

ECONOMIC INDICATORS

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Turkey's Overall Capital Structure vs The Arithmetic of The IMF Fiscal Rule

Macro Comment

Summary:

- ◆ Turkey's macroeconomic fundamentals are unable to run such a fiscal rule that will both allow for an infinitesimal adjustment of the primary budget surplus to potential deviations from the fiscal targets and secure a stable macroeconomic environment enough to fuel the engines of growth.
- ◆ The economies under the IMF's tight policy principles, such as Mexico and Argentina, have faced a tough choice between restructuring short-term debt obligations and taking unpopular restrictive fiscal measures. With relatively low domestic debt-to-GNP ratio, it was somewhat surprising to see these economies entering the vicious circle of debt crisis.
- ◆ With the fiscal rule for debt accumulation and long-term fiscal solvency, an annual primary budget surplus target of 6.5% of GNP can only pull down debt-to-GNP ratios to sustainable levels if it succeeds in securing a stable macroeconomic environment with an annual average growth rate of 5.0% and a real interest rate of 15.0% through the end of 2009.
- ◆ The extent of primary budget balance to GNP target, as an instrument to secure the fiscal austerity, is open to discussion.
- ◆ In our view, Turkey's social and macroeconomic fundamentals are inconsistent with the government's commitment to maintaining a 6.5% primary surplus, which could lead to significant cutbacks in infrastructure investment spending, productivity and efficiency losses in the labor and goods markets.
- ◆ In the absence of a large bilateral loan package, assuming that Turkey's macroeconomic environment would fairly be stabilized at an annual growth rate of 5.0% and an average real interest rate of 15.0% in the next five years, the optimal primary surplus to GNP ratio, in our view, is in the 4.1-4.4% range.
- ◆ From our perspective, the IMF fiscal conditionality facing the government sets a tougher fiscal scene than what Turkey's growth dynamics, capital structure and domestic debt stock profile currently require.
- ◆ The strength of Turkey's overall capital structure plays a critical role in making the economy more resilient to any disturbance, and hence eliminating the risk of facing long-term financial solvency. Governance in public institutions, capital adequacy needs of the domestic banking system, non-performing loans, taxation and privatisation portfolio are key components of Turkey's overall capital structure.
- ◆ With a better capitalised macroeconomic structure, Turkey's economy now looks more resilient to adverse impacts of cyclical fluctuations than in the past, raising a basic question as to whether the arithmetic of the IMF-defined fiscal rule computes an appropriate primary budget size for the Turkish economy.

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The arithmetic of the IMF-defined fiscal rule

The IMF fiscal rule requires the government sector primary fiscal balance to be adjusted on a continual basis to ensure the long-term fiscal solvency. According to this rule, when something happens to disturb the long-term fiscal solvency, the government is expected to introduce new fiscal austerity measures to improve its flow fiscal position, keeping investors' appetite high for lending domestic financial markets. Under such a strict fiscal rule, whenever the level of the outstanding public debt changes, the present value of future primary surpluses is expected to change by exactly the same amount, regardless of the path that prices and interest rate may follow. The IMF's tough stance on long-term fiscal solvency and debt accumulation requires not only a strong primary surplus commitment, but also a sustainable growth environment where financial markets broadly remain stable. However, Turkey's macroeconomic fundamentals are unable to run such a fiscal rule that will both allow for an infinitesimal adjustment of the primary budget surplus to potential deviations from the fiscal targets and secure a stable macroeconomic environment enough to fuel the engines of growth.

Such a fiscal regime, briefly mentioned above, assumes that high indebtedness results in weak growth prospects, as large accumulated debt stock raises concerns over the capacity to pay. A fall in debt service capacity makes it unlikely to incur costs today for the purpose of increased output in the future. Thus, if there is a likelihood of large levels of accumulated debt stock, debt service is expected to become an increasing function of the output level, implying lower returns from foreign investment, and hence, discouraging both domestic and foreign investment. As a result, under such a stringent fiscal rule intensely advised by the IMF authorities, heavily accumulated debt stock in an emerging economy leads to further weakening of growth performance.

Going forward, unfavorable effects of the surging debt stock on growth may not only be through the channel of reduced investment volume, but also through a poorer macroeconomic policy environment, which might stem from the fact that the debt service will be financed with distortionary types of taxation (inflation tax) or with cuts in productive public investment. Even if the macroeconomic fundamentals show consistent signs of improvement, a distortionary

taxation may result in a lower rate of return on capital, which leaves the investors more reluctant to new large-scale projects. In such economies, the investors prefer to invest in trading activities with quick returns and high risk, rather than longer-term business lines, resulting in distorted macroeconomic environment.

Main macroeconomic policy framework for the IMF programmes

Implementing stabilization programme under a monetary-fiscal regime, which combines a downward prone-interest rate rule with a strict fiscal policy commitment (aggressive primary surplus targeting) has become main macroeconomic policy framework for the IMF programmes. The ultimate aim is to help resolve the chronic public debt overhang, and in turn increase confidence in troubled economies' ability to service their debt without introducing major distortions into domestic financial markets and disturbing the disinflation process. Given that restoring international investors' confidence in a troubled economy's ability to service its debt is the first requirement to grow out of the debt trap, floating exchange rate regime is imposed to leave the investors comfortable with the view that the economy could ease the negative macroeconomic consequences of plausible political and external shocks.

Lessons from the major emerging market debt crises

Potential up and down movements in domestic financial markets that are simply a by-product of floating exchange rate regime make excessively high primary budget surplus targeting indispensable in order to avert problems in domestic debt market spilling over into additional pressures on the government budget. Thus, the economies under the IMF's tight policy principles, such as Mexico and Argentina, have faced a tough choice between restructuring short-term debt obligations and taking unpopular restrictive fiscal measures. With relatively low domestic debt-to-GNP ratio, it was somewhat surprising to see these economies entering the vicious circle of debt crisis. Under the IMF literature, especially the Mexican economy that registered a record fiscal adjustment and improved its macroeconomic growth prospects in early 1990s should not have become insolvent

in 1994. When Argentina defaulted on US\$ 135 billion of debt in late 2001 and then allowed Peso to float freely, its total debt to GNP ratio was only at 54%, much lower than the Turkish government's total debt to GNP ratio of 97.7% in the same year. Interestingly, despite considerable delays in structural reform agenda and large fiscal slippage of 2.5% of GNP in 2002, Turkey's high debt-to-GNP ratio did not feed through into a debt crisis.

Based on recent experiences and lessons from the major emerging market debt crises of the last decade, such as Mexico / Feb-1994, Russia / Aug-1998, Argentina / Nov-01, the emergence of the debt crises is currently attributed to the following problems: (1) Significant worsening of fiscal positions, (2) sharp weakening of foreign exchange reserves, (3) further widening in maturity mismatches, which, in turn, results in higher debt rollover and interest rate risks, (4) persistent rising of short-term dollar denominated debt stock and (5) further deterioration in capital structure mismatches, which arises from poor governance in public institutions, pressures on banks' capital base, NPL problems, and tax and regulatory distortions. As a result, such problems leave Turkey's long-term financial solvency increasingly dependent on how much cyclical fluctuations are disruptive to its overall balance sheet structure. Accordingly, Turkey's resilience to uncertainties and adverse exogenous shocks is the key to the debt sustainability.

The Case of Turkey

Stronger balance sheet structure requires that (1) fiscal austerity and structural adjustment be ensured, (2) regulatory and legislative problems be solved and (3) a sufficient cushion of foreign exchange reserves be maintained. With the fiscal rule for debt accumulation and long-term solvency, an annual primary budget surplus target of 6.5% of GNP can only pull down debt-to-GNP ratios to sustainable levels if it succeeds in securing a stable macroeconomic environment with an annual average growth rate of 5.0% and a real interest rate of 15.0% through the end of 2009. Moreover, the period of fiscal tightening is increasingly dependent on potential endogenous shocks and bureaucracy's ability to ease the controversial macroeconomic consequences. A high-quality bureaucracy is the key not only to ease adverse effects of potential deviations from the fiscal and structural benchmarks agreed with the IMF, but to reduce

policy deviations from the general framework in the period of political fluctuations as well.

However, the extent of primary budget balance to GNP target, as an instrument to secure the fiscal austerity, is open to discussion. In our view, Turkey's social and macroeconomic fundamentals are inconsistent with the government's commitment to maintaining a 6.5% primary surplus, which could lead to significant cutbacks in infrastructure investment spending, productivity and efficiency losses in the labor and goods markets. Coupled with the presence of distortionary taxation putting pressure on the free market mechanism, this would no doubt weaken Turkey's long-term growth prospects, and hence making it unlikely to achieve the annual average growth target of 5% in the stabilization period as a whole. In the absence of a large bilateral loan package, assuming that Turkey's macroeconomic environment would fairly be stabilized at an annual growth rate of 5.0% and an average real interest rate of 15.0% in the next five years, the optimal primary surplus to GNP ratio, in our view, is in the 4.1-4.4% range.

Fiscal Tightening: Beyond what Turkey's socio-economic structure requires

From our perspective, the IMF fiscal conditionality facing the government sets a tougher fiscal scene than what Turkey's growth dynamics, capital structure and domestic debt stock profile currently require.

According to monthly outstanding domestic debt data, the Treasury's maturity profile stopped shortening by mid November 02. Thus, existing maturity structure does not pose a potential threat to the government's debt payment capacity. Accordingly, it is fair to say that the maturity structure of the outstanding domestic debt will not put further pressure on rollover risk for the months ahead.

The Treasury succeeded in reducing the foreign exchange component of outstanding domestic debt to 31% at the end of February 03 from 36% at the end of December 01. Besides, the proportion of the floating rate notes also showed a significant drop during the period December 01-February 03, declining as much as 8 percentage points to 42% from 50%. As a result, existing interest rate structure leaves the Treasury's debt payment capacity less sensitive to

spikes in short-term interest rates, compared with a year earlier. If the Treasury continued to keep the domestic debt structure at the same level (with 86% either FX linked/indexed or set at floating interest rates), from the end of 2001 onwards, even a small increase in interest rate or a weakening of the Lira would have feed through to uncomfortable domestic debt ratios. In parallel, a sharp depreciation of the Lira, combined with a hike in interest rates would have rapidly translated into higher debt-servicing burden.

Conclusion

The strength of Turkey's overall capital structure plays a critical role in making the economy more resilient to any disturbance, and hence eliminating the risk of facing long-term financial solvency. Governance in public institutions, capital adequacy needs of the domestic banking system, non-performing loans, taxation and privatisation portfolio are key components of Turkey's overall capital structure.

First, the government has big-ticket items portfolio to be privatized, which will ensure an "equity buffer" to cushion its long-term debt service capacity against exogenous shocks.

Second, following the approval of the legislation for the second phase of the tax reform, the Parliament is expected to pass the legislation to improve the governance in public institutions (especially State Economic Enterprises) and adopt a reform package for Execution and Bankruptcy Act, strengthening Turkey's capital structure.

Third, the Turkish banking system is currently less leveraged and the ratio of capital-to-risk adjusted assets is in line with BIS international capital adequacy standards and above the levels needed to ease exposure to potential risks. Thus, a strong capital buffer can absorb adverse impacts of these risks on bank balance sheets, keeping the banks' ability to rollover the domestic debt. More importantly, according to recently announced Letter of Intent, to sustain the profitability and the capital adequacy levels of the banks, an inter-agency working committee will be established. The committee will develop an action plan to reduce the intermediation costs of the banking sector as monetary and fiscal conditions permit.

Fourth, with the approval of a framework agreement for the so-called Istanbul Approach in 2002, a total of 231 companies applied to the Istanbul Approach as of March 03. 135 deals were agreed upon and US\$ 3,797 million was restructured. Under such circumstances, corporate sector moved away from further capital losses, alleviating concerns over risk of facing a renewed systemic risk.

Fifth, based on the completion of the 4th review, the ruling government committed to make every effort to preserve the Banking Regulatory and Supervisory Authority's (BRSA) independence by describing the administrative cases, such as shortening the time limits and declaring the priority cases.

With a better capitalised macroeconomic structure, Turkey's economy now looks more resilient to adverse impacts of cyclical fluctuations than in the past, raising a basic question as to whether the arithmetic of the IMF-defined fiscal rule computes an appropriate primary budget size for the Turkish economy.