was based on high interest rates. Beyond that, FX policies pursued by governments (appreciation of Turkish Lira) have been supportive to these policies. To paraphrase, high interest rates and appreciation of local currency has been a principal reason in rushing of short-term capital movements into Turkey. In this context, "hot money" can be considered as the major factor that ignited the crisis in 1994.

Stimulated short-term and speculative foreign capital inflow finances public sector deficits as foreign savings and simultaneously accelerates imports and consumption. We observe that foreign debt has a rising trend that is in correspondence with the finance oriented development process. Foreign debt stock has increased from 50,489 million USD to 153,160 USD and average maturity of the debt has evolved into a short-term character. Foreign debt stock of public sector has reached 67,751 million USD and domestic debt has reached 167,252 million USD which sum up to an overall debt stock of 235,013 million USD. What underlies the crisis that become more and more frequent in the finance oriented development process of Turkey is the instability that arises in rolling over domestic and foreign debt which has long exceeded sustainable levels. Increasing current account deficits in this process makes rolling over the debt stock more difficult. In the entire period, PSBR (public sector borrowing requirement) perpetually increases, except for the year 1994. Highest share in public sector deficit belongs to the budgetary deficits.

In this period, interest on domestic debt has a major weight in budget expenditures. 2001 and 2002 are years during which demands of IMF ruled the economy thus, tax revenues of 2002 are achieved by IMF policies and years of stability policies must be distinguished from others (Bildirici et al 2002). In its broader policy approach in gauging whether a fiscal position is sustainable, the IMF is observed to adhere to the following steps: (i) based on the available macro-data, a projection with a five-year horizon is made assuming that the current fiscal policy is to be continued. This is regarded as the benchmark scenario. (ii) From this projection, a path for debt dynamics is generated and its sustainability is assessed. It is possible that different criteria are used for sustainability, but an increasing debt ratio is usually regarded as a cause for concern. (iii) If the path for debt dynamics is indicated as “unsustainable”, an alternative scenario is prepared, making necessary corrections on fiscal policy variables, which will typically define a “stable path” over the medium-term. Exclusive attention is usually directed on the adjustment of the primary balance in order to meet the debt target and the fiscal measures that can generate the warranted adjustment.

In the Turkish context, given the macro targets stated in the previous section it has been a routine accounting exercise to “check” the sustainability of the Turkish fiscal position by conducting various combinations of growth, interest rate, and primary surplus. Under one such study, for instance, reports that with an output growth rate of 5%, a real interest rate of 12%, and an inflation rate of 5%, a primary surplus of 3.5% to the GNP would be needed to stabilize the Turkish debt to GNP ratio at 60%. Based on his counter-factual scenarios, Agénor further reports that an additional 1 percentage point of primary surplus would be needed for each 2 percentage points of higher real interest rates (Voyvodaa, and Erinc Yeldanb 2005).

6. CONCLUSIONS

In summary, we have shown in this paper that the risk of debt distress depends significantly on a small set of factors: debt burdens, policies and institutions, and shocks. Our results indicate that the probability of debt distress is already high in many low-income countries, and is likely to increase sharply if the large-scale development finance required to meet the Millennium Development Goals is provided in the form of concessional lending at historic levels of concessionality. We have also proposed a simple scheme of financing resource transfers to low-income countries in a way that controls the probability of debt distress, provides good incentives to borrowers, and does not involve additional donor (Kraay and Vikram Nehru 2004).

IMF members have quite different economies, face different problems necessitating adjustments in their balance of payments, and display a variety of policy regimes and different ability and willingness to implement policies to correct external payments imbalances and their underlying causes. IMF programs need to be, and are, flexible instruments for addressing those problems, within a general framework that has a quantitative dimension and imposes a The IMF Approach to Economic necessary degree of consistency and discipline across users of Fund resources. (Mussa and Savastano 1999)

Three middle-income countries: Korea, as an example of a successful country which has used efficiently high external debt in the 80s to finance investment and to reduce resource gaps over time. Argentina, as an example of a debtor country bogged down in unmanageable debt problems and high budget deficits. Malaysia as an example of a country which has avoided debt problems through careful managing of external capital flows, including capital controls.

2 low-income countries: Bangladesh with low levels of external debt and good growth prospects, and Kenya with important debt problems and high growth fluctuations.

Two HIPC's (Heavily Indebted Poor Countries), Bolivia and Uganda, which have reached the completion point under the HIPC initiative and have benefited from full debt relief, but continue to have high debt indicators. Many critics and borrowers have stated that these policy conditions often lead to negative environmental, social and economic impacts - disproportionately harming people living in poverty – and provide few tangible benefits in exchange for large increases in debt. In addition to the well-known consequences such as the increase in public indebtedness, negligible or negative growth, and socio-environmental degradation, these measures reassert a dependency of borrowing countries on 'creditors'. As a consequence of this situation, civil society organisations seeking solutions to the debt problem propose alternatives ranging from the sole acknowledgement of legitimate debts to the non-payment or condonation of debts. Several campaigns around the world seek to create awareness in poor countries of how unfair this situation is and to call the attention of national governments and IFI's (International Finance Institutions).

Incurring external debt by itself increases the exposure of the domestic economy to external influences. Consequently, debtor countries should pay attention to the impact of external financial flows on their economies and to the adequate macroeconomic management of these flows, according to their specific circumstances and level of development. Some countries, especially the low-income countries, are highly vulnerable to external shocks while having a narrow productive base. These countries need to take into account such vulnerabilities in managing their debt, often with the assistance of their development partners.

International investors care about the macroeconomic, political, and institutional settings in which issuing companies operate. Such considerations define the entry and exit points for the cross-country allocation and management of investment portfolios. The econometric analysis conducted for this report finds that a 10 percent reduction in a country's perceived economic risk decreases corporate bond spreads by 52 basis points, while a 10 percent decline in perceived financial risk reduces spreads by 63 basis points—roughly equivalent to a credit rating upgrade of two notches. The importance of sound macroeconomic management is particularly evident in the impact of higher growth and lower inflation on the spreads available to corporate borrowers. Investments in financial infrastructure to strengthen legal, regulatory, and supervisory institutions for local equity and debt markets also reduce spreads for emerging corporate borrowers.

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