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POLICY ISSUES AND THE 2001 CRISIS

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ABSTRACT

This article takes up the subject of policy prescriptions and offers a particular policy implication for Turkey's latest currency crisis. After the outbreak of the East Asian crises, the IMF initially implemented a set of macroeconomic policies so as to reestablish financial market confidence in those countries. A number of prominent economists heavily criticized the IMF's macroeconomic programs and argued that its contractionary programs exacerbated the turmoil in the markets rather than actually improving it. The IMF's view and the views of its critics are briefly introduced in the initial section. Their relevance and usefulness for Turkey are then assessed on the basis of the circumstances in the country. After these assessments, it is concluded that neither the IMF view nor the views of its critics perfectly suits Turkey and a combination of both views (a contractionary fiscal and an expansionary monetary policy) provides the best policy mix for reestablishing market confidence.

Keywords: *Currency Crises, Fiscal Policy, Monetary Policy, East Asia, Turkey.*

POLİTİKA TARTIŞMALARI VE 2001 KRİZİ

ÖZET

Bu makale alternatif politika seçeneklerini tartışmakta ve Türkiye'nin en son döviz krizine en uygun olan bir politika seçeneği sunmaktadır. Uzakdoğu krizlerinin çıkmasından sonra, IMF bu ülkelerde yeniden mali güveni tesis etmek için bir dizi makro-iktisat politikaları uyguladı. Bazı önemli iktisatçılar IMF'nin bu politikalarını ağır bir biçimde eleştirdiler ve IMF'nin daraltıcı poltiklarının krizi gidermek yerine daha da ağırlaştırdığını iddia ettiler. IMF ve karşıtlarının politika önerileri ilk bölümde özetlenmektedir. Daha sonra Türkiye'nin kendi koşullarında IMF ve karşıtlarının politika önerilerinin Türkiye'ye uygulanabilirliği tartışılmakta; netice olarak ne IMF ne de karşıtlarının politika önerilerinin tam olarak uygun olmadığı kanaatine varılmaktadır. Her iki görüşün bir kombinasyonu olan daraltıcı maliye ve genişletici para politikalarının birlikte uygulanmasının ideal olduğu ileri sürülmektedir.

Anahtar Kelimeler: *Döviz Krizleri, Maliye Politikası, Para Politikası, Uzak Doğu, Türkiye*

1. INTRODUCTION

In this article I will, in the short-term perspective, discuss available post-attack policy implications for Turkey to overcome the effects of a currency collapse. When the Asian crisis was unfolded at the end of the last decade, number of analysts suspected the IMF's view of currency crisis management after the failure of IMF's initial programs in crisis hit Asian countries. In the East Asian crisis, the original strategy of the IMF was centered on overhauling the financial system. It targeted exchange rate stability in order to reestablish financial market confidence. Exchange rate stabilization objective was tried by a combination of macroeconomic policies (tight monetary and fiscal policies), availability of foreign reserves in the form of loan packages, and economic reforms. Critics argued that those programs have dramatically failed. Loan packages made the East Asian Central Banks creditors of the commercial banks domestically and the debtor of the IMF internationally. The owners of the domestic banks and the foreign creditors incurred no losses, instead the burden shifted to governments, that is, the original private loans were socialized. The IMF thought that avoiding the default through the loan packages would help stabilize the exchange rate. On the other hand, economic reforms (closing financial institutions, tightening regulatory standards, etc.) were aimed to restructure financial markets. The IMF approach to monetary and fiscal policy indicates that higher interest rates tend to appreciate the domestic currency. This approach favors tight monetary and fiscal policies in order to control exchange rates and maintain external balance. According to the IMF, tightening credit, cutting budgetary spending, and increasing interest rates rapidly raise investor confidence. It also accepts that these policies may initially cause lower domestic demand.

The view of Critics instead advocates easy monetary and fiscal policies and lower real interest rate to control exchange rate because contractionary policy during a crisis will lower investor confidence; due to uncertainty after a crisis, output shrinks, and the tight fiscal and monetary policies will only exacerbate this tendency (Krugman, 1999, Radelet and Sachs, 1998, Furman and Stiglitz, 1998).

In this article, the IMF's view and the views of its critics are applied to Turkey's latest crisis. Their relevance and usefulness for Turkey are assessed on the basis of the circumstances in the country. My goal is to determine which approach would be more appropriate for Turkey or to search for another possible policy mix.

2. A BRIEF OVERVIEW: ONSET OF THE ASIAN CRISIS

Before explaining the analytical thoughts in both views, it is very important to look at the onset of East Asian crisis since policy designs are always strictly tied to the problems. The debate over the Asian crisis will then be better understood and the differences and similarities between Turkish crises and that of Asian will help understand which view is the most relevant for Turkish case.

In the Asean-5 (Indonesia, Malaysia, Singapore, Philippines, and Thailand), the governments' fiscal stances were in balance, and each government had continued to manage budget surplus toward the crisis. Table 1 depicts the overall budget deficit in Asean-5 countries. Note that Singapore was running a very high fiscal surplus, which was about 15 % of GDP. All governments in the table showed a very strong

and responsible fiscal stance before the crisis. Additionally, Table 2 shows that although Philippines and Indonesia have relatively high levels of public external debt, in each of these countries, public external debt as a share of GDP was progressively decreasing.

Money growth rate was at prudent levels across region, and annual inflation in Asean-5 countries remained less than 10 %. Countries had been accumulating foreign exchange reserves despite large current account deficit because capital inflow was greater than the observed current account deficit. Growing imbalances and weaknesses were not in the public sector; rather, problems centered on the private sector. Due to East Asia's success to attract foreign capital and new channels for flows that emerged from the financial liberalization in those countries, short-term external debt into the financial system were rapidly on the rise, which increased the likelihood of a sudden reversal of capital flows. Banks in turn grossly expanded their lending into the private sector. These funds went into real estate and property purchases. The foreign liabilities of the banking system grew increasingly; the ratios of short-term debt to foreign reserves in each of these countries exceeded one prior to the crisis year. East Asian countries indicated a vulnerability to a sudden reversal; hence, the behavior of foreign creditors was indeed a critical factor to spark a crisis (Radelet and Sachs, 2000).

3. THE IMF VIEW: HOW DOES IT WORK?

The view of IMF over the Asian crisis can be roughly and analytically explained by the celebrated Mundell-Fleming model (the M-F hereafter). Leaving aside the longer-term tasks of the program, such as restructuring the financial sector and increasing transparency, I concentrate only on the short-term policy proposals, which were initially post-attack contractionary monetary and fiscal policies.

The M-F model is a short run analytical model and assumes that prices are fixed, output is below the full-employment level, and Marshall-Lerner condition is satisfied. The policies' impact works through the two channels: the interest rate channel and the exchange rate channel. Let's assume that monetary policy works first, and then fiscal policy starts to operate. This assumption increases the clarity, and it is essentially reasonable to assume although fiscal policy has shorter outside lag relative to monetary policy. Asian countries are successful in attracting capital flows, but it is also conceivable to assume low capital mobility in the model as compared to the conditions in industrial countries. This assumption, to some extent, gives the channels of the exchange rate and interest rate a similar power in response to policy-induced changes.

Table 1: Overall Budget Deficits (% of GDP)

Year	Indonesia	Singapore	Malaysia	Philippines	Thailand
1993	0.6	15.5	1.3	-1.5	2.1
1994	0.9	16.0	4.5	1.0	1.9
1995	2.2	14.3	2.3	0.6	2.9
1996	1.2	n.a	2.1	0.3	2.3

Source: *World Development Indicators,* 1998, CD-ROM.

In the M-F framework, the overall equilibrium is achieved when the equilibria in the goods market, the money market, and the balance of payments are simultaneously satisfied. The balance of payments will be in zero balance when the current account balance exactly matches with the capital account balance. The capital account responds positively to the level of domestic interest rates and negatively to the level of foreign interest rates. Current account balance is associated positively with the exchange rate and the level of foreign output, and negatively with the domestic output. Another simplified assumption in the analysis is that all markets are initially clear before policy-induced changes.

Table 2. Public External Debt (% of GDP)

Year	Indonesia	Singapore	Malaysia	Philippines	Thailand
1993	36.1	n.a	21.4	50.5	11.7
1994	36.1	n.a	19.2	47.2	11.3
1995	32.4	n.a	18.7	40.3	10.0
1996	26.6	n.a	15.8	33.3	9.2

Source: *World Development Indicators,* 1998, CD-ROM.

A Contractionary Monetary Policy

A policy-driven decrease in money supply will disturb money market in that the real money balances become less than the money demand. Individuals will in turn reallocate their portfolios, causing interest rates to increase and domestic demand to decline. Increases in domestic interest rates attract foreign funds, and a contraction in domestic demand improves trade balance. Then the resulting capital inflow in capital account and a favorable trade balance change in current account will push overall balance of payments into a surplus. Because post-attack exchange rate regime is a floating exchange rate, the surplus drives domestic currency to appreciate.

Now appreciation in domestic currency tends to make domestic goods less attractive (more expensive) relative to foreign goods in global markets. More expansive exports will sell less and, therefore, the trade balance deteriorates in response to appreciating domestic currency. The deterioration will continue until it offsets the interest rate and demand-driven surplus in the overall balance of payments. Hence, exchange rate effect on net exports and the initial shortfall of output push market forces toward the new equilibrium point. At that point, the condition for goods, money, and balance of payments is restored yet again at a higher interest rate and lower level of output. The resulting exchange rate, as compared to previous equilibrium point, has been appreciated within the adjustment period owing to two reasons: interest rate effect in capital account and demand-driven effect in current account. A negative relationship between the interest rate and the exchange rate has been observed after contractionary monetary policy. The domestic interest rate increased, the exchange rate appreciated, and the output contracted as a result of monetary policy-induced change.

A Contractionary Fiscal Policy

Now the effects of a contractionary fiscal policy are considered. After the policy- induced change, disequilibrium occurs in the goods market and output

contracts. Reduced output means less domestic demand, improving trade balance; then overall balance of payments will be in surplus. Exchange rate appreciates. Appreciation in turn makes domestic goods less attractive to international markets; and therefore, the balance of payments surplus will be eliminated by exchange rate appreciation. On the other hand, fiscal policy induced tightening in domestic demand causes interest rates to decrease, which leads an outflow of capital. This outflow partially offsets improvements in current account; hence, the overall balance of payments surplus will be smaller when we take into account developments in capital accounts. Therefore, appreciating exchange rate, resulting contraction in exports, and output will be lesser. However, improvement in current account dominates outflow in capital account with low degree of capital mobility, and exchange rate appreciates. The results after fiscal policy tightening are that interest rates decrease, domestic currency appreciates, and output contracts.

In summary, within the assumption of low degree of capital mobility, the monetary and fiscal policy mixes, which are both restrictive, causes exchange rate appreciates, and output severely declines. Additionally, current account deficit is corrected with this policy mix. The only ambiguity remains somewhat over the interest rate. While monetary policy first increases interest rates, fiscal policy reduces them later. Although the overall impact of policy mix on interest rates is ambiguous, it definitely fits the pattern of interest rate movement over time, which means that interest rates spark at first and then gradually decline over time. In fact, Fischer (1998a) reported that the IMF intends to have higher interest rates first and expect to observe declines in interest rates over time. Hence, the IMF's initial contractionary policy mix over Asia can be well explained by the Mundell- Fleming model.

The IMF's first objective with the policy mix was to restore confidence in the domestic currency. It hoped to make domestic currency more attractive to hold by temporarily increasing interest rates. In their view interest rates would start to decrease by the time confidence is restored in the economy. Although it was likely that interest rate increases would harm weak banks and corporations, the IMF chose this strategy because the harm of sharply depreciating currency would be far greater than the harm of interest rate increase. Moreover, higher interest rates would lead corporate sector to move away from debt financing toward equity financing (Fischer ,1998a).

Why did the IMF add contractionary fiscal policy into its programs? One reason was that it strengthens the domestic currency. Another reason is that countries should deal with the expected costs of bank bailouts and financial structuring as well as with current account deficits. Even letting automatic stabilizers work was thought to be risky because the countries were having difficulty finding creditors to finance their budget deficits. In the face of this difficulty, if a fiscal deficit was observed, the only viable alternative to finance it would be seigniorage, which IMF thought to be a disastrous option in the case of Asian countries (Fischer ,1998a, 1998b).

4. THE IMF AND THE VIEW OF ITS CRITICS

After the launch and the failure of initial policies, a number of researchers criticized the IMF. In their view, increasing today's interest rates and the contractionary fiscal policy may not always strengthen the exchange rate; they may warrant an even weaker exchange rate depending on the circumstances. They asserted that contractionary monetary and fiscal policies exacerbated already weak currency in the Asian case; therefore, the IMF was incorrectly judged the circumstances and put in effect wrong policies as a result of its initial judgment.

The Circumstances for Weaker Exchange Rate

The movement of exchange rate during a period of high interest rates depends on three factors: the probability of bankruptcy, the rise in risk premium, and the expected return from holding domestic currency. Furman and Stiglitz (1998) showed the effect of these factors within the uncovered interest parity framework. Formally,

$$(1+i_t)-\delta i_t-\delta-v=\frac{e_{t+1}^{E}}{e_t}(1+i_t^*)$$

e_t is exchange rate per domestic currency; the subscript E stands for expectation; i_t and i_t^* are domestic and foreign interest rates respectively; δ denotes the probability of bankruptcy, and v denotes the risk premium. The probability of bankruptcy and the risk premium are said to be increasing function of interest rates; therefore, any increases in interest rate has an ambiguous effect on exchange rate because the left hand side of the equation is uncertain in the case of interest rate raise.

When the investors' confidence grows weaker, then the country will be seen as a less attractive place for an investment. Moreover, monetary tightening decreases the supply of exports, and then demand for currency further falls. These two effects, to some extent, offset the effect of the interest rate raise. Additionally, higher interest rates have unpleasant macroeconomic consequences. These adverse effects may produce higher probability of bankruptcy, then expected returns lower, and lower expected returns in turn means less attractive investment in the country. Finally, markets may be risk averse. Policies that signal future recession may unfavorably increase risk premium. Furman and Stiglitz (1998) also argued that Asian countries had followed prudent fiscal policies before the crisis, and a contractionary fiscal policy in these countries intensifies the economic downturn because the probability of bankruptcy and uncertainty regarding the future aggravate. Consequently, uncertain environment and expected bankruptcies will not attract investment and capital inflows, thereby calling more depreciation.

Therefore, these circumstances play essential role in determining the value of exchange rate. A policy-induced increase in interest rate may actually exacerbate the weakness of domestic currency depending on the circumstances.

5. WHICH VIEW IS MORE APPROPRIATE FOR TURKEY IN 2001?

As it is clear from the debate over the Asian crisis, the choice of policies between competing views strictly depends on the circumstances of a given country. For this reason, the most important part for a policy decision actually relies on the assessment of the conditions in Turkey. Understanding the similarities as well as differences between Turkey and Asian countries is imperative.

Contractionary or Expansionary Fiscal Policy?

Table 3 illustrates consolidated budget and public-sector borrowing requirements (PSBR) in Turkey over the four-year period before 2001 crisis. The consolidated budget deficit, as well as the deficit of public sector, had been sharply growing over time, and the public sector overall deficit as a share of GNP reached 12.5 percentage point in 2000. Although a primary surplus had been achieved in this period, widening budget deficits continued. Hence, the table implies that government liabilities were actually in increasing trend. This is what we observed in the previous chapter when looking at the debt figures. How was the deficit financed? For a long time, the government has been relying on the domestic borrowing as a financing mechanism. Over this period, the use of central bank advances was zero, and the share of foreign borrowing on the average as a percentage of GNP was actually minus one, meaning repayment.

Table 3. Consolidated Budget and PSBR of Turkey (% of GNP)

	1997	1998	1999	2000	2001
I. Revenues	19.56	21.87	24.03	26.47	28.47
II. Expenditures	27.19	29.15	35.89	37.40	44.49
II. a) Current	9.46	9.67	11.70	10.82	11.27
II. b) Investment	2.01	1.87	2.00	2.20	2.17
II. c) Transfers	15.72	17.61	22.18	24.37	31.05
Interest Payments of which	7.75	11.54	13.69	16.27	22.88
Domestic Borrowing	6.73	10.52	12.55	14.96	20.89
Foreign Borrowing	1.02	1.02	1.14	1.31	1.99
II. d) Other Transfers	7.97	6.07	8.49	8.10	8.17
III. Budget Balance	-7.63	-7.28	-11.86	-10.93	-16.03
IV. Primary Deficit	0.1	4.3	1.8	5.3	6.9
PSBR	-7.7	-9.4	-15.6	-12.5	-15.4
PSBR (Excluding Interest)	0.0	-2.1	1.9	-3.8	-6.9

Source: State Planning Organization (SPO) Main Economic Indicators. Roman numbered items are consolidated budget figures. Public sector is the total of consolidated budget, state economic enterprises, special funds, and municipalities.

The central element that actually widens the overall budget deficit is interest payments. The share of interest repayments in government expenditures sharply increased and reached a point that nearly consumes the government's entire revenues. The ratio of interest repayments over the consolidated budget revenues was 39.6 % in 1997 and 61.5 % in 2000. The government borrows in order to pay interests; meantime liabilities keep increasing, which in turn demands greater interest payments in the next. Note that realized primary surpluses were not enough

to prevent increases in the debt to GDP ratio. On the other hand, the monetization of the budget deficit had been completely avoided by authorities. Ratio of debt to GDP was not constant, and its growth rate was actually in the excess of GDP growth rate, which implies unsustainability.

Akcay, Alper and Ozmucur (2001) investigated the sustainability of fiscal stance over the period from 1970 to 2000 based on the "no Ponzi Game" condition. They conducted Augmented Dickey Fuller unit root tests and the Phillips-Perron unit root tests for the variables and found that fiscal stance of Turkey is unsustainable. Moreover, their finding indicates a fiscal policy change toward the fiscal austerity is needed if the government wants to avoid insolvency in the future.

In sum, Table 3 indicates that Turkish authorities had not followed prudent fiscal policies before the 2001 crisis despite some efforts in primary surplus. Large debt to GDP ratio has been grossly accumulated over the years, interest repayments have been excessively growing, current fiscal stance is unsustainable, and government insolvency is on the way if fiscal policy does not change toward fiscal austerity. Creditors' assessment about the debt to GDP ratio and its future path for Turkey is in high concern, and further worsening toward insolvency may shift market expectations into more pessimistic state. Therefore, an expansionary fiscal policy will add to the probability of government bankruptcy and more uncertainty. Expected government bankruptcy, therefore uncertain environment, will in turn discourage capital inflows, which calls additional depreciation. Furman and Stiglitz's prescription for fiscal policy should completely be reversed in the case of Turkey; that is, a contractionary fiscal policy ought to be followed instead of expansionary policy for the very same reasons. After the restriction, output declines and the net export improves. This improvement in trade balance causes the domestic currency to appreciate. The lower interest rate, on the other hand, leads to capital outflow. Trade balance dominates in the case of low capital mobility like Turkey, hence exchange rate should appreciate.

Again, the Table 3 illustrates that growing budget deficit is mainly the result of interest repayments, which is in fact a transfer payment. An effective contractionary fiscal policy, however, increases the supply of funds available to private borrowers. Households and firms with more available funds and lower interest rate decide to increase their investments. This will shift market expectation toward a more optimistic stance.

To summarize, with the identified circumstances in Turkey, a restrictive fiscal policy is superior to expansionary policy. The government is on the way toward insolvency; a reduction in budget deficit will stabilize the debt to GDP ratio, as well as increase funds available to the private sector. The interest rate declines and private firms invest more. Combined with improved fiscal sustainability, more investment shifts market expectation toward a more optimistic outlook. Confidence improves, and exchange rate is expected to appreciate.

Monetary Policy: Expansionary or Contractionary?

The appropriate monetary policy for Turkey also depends on a set of factors that prevail in the economy. These factors can be essentially broken down into two primary grounds: the level of harm that higher interest rate does to the economy, and

the credibility of higher interest rate policy of the monetary authority. If the higher interest rates harm the economy in a great deal, the credibility of the policy will be seriously at stake, and the policy will most likely be doomed. Hence, looking at the probable effect of higher interest rates in Turkey is a first primary task. We will do so in comparison to Asian countries. Then, we will ask what information monetary authority conveys about the higher interest rate policy.

In the version of Furman and Stiglitz's uncovered interest rate parity, the contemporaneous connection between interest rates and exchange rate depends on the probability of bankruptcy and the level of uncertainty. These two variables are also positively associated with interest rates. In Table 4, we see some similarities and differences between Turkey and Asian countries. The most important difference is that firms in Turkey are not as highly leveraged as the firms in Asian countries. Credit to private sector as a percentage of GDP in all of the Asian countries is considerably greater than the credit to private sector in Turkey. While financial resources provided to private sector had been decreasing in Turkey prior the crisis, they were increasing in Asian countries. The situation is reverse, however, when looking at the credit to the public sector. Private external long-term debt in Turkey and Asian countries are similar. As for short-term debt, Table 4 indicates that most debts are short-term debt in Korea and Thailand; Turkey is more in line with other three Asian countries. However, while Turkey's short-term debt is shared with banks and private firms, it is mostly on private firms in Asian countries.

Therefore, the effect of interest rates over private sector will be limited in Turkey since firms are not as highly indebted as those of the Asian countries. With higher interest rates, the probability of bankruptcy in private sector is greater in the Asian countries relative to Turkey. On the other hand, the default in Turkey remains in the public sector. As we mentioned in the previous section, the government is highly indebted, and prolonged higher interest rates can promptly bring the public sector to insolvency, especially with the possibility of bank recapitalizations.

Table 4: A comparison between Asian Countries and Turkey

	Indonesia	Korea	Malaysia	Philippines	Thailand	Singapore	Turkey
Credit to Private Sector (% of GDP)	55.4	69.6	141.6	54.8	147.1	112.5	23.7
Short-term debt (% of Ext. debt)	24.9	57.4	27.8	19.8	42.2	n.a	24.4
Private Ext. LT debt (% of Ext. debt)	28.4	20.5	32.5	12.2	42.7	n.a	23.5
M2 / gross international reserves	6.1	6.4	3.3	3.9	3.8	n.a	3.9
Foreign Assets / Foreign Liabilities (%)	70.0	78.5	38.7	56.9	14.4	77.8	74.4

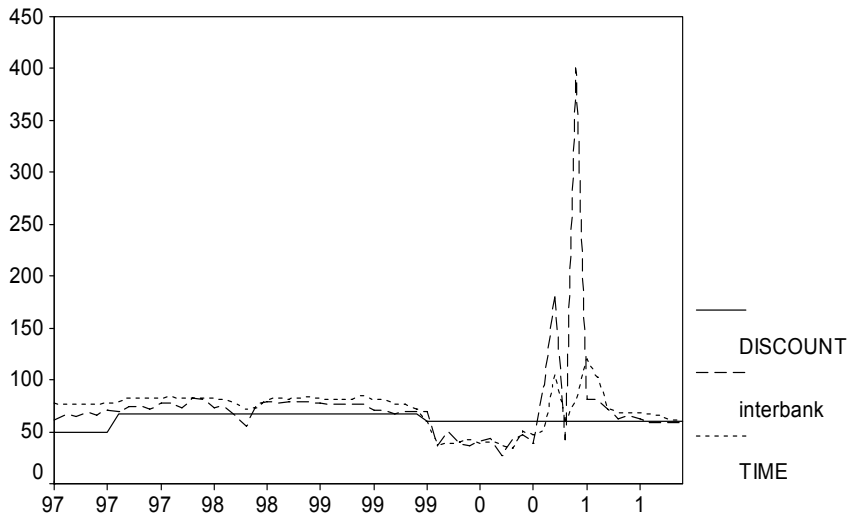
Source: World Development Indicators (WDI) CD-ROM and International Financial Statistics (IFS). Data are from 1996 for East Asian countries and from 2000 for Turkey. Foreign assets and foreign liabilities are of deposit money banks.

An important similarity between Turkey and Asian countries prior to crisis is the financial fragility. Deteriorating foreign currency exposure position, growing

nonperforming loans toward the crisis year and borrowing short-term are evident. Table 4 shows that the percentage ratio of foreign asset to foreign liabilities is considerably less than one in each country. Turkey's ratio in this variable is worse than the ratios in Korea and Singapore, but it is virtually the same with Indonesia's ratio. On the other hand, Turkey's illiquidity, represented by the ratio of M2 to gross reserves, is more in line with three Asian countries. Indonesia and Korea had higher illiquidity ratios than the rest of the table. Although the degree of financial fragility varies in each of the countries, it is certainly evident that Asian countries and Turkey share the characteristics of weak financial sector on the onset of the crisis.

Another important point in deciding policy evaluation is whether or not capital markets are segmented. That is; a part of interest rates in capital markets moves in some way different from or is affected differently than the whole. Then if interest rates move together, we can say that capital markets are not highly segmented.

Figure 1: Interest Rates (1997: 1/12 – 2001: 12/12)



Source : International Financial Statistics.

Figure 1 illustrates monthly moves of three interest rates in the period between 1997 and 2001: Discount rate, interbank rate, and deposit rate (three month's time deposits). As can be seen from the figure, interest rates in Turkey generally move together. IFS Data on Turkey's Treasury bill rate (not reported here) is incomplete; but available data do seems to be in connection with the rest of the market rates. Hence, we can say that capital markets in Turkey are not highly segmented. An increase in a rate is generally translated into higher rates for most borrowers. This finding in Turkey is the same as the case for Asian countries. Furman and Stiglitz (1998) reported that capital markets in the Asian countries are not highly segmented.

Finally, whether or not the higher interest rates policy of the government is credible is important for the confidence build-up. As we have stated earlier, higher interest rate policy can work as a signal of the monetary authority to maintain stronger exchange rate. However, if the cost of pursuing higher interest rate policy is exceptionally high, then policy is not credible because nobody will believe it is continued. In Turkey, this policy is exceptionally costly and, therefore, not likely to be credible because of the fiscal stance and the fragility in the banking sector. Also, past records of the Turkish monetary authority contribute to the disbelief.

So, what policy should the monetary authority follow in Turkey in order to deal with the crisis? In the preceding analysis and, we have studied the circumstances in Turkish economy. Also, the preceding analysis incorporates useful comparison between Turkey and the selected Asian countries. The critics argued that contractionary monetary policy in Asian countries did not work because firms were much leveraged, significant build-up of short term debt and fragility in the banking sector were present, and capital markets were not highly segmented. Therefore, rising interest rates had large and unpleasant macroeconomic effects. The probability of bankruptcy had considerably increased, this in turn reduced expected return in the economies, and then investment in Asian countries turned out to be less attractive. In the case of Turkey, however, firms were not highly leveraged; instead the government was highly indebted. Short-term debt build-up is at an important level, although it is not as great as those of the majority of the Asian countries. On the other hand, the banks were fragile, and capital markets were not highly segmented in both Turkey and Asian countries. Hence, higher interest rates will produce similar effects in Turkey, though somewhat differently. The government is extensively indebted and domestically borrowing from the banking sector in order to cover its growing budget deficits. Higher interest rates together with expected recapitalization costs in banking sector increase the probability of government insolvency. If government cannot pay back, then banks that borrow from overseas will not be able to service its foreign liabilities. This will cause further loss of confidence in the midst of turmoil because an investment becomes riskier; therefore, it is less attractive place for capital inflows. Hence, I favor expansionary monetary policy for Turkey.

Overall, the Monetary-Fiscal policy mix for Turkey in 2001 crisis should have been restrictive fiscal and expansionary monetary policies. Thus, together with the IMF's contractionary fiscal policy and its critics' expansionary monetary policy fit better rather than completely choosing one of the views.

6. CONCLUSION

In this article, I discussed the subject of stabilization policy for the most recent Turkish crisis. The IMF's initial contractionary macroeconomic policies and the view of its critics are assessed for Turkish case, and was found that neither the IMF view nor the view of its critics are well suited for Turkey. The policy debate is essentially rooted on the assessments of circumstances, and the restrictive fiscal policy-easy monetary policy mix should be proposed for reestablishing market confidence.

In order to do that, we need to ensure that government is not defaulting because government fiscal stance has been found to be unsustainable and the probability of insolvency increases. The share of interest payments in government consolidated budget has been sharply increasing and reached a point that consumes about 80 % of government revenues. So, the sharp increase in debt / GNP ratio is coming from the fact that interest rates exceed well above GNP growth rates despite realization of primary surpluses. The gap between two is large because growth rate of GNP is low and interest rates are high. Interest rates and low GNP growth rate should be our concern as well, in order to achieve the sustainability of government fiscal stance. It is important to run growing primary surpluses (by increasing taxes, reducing purchases and transfer payments, or some combination of both) because fiscal discipline is our major concern. This contractionary fiscal policy will dampen economy's growth rate. In order to reduce interest rates and offset the decline in GNP growth rate, which is caused by restrictive fiscal policy, we should use accommodating easy monetary policy.

This policy mix reduces the likelihood of government default, which signals foreign creditors since the government is using domestic borrowing so as to cover its budget deficit, and banks are the sole creditors of government. However, the banks borrow from foreign creditors and lend it to the government. If there is an increasing likelihood of default of bank's largest client, then foreign creditors will not roll over the debt coming due because they won't at least get their investment back in timely manner. Therefore, reducing the likelihood of government default increases creditors' confidence. On the other hand, easy monetary policy stimulates investments and consumption in the private sector, which further adds up confidence.

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