Fiscal Liberalization in Turkey*  

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Introduction  

Towards the end of the 1970s and throughout the 1980s the dominant feature of the economic relations between nations has been the emergence of international capital movements. Investors abandoned their traditional confinement to domestic financial markets while, at the same time, nation states developed some measures in the way of creating an integrated financial world market. They deregulated financial activities by easing cross border controls and lifting some other restrictive measures.  

Such developments have emerged, one way or another, as a response to an increasing demand for financial tools. After the recovery of the nations which had been destroyed in the Second World War world international trade increased more rapidly than world output. Between 1964 and 1985 world output increased at a rate of 10.4% per year, foreign trade increased at an annual rate of 12.4% and the size of gross international bank credit increased at an annual rate of 26.1%.
high increase in world trade created the problem of financing foreign trade. Thus nations increased their demand for international means of financing to defy their deficit in current accounts.

Globalization of financial markets has been facilitated by recent developments in telecommunications. Thus investors now possess means of sending commands and transferring their funds throughout financial markets at a very high speed. The set of integrated world financial markets has become a huge system resembling a one–nation market.

Financial globalization and deregulation of markets resulted in an increased number of foreign banks in nation states. The second half of the 1980s witnessed globalization of financial institutions together with the enlargement of financial markets. Banks opened up branches in foreign countries and the volume of international financial transactions surpassed that of commodity trade.²

Fiscal deregulation has had different consequences in different economies. Despite the fact that nations have resorted to this means of financing to finance their foreign trade deficits, some of them have developed even larger volumes of foreign debt and have thus became more heavily burdened at the present time than they were before. Turkey, unfortunately, constitutes one such example. It is, therefore, interesting to approach the case of the newly emerging financial markets from the viewpoint of Turkey and assess the results. The important point in this context is not the financial deregulation itself, but the integration of this mechanism in the case of a developing country and its utilization as an ordinary financing tool of economic deficits, both internal and external.

The Framework

The main means of regulating financial flows among nations is the discrepancy between the world interest rate and the rates prevalent in the different countries. Financial capital, in search of the highest possible return, is directed towards the region where it collects the highest return.

The high level of public sector borrowing requirement compared to the size of financial markets, under fiscal liberalization, results in increased interest rates and a reduced demand for money. Dollarization and/or shifting to any other sort of financial intermediary other than the domestic currency aggravates inflation and causes an increase in the demand for foreign currency. It is therefore self-evident that financial liberalization aggravates inflation rather than contributes to anti-inflationary policies.

Financial capital, being quite different from investment capital, is in the nature of short-term, speculative portfolio capital and one cannot therefore expect to exert a direct effect on the volume of investments. It may only be through the interest-effect that such a link may be constructed between capital inflow and the volume of investments in a country.

Despite the fact that financial capital inflow eases foreign payments problem during the initial period, in the long run it aggravates foreign payment problems in two different ways. Firstly, unless the received capital is not invested to increase the foreign exchange earning capacity of the economy at a higher rate than that of interest, foreign payment deficit may even become worse at the period of redemption. In Turkey,
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as in all developing countries with huge internal and external deficits, received financial capital is mostly used to finance such deficits instead of directing them to material investments. Empirical studies indicate that financial deregulation has not contributed as much to the total volume of investments as was expected.3

Secondly, financial capital inflow increases in response to high interest rates at home. Thus accumulated foreign exchange makes the domestic currency overvalued, which impedes exports and fosters imports, and results in an enlarged foreign trade deficit. In this way, the economy is pushed into a huge foreign trade deficit, making it necessary for the country to resort to increased borrowing and resulting in a kind of vicious circle that cannot be broken by inherent economic forces.

Financial capital inflow is triggered by overvalued domestic currency and high interest rates fueled by the large volume of public sector borrowing requirement. The well-known process of hot-money policy is based on these two factors; namely, overvalued domestic currency on the one hand, and high interest rate on state bonds on the other. Devaluation may be necessary in order to avoid the harmful effects of overvalued domestic currency on exports. However, such an attempt directs speculators towards foreign currency abruptly and the tragedy of capital outflow begins.

Policy makers, therefore, are very unwilling under such conditions to resort to devaluation because of the threat of immediate capital outflow without giving enough time to increase exports to compensate for financial capital drainage. Thus a vicious circle is created; namely, high PSBR will cause high interest rates, high interest rates will cause fi-

3) Önis–Riedel (1993), pp. 87–89.
Financial capital inflow will repress foreign currency parity, thus domestic currency will be overvalued, overvalued domestic currency will cause an increase in imports and a decrease in exports, increase in imports at a higher rate than the increase in exports will result in an increased foreign trade deficit, and the surge in foreign trade deficit will make foreign currency necessary.

Financial liberalization results in currency substitution and dollarization in most of the developing countries.\(^4\) Currency substitution, narrowing the inflation tax–base, further aggravates inflation.\(^5\) Currency substitution causes an increase in the volume of foreign exchange deposits compared to that of domestic deposits. The injection of foreign exchange into income flow limits the role of the central bank in controlling the money base and other monetary variables. The high rate of currency substitution makes it necessary for central bank to accumulate an excessively large volume of foreign exchange reserves against the threat of a sudden shift to foreign exchange by investors.

Large volume of capital inflow leads to steep increases in stock prices and thus renders the stock market volatile. When a large volume of financial capital inflow takes place in a relatively shallow stock exchange market stock prices increase over their would–be optimum values, which would be determined by the productivity and profitability of the companies to which they belong. Such a steep increase in stock prices not only reflects an artificial jump, it also makes the market very sensitive to external shocks.\(^6\)

\(^6\) Akyüz (1992), pp. 16–18.
Financial liberalization in a country where the volum of PSBR is very high and shallow financial markets prevail makes it very difficult for public authorities to realize macro adjustments. An economy under such conditions becomes exposed and very sensitive to external variables, and, in most cases, to external shocks.

Currency substitution also exerts a deteriorating effect on real markets. That the central bank is obliged to keep the interest rate at a high level in order to prevent the public and financial investors from shifting to foreign exchange creates a very powerful incentive for capital owners to substitute financial capital for material investment capital. In other words, both foreign and domestic investors prefer to enter into financial markets rather than invest in real markets. Narrowing the size of real investments and output in the face of high interest rates not only aggravates inflation due to the relatively small size of the gross domestic product, but also impedes exports by limiting the size of exportable commodities.

A relatively small size of gross national product on the one hand, and high interest on the other, make income distribution worse. Owners of large capital can save their principal and earn high interest income, whereas wage and salary earners are deteriorated. In other words, in such an economy wages and salaries will be crowded out by high interest rates.

Last but not least, financial capital is very mobile, which makes it difficult to levy tax on this income category. As the share of interest income in national income increases the tax base will be reduced. While increased inflation together with high interest rates and unequal income distribution make it necessary for the state to increase public ex-
penditure, the impossibility of taxing this ever-increasing unique factor income, namely interest income, enlarges the gap between public expenditure and tax revenue. Thus, financial liberalization, through a series of very intricate and complicated stages, has a deleterious effect on the national economy and increases public sector borrowing requirement.

**Causes and Effects of Financial Liberalization in the Turkish Economy**

The beginning of the 1980s constituted a turning point in the Turkish economy, which was then converted from an inward oriented economy to an outward oriented economy. Several measures were taken in order to integrate the economy into the world market. Financial liberalization was one of the measures launched at various different stages at that time. Until these liberalization measures were put into effect, financial repression policy such as taxing financial income and applying negative interest rates, etc., were the rule.7)

The very first step was to lift the interest rate ceiling on deposits, which led to a somewhat cut-throat competition between banks. Ultimately the system was halted by the financial crisis of 1982. Some of the banks, especially those with small deposit volume and a relatively weak financial structure became insolvent.

The liberalization of foreign exchange, in the sense that domestic banks were allowed to accept foreign exchange deposits and foreign banks were allowed to open up branches in Turkey, was realized in the beginning of 1984. Following this very first step, controls on foreign ex-

7) Önis–Riedel (1993), ch. 7.
change were lifted, thus completing full liberalization of capital accounts. However, one last point in this process was the acceptance of full convertibility of the Turkish Lira, which was realized in 1989.

The financial liberalization measures, which were gradually put into effect led to a large volume of foreign exchange inflow in the form of portfolio investment and/or foreign exchange deposits. Such massive capital inflows were regarded not only as a miracle solution to the balance of payment problems, but also as a threat to capital outflow in the future and a brake on the domestic production. The central bank was burdened by the new function of controlling the tendency of the public towards currency substitution.

Financial liberalization in Turkey has been perceived as a means of overcoming foreign trade deficits. As can be seen in column–7 of Table–1, exports have always lagged behind imports. Despite all economic efforts to get rid of the foreign exchange bottleneck problem from which Turkey has suffered since the mid–1950s no solution to the problem was found. Therefore Turkey tried a rather risky way of by–passing this difficulty by creating a capital account surplus and it has been discovered that the easiest way of creating a capital account surplus is to attract foreign exchange from the enlarged volume of world financial capital.

There is another reason worth mentioning here for Turkey's attempt to repress the value of foreign exchange, especially the US dollar against the Turkish Lira. About 80% of imports consists of investment goods and industrial inputs. It was therefore inevitable that Turkey should increase its imports during economic progress in order to obtain the benefit of low–cost industrial inputs. Under inflationary pressures,
Table 1: Some Economic Indicators

<table>
<thead>
<tr>
<th>Years</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
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</thead>
<tbody>
<tr>
<td>1980</td>
<td>-2.8</td>
<td>19.6</td>
<td>8.8</td>
<td>0.6</td>
<td>11.3</td>
<td>4.2</td>
<td>36.8</td>
<td>90.3</td>
</tr>
<tr>
<td>1981</td>
<td>4.8</td>
<td>18.7</td>
<td>4.0</td>
<td>0.9</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>34.1</td>
</tr>
<tr>
<td>1982</td>
<td>3.1</td>
<td>18.0</td>
<td>3.5</td>
<td>0.8</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>27.4</td>
</tr>
<tr>
<td>1983</td>
<td>4.2</td>
<td>18.9</td>
<td>4.9</td>
<td>1.5</td>
<td>14.8</td>
<td>9.2</td>
<td>62.0</td>
<td>28.1</td>
</tr>
<tr>
<td>1984</td>
<td>7.1</td>
<td>17.9</td>
<td>5.4</td>
<td>2.0</td>
<td>17.7</td>
<td>11.7</td>
<td>66.3</td>
<td>46.4</td>
</tr>
<tr>
<td>1985</td>
<td>4.3</td>
<td>20.0</td>
<td>3.6</td>
<td>1.9</td>
<td>16.6</td>
<td>11.7</td>
<td>70.2</td>
<td>41.7</td>
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<td>1986</td>
<td>6.8</td>
<td>23.1</td>
<td>3.7</td>
<td>2.6</td>
<td>14.5</td>
<td>9.8</td>
<td>67.1</td>
<td>27.5</td>
</tr>
<tr>
<td>1987</td>
<td>9.8</td>
<td>24.6</td>
<td>6.1</td>
<td>3.0</td>
<td>16.1</td>
<td>11.6</td>
<td>72.0</td>
<td>39.3</td>
</tr>
<tr>
<td>1988</td>
<td>1.5</td>
<td>26.1</td>
<td>4.8</td>
<td>3.9</td>
<td>15.8</td>
<td>12.8</td>
<td>81.4</td>
<td>60.8</td>
</tr>
<tr>
<td>1989</td>
<td>1.6</td>
<td>22.5</td>
<td>5.3</td>
<td>3.6</td>
<td>14.5</td>
<td>10.7</td>
<td>73.6</td>
<td>64.2</td>
</tr>
<tr>
<td>1990</td>
<td>9.4</td>
<td>22.6</td>
<td>7.4</td>
<td>3.5</td>
<td>14.6</td>
<td>8.5</td>
<td>58.1</td>
<td>50.0</td>
</tr>
<tr>
<td>1991</td>
<td>0.3</td>
<td>23.5</td>
<td>10.2</td>
<td>3.8</td>
<td>13.8</td>
<td>8.9</td>
<td>64.6</td>
<td>52.6</td>
</tr>
<tr>
<td>1992</td>
<td>6.4</td>
<td>22.8</td>
<td>10.6</td>
<td>3.7</td>
<td>14.3</td>
<td>9.2</td>
<td>64.3</td>
<td>67.1</td>
</tr>
<tr>
<td>1993</td>
<td>8.1</td>
<td>25.3</td>
<td>12.2</td>
<td>5.8</td>
<td>16.2</td>
<td>8.4</td>
<td>52.1</td>
<td>55.2</td>
</tr>
<tr>
<td>1994</td>
<td>-6.1</td>
<td>24.3</td>
<td>8.1</td>
<td>7.7</td>
<td>17.8</td>
<td>13.8</td>
<td>77.8</td>
<td>120.5</td>
</tr>
<tr>
<td>1995</td>
<td>7.1</td>
<td>23.2</td>
<td>6.7</td>
<td>7.5</td>
<td>21.1</td>
<td>13.0</td>
<td>61.5</td>
<td>88.0</td>
</tr>
</tbody>
</table>

Notes: Explanation of the Columns
(1) Annual percentage change in GNP (new series).
(2) Fixed capital formation, as percentage of GNP.
(3) PSBR, as percentage of GNP.
(4) Public sector interest burden, as percentage of GNP.
(5) Imports, as percentage of GNP.
(6) Exports, as percentage of GNP.
(7) Export/Import ratio.
(8) Annual price increase (wholesale prices).

Related pages for each column (C) are as follows: C1–P3, C2–P19, C3–P53 and 54, C4–P53 and 54, C5–P30, C6–P28, C7–P32, C8–P88.

Undervalued foreign exchange used to import industrial inputs and investment goods contributes, in its own capacity, to anti-inflationary policies by keeping prices relatively low. Though it is difficult to specify the exact degree of the effect of such undervalued foreign exchange policy, one can say that it has certainly put a brake on rises in the general price level. However, the difficulty in this policy has been the fact that the very same policy has led to currency substitution, i.e. dollarization,
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Table-2 Wholesale Price Index and the Index of Values of Selected Foreign Currencies

<table>
<thead>
<tr>
<th>Years</th>
<th>Wholesale Price Index</th>
<th>US $</th>
<th>Y</th>
<th>DM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1988</td>
<td>158</td>
<td>166</td>
<td>186</td>
<td>169</td>
</tr>
<tr>
<td>1989</td>
<td>263</td>
<td>247</td>
<td>257</td>
<td>236</td>
</tr>
<tr>
<td>1990</td>
<td>416</td>
<td>304</td>
<td>304</td>
<td>339</td>
</tr>
<tr>
<td>1991</td>
<td>620</td>
<td>487</td>
<td>521</td>
<td>525</td>
</tr>
<tr>
<td>1992</td>
<td>1,048</td>
<td>802</td>
<td>912</td>
<td>925</td>
</tr>
<tr>
<td>1993</td>
<td>1,600</td>
<td>1,283</td>
<td>1,673</td>
<td>1,388</td>
</tr>
<tr>
<td>1994</td>
<td>2,570</td>
<td>3,471</td>
<td>4,919</td>
<td>3,871</td>
</tr>
<tr>
<td>1995</td>
<td>6,600</td>
<td>5,341</td>
<td>8,136</td>
<td>6,685</td>
</tr>
</tbody>
</table>

Source: Main Economic Indicators, State Planning Organization, Ankara, June, p. 77, 114.

which has had a negative effect on anti-inflationary policies. Table-2 makes it evident that Turkey has repressed the value of foreign exchange considerably over the last ten years or more. The year 1994 exceptional insofar as a serious crisis took place then, which resulted in a tremendous increase in both the value of foreign exchange and interest rates. Another striking fact in the table is that the Japanese Yen has gained its normal value over the period. The reason for this divergence is that only 3–5% of Turkish imports come from Japan and that the foreign debt of Turkey is largely on a dollar basis.

The three tables given in the appendix when considered together reveal one important fact. A gradually increasing public sector borrowing requirement has been the main triggering factor for financial liberalization in Turkey. In the second of the 1980s, PSBR began to show an increase, reaching about 10% at the end of the 1980s. At the same time, export/import ratio has never risen above 80%, remaining for most of the period below 70%. The foreign trade deficit has not been eliminated.
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Under these conditions short term speculative capital was thought to be helpful in coping with both the balance of payments problems and domestic deficits. With this purpose in view, financial liberalization policies, together with full convertibility of the Turkish Lira, have been launched on a gradual basis. As a result, the volume of foreign exchange deposits increased to about 45% of the total deposits in 1994 from a level of 24% in 1988. The total volume, including direct short-term portfolio investments and foreign exchange credits extended by international financial circles can be seen in Table-3.

Table-3 Speculative Short-Term Capital Flow and Some Related Indicators (Million US $)

<table>
<thead>
<tr>
<th>Years</th>
<th>Return on Hot Money</th>
<th>Net Inflow</th>
<th>Reserves at Central Bank</th>
<th>For. Ex. Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>-0.07</td>
<td>-1,766</td>
<td>2,307</td>
<td>24.4%</td>
</tr>
<tr>
<td>1989</td>
<td>0.23</td>
<td>2,464</td>
<td>4,831</td>
<td>21.9%</td>
</tr>
<tr>
<td>1990</td>
<td>0.29</td>
<td>1,627</td>
<td>5,972</td>
<td>22.2%</td>
</tr>
<tr>
<td>1991</td>
<td>-0.04</td>
<td>1,431</td>
<td>4,918</td>
<td>29.1%</td>
</tr>
<tr>
<td>1992</td>
<td>0.15</td>
<td>3,314</td>
<td>6,116</td>
<td>33.8%</td>
</tr>
<tr>
<td>1993</td>
<td>0.04</td>
<td>5,997</td>
<td>6,213</td>
<td>38.7%</td>
</tr>
<tr>
<td>1994</td>
<td>-0.32</td>
<td>-3,914</td>
<td>7,112</td>
<td>45.7%</td>
</tr>
<tr>
<td>1995</td>
<td>0.20</td>
<td>8,388</td>
<td>12,390</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: 'Net Flow' shows the total of inflow of portfolio investments, foreign exchange deposits, and foreign exchange credits of the banking system.

Financial liberalization brought about a change in the role of the central bank. As mentioned above, the bank began to increase its reserves to fulfill its new duty. The central bank must be ready to stop the public and financial centers from shifting to the US dollar or any other foreign currency in anticipation of devaluation and a sudden drop in the net yield of foreign exchange, especially the US dollar. The large vol-
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Volume of dollar reserves held by the central bank is a safeguard against capital outflow. This requirement not only limits the room for manoeuvre open to the central bank, but also makes it very costly for the bank and the economy as a whole.

The most important aspect, and the most tragic one at the same time, of financial liberalization as realized in Turkey in the 1980s has been the fact that it has become more difficult for the authorities to govern the economy. Under such conditions, since capital inflow was not channelled to productive and foreign exchange yielding investments, the economy was burdened with ever-increasing foreign deficits. Due to increasing foreign borrowing the interest payment to foreigners reached about 2% of GNP in 1995 from a ratio of only 0.2% at the beginning of the 1980s. This percentage implies, on the average, about one half of the annual net increase in GNP. In addition to this, interest payments were made on foreign exchange deposits and foreign exchange loans. That such short-term portfolio capital inflow made no contribution to the foreign exchange earning capacity of the economy through increased real investments resulted in high foreign payment deficits, which increased the need for foreign exchange.

The system exerted an inherently deleterious effect on the economy without the authorities being able to take any corrective measures. If the system were left to its own dynamics it would lead the economy to far-reaching internal and external deficits and shocks. But on the other hand, if some corrective measures were to be taken, it would merely hasten the catastrophe. Thus, without any deliberate manipulation, the economy entered the year 1994 in a very weak and fragile condition. No effective measures were taken, simply because it was absolutely impos-
sible. In fact, the government tried to put a brake on the rise in interest rates in order to stimulate retarded investments. That was the final cause of the 1994 crisis. Two rating institutions, namely “Standard and Poors” and “Moody” lowered the credibility rating of Turkey and this resulted in a sudden outflow of portfolio capital from Turkey. The response of the policy makers against the drainage of financial capital has been to increase the interest rates together with the implementation of a sharp devaluation. The cost of the 1994 crisis to the economy has been a 6.1% real decrease in the GNP, and an annual price increase of about 150%, let alone a fall in capacity utilization and mass lay-offs.

Financial liberalization has not only weakened the basis of real investments, but has also aggravated income distribution. As can be observed in Table–1, column–4 in the appendix, interest burden on the state budget has increased tremendously. The fact that interest accrues to the relatively rich groups in the economy is a factor which has impaired income distribution. Besides, as interest is a cost element, wages and salaries have been squeezed by high interest costs. Eventually, the unequal distribution of income gave rise to distortion in consumption patterns, and contrary to the general belief, the general level of consumption shows a relative rise, which implies deterioration in the general level of investments. The result falsifies the McKinnon–Shaw hypothesis, which asserts that removing financial repression will have a strong positive effect on savings.8

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McKinnon (1973).
Shaw (1973).
Conclusion

The beginning of the 1980s has been a turning point for Turkey. It was decided then to shift the economy from an inward oriented and protected system into an outward oriented and liberalized setting. The lifting of repressive measures on financial markets, referred to as financial liberalization, has been realized gradually over the 1980s as part of a general policy change. Financial liberalization was put in effect mainly for two distinct reasons. One of these reasons was rather theoretical. It was believed in some circles that financial repression is the main cause of macroeconomic distortion and some main economic problems such as deficits, trade problems, etc. It was therefore inevitable, according to this view, that recourse should be made to financial liberalization if such economic disorders were to be avoided.  

The second reason has been the search for a solution to the state of heavy indebtedness that Turkey was then in. The advice given by financial centers was that Turkey ought to adopt financial liberalization policies in order to attract capital inflow and thus ease the foreign trade problem.

However, the realization of financial liberalization did not contribute to the solution of the main economic problems, as was expected, but led to perverse results in the economy as regarded both allocative and distributive efficiency. The findings may be summarized as follows:

- Financial liberalization did not increase total savings as expected. Though fixed capital formation, taken as an indicator of savings potential of the economy, increased from 19.6% in 1980 to around 24% to-

wards the end of the 1980s, such an increase cannot compensate for the budgetary loss and other problems attributable to financial liberalization.

- Financial liberalization resulted in currency substitution, which became a widely used practice, especially in the second half of the 1980s. The percentage of foreign exchange deposit in total deposit showed a huge increase from 24% in 1980 to 46% in 1994.\(^{10}\)

- Dollarization aggravated inflationary pressure on the economy, while exerting a negative effect on anti-inflationary policies by providing a means of hedge against inflation to the newly injected currency. However, as the volume of dollar currency grew, the threat of inflationary pressure on the economy increased.

- The lifting of the restrictions on fiscal instruments resulted in an increase in interest rates and the increase in nominal interest rates resulted in short-term speculative portfolio capital inflow. Capital inflow, while being of some help in solving short-term balance of payments problems, aggravated foreign payment issues by causing overvaluation of the domestic currency. As a result of the revaluation of the Turkish Lira, exports decreased, while imports grew. As can be seen in Table–1, column–7 in the appendix the export/import ratio showed no improvement in favor of exports throughout the period. One reason for this was the undervaluation of foreign currency, which can be traced in Table–2 in the appendix. Without fostering exports it is impossible to improve the foreign exchange earning capacity of economy and to cure foreign trade deficits. Keeping the value of foreign exchange repressed thus creates a vicious circle of trade deficit–capital inflow–repressed or unser-\(^{23}\)

\(^{10}\) See Table–3, Column–5 in the appendix.
valued foreign exchange—and again trade deficit.

- Financial liberalization exposes financial markets to artificial shocks, thus making them vulnerable. High interest rates, together with overvalued domestic currency, is a combination of policies which yields very high nominal return on speculative capital. Rate of return on hot money increased by up to 29% in 1990, as can be seen in Table–3. The capital inflow thus attracted makes it necessary for the central bank to hold high foreign exchange reserves in order to be able to keep the rate of foreign exchange at reasonable levels if a capital outflow should take place. Since nominal return on one unit of foreign exchange, e.g. the US dollar, depends on both interest rates and overvalued domestic currency, any threat of devaluation causes an abrupt decrease in the nominal return on foreign exchange, thus causing capital outflow. It is therefore necessary a large volume of foreign exchange reserves must be held by the central bank in order to meet a period of crisis without causing a steep increase in the interest rate.

- Uncontrolled capital inflow also causes financial bubbles in securities markets. Under inflationary pressures, people become more inclined to take high risks and bid higher prices for financial instruments. But when a downturn of the cycle appears, everything gets even worse. Financial bubble creation is very dangerous, especially when markets are too shallow. Creating financial instability can undermine the productive efficiency of the system.11

- Financial liberalization and subservience to the increased role of the pricing mechanism without developing any supervisory system and/or having an efficient and appropriate market structure leads to finan-

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cial disaster. It is therefore necessary to resort to financial liberalization not as a means of curing instability, but just the reverse, as a mechanism which can function efficiently only under conditions where macroeconomic dynamics are in good shape and a certain level of development has been attained.

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