TURKISH DEVALUATION: PROMISES AND PITFALLS *

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The devaluation of the Turkish Lira in August, 1970, offers the prospect that Turkey may, during the 1970's, enter a new phase of economic growth. If all goes well, the economy may embark upon a period of rapid growth, the primary stimulus to which will come from changed structural relations and rationalization of economic activity. With such an altered growth orientation, the prospects would indeed be rosy: whereas balance-of-payments difficulties, a rising capital-output ratio, intensive resource accumulation, high-cost industry, and excess demand characterized Turkish economic growth during the 1960's, the 1970's might well be a period during which increasingly competitive Turkish industry enables more rapid growth without such excess demand or foreign exchange bottlenecks. Moreover, it is quite conceivable that a decline in the capital-output ratio could enable a lower rate of increase in the rate of resource accumulation, while simultaneously permitting more rapid growth.

However, it is also possible that, within a fairly short period of time, domestic inflation and other phenomena will erode the potential gains that could have been achieved by devaluation. If that happens, the economy will quickly return to the atmosphere of shortages, high-cost production, and sellers' markets that prevailed during the late 1960's. Then it would be doubtful whether the seven per cent growth rate of the 1960's could be sustained. Indeed, the problems that characterized the Turkish economy of the 1960's could intensify, resulting in slower growth, if not relative stagnation.

Which of these outcomes occurs will depend, in large part, on government policy over the next two years. Government policy, in turn may well depend upon the degree to which various groups within the

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economy understand the potential gains and losses likely to result from these policies. It is the purpose of this article to suggest some of the factors likely to determine the outcome of devaluation and its aftermath. The first section provides a brief explanation of the theory of devaluation under conditions of exchange control. The second section contains a brief analysis of the devaluation of 1958, and its effects. In the third section, there is a discussion of the problems of the Turkish payments system in the late 1960's, and the reasons why reform was desirable. A final section contains an evaluation of the factors upon which the success of the 1970 devaluation will depend.

I. DEVALUATION FROM A POSITION OF EXCHANGE CONTROL

European and American economics textbooks typically discuss devaluation and its outcome in terms of the "elasticities" and "absorption" approaches[1]. These analyses are relevant for countries wishing to reduce or eliminate a balance-of-payments deficit. The absorption analysis is useful in evaluating the macro-economic conditions under which devaluation will be successful: A country's real expenditure must be reduced relative to its real income. This implies, in particular, that monetary and fiscal policy must not be too expansionary, or any gains that would otherwise have resulted from devaluation will bu nullified by rising domestic prices and domestic demand pressures. The elasticities analysis pertains to the micro-economic conditions for success of devaluation: The higher are the foreign elasticities of demand (for the country's exports) and supply (of the country's imports), the greater will be the net improvement in the payments position for a given devaluation. In practice, most countries are confronted with an almost perfectly elastic supply of imports. The relevant question pertains to the elasticity of foreign demand for its exports. Occasionally, there is a commodity (or group of commodities) for which foreign demand is price-inelastic. In such cases, of course, the country should impose an optimal tax on its exports which would be sufficient to make the equilibrium point lie in the price-elastic range. With such optimal taxes, the elasticities condition for successful devaluation will always

[1] See, for example, C. P. Kindleberger, *International Economics*, Fourth Edition, Chs. 15 and 16. Richard D. Irwin (Homewood, Illinois), 1968.

be met. In practice, there is a tendency to underestimate the degree of demand elasticity: Even Brazilian coffee turned out, once the Brazilians restricted supply, to be in elastic demand, due to the presence of competitive foreign suppliers[2].

With optimal export taxes (which should be imposed independently of the exchange rate) devaluation must -assuming the macroeconomic conditions are met-lead to an increase in foreign exchange earnings; the higher the elasticity of foreign demand, the greater will be the percentage increase in export earnings for any given devaluation.

When countries rely on quantitative restrictions to maintain their payments position, they usually do not have unsustainable deficits (or they could, if they wished, prevent the deficit by tightening their quantitative restrictions); the deficits that would otherwise occur are precluded by issuing import licenses only to the extent of foreign exchange availability[3].

As such, devaluation, if it is successful, will serve fundamentally different purposes than in unified-currency countries. It will tend to reduce or eliminate the implicit or explicit windfall gains and black market profits accruing to those who do receive import licences; it will also alter the relative incentives for import-competing and export production.

These differences are illustrated in Figure I. The vertical axis represents the price of foreign exchange; the horizontal axis the quantity of foreign exchange. Hypothetical demand-for-foreign-exchange (representing the quantity of foreign exchange exporters and others would earn) and supply curves are drawn as DD and SS respectively. The

[2] As a first approximation, the elacticity of demand for an export product from a given country is equal to the elasticity of world demand for the product times the reciprocal of the country's share of the market. The demand for coffee appears to have a price elasticity of demand of about (minus) 0.6. The Brazilian share of the market was 0.5. Hence, after the restriction of supply (equivalent to an export tax), the Brazilian share fell, and other countries increased their share of world coffee exports.

[3] In many cases, a country already subject to quantitative restrictions is incurring an unsustainable deficit and chooses devaluation rather than tightening restrictions. That part of devaluation designed to eliminate unsustainable realized or prospective imbalances can be analyzed along the lines used to evaluate devaluation from a position of open deficit. The remainder -that part designed to liberalize the system- should be analyzed as indicated below.

price of foreign exchange p would enable all who wished to undertake transactions to do so at the prevailing exchange rate, and there would simultaneously be payments balance. Suppose, however, that the price of foreign exchange is fixed by the government at p. An economy not relying upon cpiantitative restrictions would have exports in the amount **oe,** and imports in the amount **om,** with a resulting deficit of **em.** Note especially that, if such a country devalued, the domestic price of *both* exportables and importables would increase; resource reallocation would take place from non-tradeable goods to tradeable goods (providing that domestic inflation did not result in an increase in the price of home goods proportionate to that for traded goods), and the domestic price level would increase, once-and-for-all, but by less than the amount of devaluation.

price of
foreign
exchange

quantity of
foreign exchange

FIGURE 1

By contrast, a country relying upon quantitative restrictions would also earn **oe** of foreign exchange, but would limit the value of import licenses issued to that amount. With imports restricted to the value **oe,** the domestic price of imported goods (and import-competing goods) would be **oq,** even though, at the official exchange rate, the international price was **op.** The black market premium (in a perfect market) import licenses would be **pq.**[4]

Now, if the quantitative-restriction imposing country devalued to the exchange rate p, export earnings would increase and imports would also increase. Therefore, the *domestic* price of imports would fall from *q* to p, while the domestic price of exports would rise from p p. The inflationary effects of devaluation would be smaller, or perhaps even negative, while the value of imports (and exports) would increase, in contrast to the op en-deficit situation. The big change in incentives would be between export and import-competing production. These results contrast sharply with those from devaluation from open deficit, exports rise, imports fall, and the big change in relative prices is between home and traded goods.

In either situation, a sufficiently expansionary monetary and fiscal policy can make the effects of devaluation very short-lived. However, even in the absence of expansionary policies, the analysis of actual situations must take into account several other phenomena: 1) the short run speculative response, 2) the time lags involved in shifts in resource allocations, and 3) expectation.

In reality, most countries undertake devaluation in an atmosphere close to one of crisis[5]. As such, there is typically some discussion of the possibility of an exchange-rate change in domestic and foreign business circles. This inevitably leads to some speculation against the currency (in forms such as failing to repatriate export earnings, under-invoicing exports and over-invoicing imports, building up inventories of export and import goods, etc.), which can, sometimes, force the devaluation decision. Even if the decision to devalue is not forced by speculative pressures, however, the presence of prior speculative activity implies that there will be a short-run improvement in the balance of payments as a result of the reversal of speculative flows. This will be a once-and-for-all reversal, but will nonetheless typically pro-

[4] When there are many commodities with different licenses issued for each, the analysis is more complicated. The underlying reasoning, however, is unchanged. Similarly, the supply and demand curves can easily he reinterpreted to allow for the possibility that the demand for the country's exports is less than perfectly elastic.

[5] This is the almost inevitable result of the fact that devaluation cannot be debated, by democratic processes, before it is undertaken.

vide for a net improvement in the country's payments position; the amount of improvement will be greater, the greater the prior speculative activity.

In contrast to the once-and-for-all effects of reversing the speculative flows, the longer run continuing response to devaluation depends upon shifts in resource allocation and consumption decisions in response to changes in relative prices and the price level. From positions of open deficit, these shifts are generally rather small -a change in the relative price of home goods of more than 10 per cent is rare- and can be effected through incremental changes in output over time. Also, with a higher price level, consumers typically tend to reduce their expenditures on all commodities, thereby freeing part of existing production for export and reducing import demand. Hence, from a position of open deficit, consumption responses can follow very quickly upon the heels of devaluation, while production responses will be marginal, and can be absorbed out of the allocation of new resources in a context of economic growth.

The changes are much sharper in the case of devaluation from a position of quantitative restrictions: changes in the relative domestic prices of exports in terms of imports can be 25 per cent, and even more.[6] Such a shift in relative prices must, by its nature, induce more significant readjustments; incentives for import-competing production for the domestic market are drastically reduced, while those for export production are significantly increased. A full response to the shift in incentives entails a shift in investment plans, and often, in addition, results in decreased levels of production out of existing capacity, in import-competing industries. While the increased domestic price of exports may result in some decrease in domestic consumption, the reduced-consumption effect of devaluation from a position of quantitative restrictions is typically much smaller than in the open-deficit situation. For export production to increase significantly often requires the development of investment plans to expand capacity. This is especially so in situations where the currency has been overvalued for a considerable period of time, and export production of all but a few agricultural commodities has become unprofitable.

[6] This is only symptomatic of the much greater fundamental disequilibrium that can occur with quantitative restrictions.

Because of these considerations, it is often the case that, for devaluation to be successful, investment in import-competing industries declines sharply immediately after devaluation, whereas investment in export industries does not expand significantly for a period of months. This is partly the result of the fact that it takes time to get new investment plans underway, and partly a result of expectations, to which attention will return below.

Under these circumstances, devaluation from a position of exchange control may, if it is to be successful in liberalizing the payments regime on a sustained basis, result in a slowing-down of the rate of growth, or even a recession, for the first half year or year after devaluation. Such a recession may be part of the cost of achieving a more liberalized payments regime; the recession (or reduced growth rate) can free recources which can then be absorbed by the newly-profitable industries. One question, about which little is known, is the degree of recession, or slow-down which is needed to affect the appropriate resource transfers. That such transfers themselves must occur, however, is incontestible.

It is at this point that expectations enter the picture in a critical way. Entrepreneurs are reluctant to make long-term commitments of their recources unless they are confident that those investments will be profitable. After devaluation, there may occur a period of uncertainty during which people are not sure whether the altered relative prices will be sustained or whether the economy will revert, in a short period of time to the old predevaluation relative prices. Whatever recessionary tendencies there might be with devaluation will be greatly intensified if expectations of inflation must be reversed. Under these circumstances, government determination to allow time for readjustment is critical: any move toward expansionary policies can serve to convince decision-makers that inflation will erode the changes which have occurred.

Expectations are likely to be more of a problem, the greater has past inflationary pressure been, and the more expansionary government policies are[7]. However, once producers are convinced that altered relative prices will continue, new investments will be forthcoming.

[7] They will also be more problematic, the more frequently in the past have attempted devaluations and structural realignments been temporary. This is one of the reasons

From the above discussion, it is clear that the policies pursued in the year or so immediately following devaluation will be critical in determining the outcome. Devaluation is not an instantantaneous act: rather, it is a series of policies, designed to achieve a restructuring of the economy. If successful, the rate of growth of exports will increase markedly; moreover, exports will typically diversify. In some case, exports even became a leading-growth sector. Moreover, with successful devaluation and liberalization, greater efficiency and reduced costs within the domestic economy are possible. Changes in the structural parameters underlying the determinants of the growth rate can result not only in more rapid growth, but also in growth which no longer is periodically interruped by payments crises. With this background, we turn to considering Turkey's experience with devaluation in the 1950's.

II. THE 1958 DEVALUATION

Causes of Imbalance:

From the immediate post-World War II years until 1958, the Turkish economy was characterized by intense excess demand. The major cause was government monetary and fiscal policies. Table 1 presents pertinent data on monetary and fiscal policy during the period. Between 1950 and 1958, the money supply was virtually quadrupled rising at an annual rate of over 20 per cent. Simultaneously, government expenditures rose at an average annual rate of 25 per cent. The deficit of the general government budget, not including the deficits of the State Economic Enterprises, was about 2 per cent of government expenditures. When the deficits of the State Economic Enterprises are included, the government deficit approached 10 per cent of GNP in the 1956-1958 period.

The price level, according to official statistics, rose 30 per cent between 1950 and 1954: it fell slightly in 1955 in response to an excep-

why the rapid-inflation Latin American countries have such difficulty in achieving a sustained realignment of relative prices; expectations are for failure, based upon past experience. The fact that future efforts are rendered more difficult by past failures makes it even more important that government policies enable success in any given attempt; each failure will increase the likelihood of subsequent failures. In addition, the costs, in terms of recession or reduced growth, will be higher, the more expectations must be broken.

TABLE 1

MONEY SUPPLY, GOVERNMENT ACCOUNTS, AND PRICE LEVEL
1950 - 1960

	Money Supply	General Government Expenditures	Receipts	(—) Deficit	GNP	Wholesale Price Index
		(billion TL)				
1950	1.13	1.467	1.419	.048	10.4	42
1951	1.37	1.590	1.645	.055	12.3	44
1952	1.60	2.248	2.235	-.013	14.3	47
1953	1.90	2.294	2.272	-.022	16.8	48
1954	2.07	2.564	2.390	-.174	17.1	54
1955	2.65	3.308	3.148	-.160	21.1	50
1956	3.32	3.487	3.304	-.183	24.3	74
1957	4.07	4.162	3.966	-.196	30.5	90
1958	4.35	4.977	4.822	-.155	36.1	100
1959	4.96	6.728	6.385	-.343	44.7	118
1960	5.50	7.320	6.933	-.387	49.0	117

Sources **J**

1) Money supply : International Monetary Fund, *International Financial Statistics,*
2) Goverment Accounts: State Institute of Statistics, *Statistical Yearbook,* 1968, p. 330.
3) GNP : State Institute of Statistics.
4) Wholesale price index (1958 = 100) : International Monetary Fund, *International Financial Statistics.*

tionally good crop year and a major increase in government tax receipts (imposed in a short-lived effort to halt the inflation), and then rose 30 per cent annually between 1955 and 1957. Even these figures understate the extent of inflationary pressures: both agricultural prices and the prices at which the State Economic Enterprises (which account for about half of all industrial output) sold their output, were controlled by the Government, and were kept down in an effort to keep the inflation in check.

In the period 1948-52, the favorable terms of trade confronting Turkey enabled rapid increases in government expenditures with little domestic inflationary effect; imports were permitted freely, and increased to absorb the inflationary pressure that would otherwise have resulted. Turkey had set the TL 2.80 exchange rate in 1946. Although that rate continued official until 1960, balance-of-payments pressures were felt by late 1952. From 1952 on, mounting restrictions were placed upon imports, and multiple exchange rates, combined with quantitative restrictions upon imports, characterized the payments regime.

Table 2 presents the relevant data on the payments regime during the rest of the 1950's. As can be seen, exports declined almost without interruption from 1953-1958. Imports also declined, in response to the quantitative restrictions imposed upon them. The net current account deficit was substantially reduced after 1955, as Turkey's foreign exchange reserves were run down and further borrowing capacity was impaired; imports declined by $80 million between 1955 and 1956, and by a further $50 million between 1957 and 1958; imports in 1958 were less than 60 per cent of their 1953 level. With the rapid inflation of the late 1950's private foreign capital ceased investing in Turkey; there was a net outflow of foreign capital in 1956 and 1957. Simultaneously, errors and omissions turned strongly negative, indicating fairly massive capital outflows [8]. In an effort to control the inflation, the government intensified price controls. The SEE's were instructed not to raise their prices. This not only led to large operating deficits, but the inability of competing private firms to cover their costs. Similarly, a law was passed making it illegal to charge a price yielding a profit margin of more than 5 per cent, or to earn profits in any given year in excess of 20 per cent of invested capital[9].

As a consequence of these, and related moves, a sizeable black market developed, both for domestic goods and in foreign trade. This black market further reduced Turkey's available foreign exchange by diverting it out of official channels.

In addition to black market activities, speculation against the lira rapidly developed. The evidence can only be suggestive of orders of magnitude. The gold ingot price, which, at the official exchange

[8] The International Monetary Fund estimated that exports *and* imports were underinvoiced by more than $100 million annually in the middle 1950's. See *Balance of Payments Yearbook*, Volumes 9 and 10. This evidence is confirmed by comparison of Turkish commodity trade statistics with those of her large trading partners; Turkey's eight largest trading partners reported more imports from Turkey than the total of Turkish exports in 1957 and 1958. The degree of underreporting increased annually from 1954 to 1958 and fell abruptly thereafter.

[9] OEEC, *Economic Conditions in Turkey*, 1956, p. 11.

TABLE 2

THE BALANCE OF PAYMENTS, AND THE REAL EXCHANGE RATE

1953-60

A. Balance of Payments, 1953 - 1960
(millions of U.S. dollars)

	1953	1954	1955	1956	1957	1958	1959	1960
Exports	396	335	313	305	331	249	363	336
Imports fob	468	421	438	358	346	284	433	427
Trade Balance	-72	-86	-125	-53	-15	-39	-70	-91
Net Goods & Services	-141	-159	-130	-25	-34	-84	-124	-122
Net Donations	49	45	51	89	67	91	91	81
Net Private Capital	141	76	12	-29	-61	73	14	25
Net Offical Capital	-49	28	113	7	126	-47	86	-30
Errors and Omissions	0	10	-45	-42	-97	-33	-64	46

B. Turkish Exchange Rates, 1953 to 1960
(liras per U.S. dollar on December 31)

	1953	1954	1955	1956	1957	1958	1959	1960
Export Rates :								
High*	2.80	2.80	2.80	**2.80**	**2.80**	9.00	9.00	9.00
Low	2.80	2.80	2.80	**2.80**	**2.80**	4.90	5.60	9.00
Import Rates :								
High**	4.20	5.60	4.90	5.18	9.02	**9.02**	9.06	9.04
Low	2.82	2.82	2.82	**2.82**	3.50	5.60	5.60	9.04
Real Export Rates***:	208	185	167	135	**111**	**100**	272	272

* Does not include export premia.

** Does not include guarantee deposits or tariffs

*** Export exchange rate divided by wholesale price index.

Sources : International Monetary Fund, *Balance of Payment Yearbook*, Vols. 9 and 10.

rate would have been 4 TL/gram stood at 9.72 TL/gram in 1955, and rose to 18.99 TL/gram by 1958. Inventories of many export commodities rose substantially. This speculation contributed still further to the foreign exchange shortage.

Simultaneously, the deficits of the SEE's required financing. This was accomplished primarily through the creation of Central Bank credits, which led to a further increase in the money supply and hence more inflationary pressures. Central Bank loans to the agencies involved in agricultural marketing alone rose from TL 830 million in 1952 to TL 2,378 million in 1958[10].

The non-agricultural SEE's were estimated to have incurred operating losses of TL 245 million in 1956, and TL 203 million in 1957. Since, in addition, they made investments of TL 593 and TL 761 million in those years, the net borrowing of the SEE's and agricultural marekting agencies was TL 856 million in 1956, and TL 1,330 million in 1957. This was *in addition to* Central and Annexed Budget deficits of TL 197 and TL 223 million in those years[11].

These deficits had to be financed through money creation, which, of course, was more inflationary than price increases would have been.

Meanwhile, the balance of payments situation became critical. As described by one expert :

> "On this basis [of bilateral payments agreements] and with the accumulation of large payments arrears to Western European countries, it [the Government] was able to obtain sources from abroad to continue its policies for a while. The Government later found that, when the external supply of capital goods on credit also diminished, it could still proceed, albeit temporarily, with infrastructure development projects, . . . with the existing machinery. (It used military trucks and bulldozers when the civilian equipment wore out). Construction thus progressed : there were new roads, new dams, and new harbors, but no new vehicles on the roads. Industrial consumer goods, based on imported raw materials, also disappeared from the market..."[12]

[10] Alan D. Forker, "Agricultural Price Intervention by the Government of Turkey", Table 15, mimeo, August 1967.

[11] OEEC, *loc. cit.*, 1958, pp. 17-19.

[12] Ernest Sturc, "Stabilization Policies: Experience of Some European Countries in the 1950's", *IMF Staff Papers*, July, 1968.

The "Stabilization Programme

By the second cpiarter of 1958, the Turkish Government had insufficient foreign exchange[13] to enable it to meet its foreseeable obligations for even a few weeks. Import licencing was virtually suspended, and industrial production declined sharply as even necessary spare parts and raw materials could not be obtained.[14] Inflation was accelerating.

In consultation with the IMF, a Stabilization Programme was agreed upon. As described by the OECD,

"In August 1958, after close consultations with the O.E.E.C. and the I.M.F., the Turkish Government introduced a new economic stabilization programme. Steps were taken to remove the basic causes of inflation, and thus to enable the abolition of controls which were distorting economic development, and the effective rate of exchange of the Turkish lira was reduced considerably. At the same time international co-operative action was taken to alleviate Turkey's immediate balance of payments difficulties: financial aid was granted to meet the short-term foreign exchange needs of the economy ...

> "Vigorous action was required because of the pace of economic development in Turkey had produced a situation of grave internal and external difficulties. Previous attempts to control inflationary developments resulting from large-scale bank financing of private and public investment had had only limited effect; indeed the methods of control used had produced a serious distortion of the international price structure. The discrepancy between internal and external prices had necessitated import taxes and export subsidies, and produced serious increases in foreign debt arrears. By 1957, the shortage of foreign exchange had become so acute that Turkey was unable to purchase

[13] The OEEC estimated short-term Turkish debt to be SI, Oil million at the end of 1957. OEEC, *Economic Conditions in Member and Associated Countries of the OEEC, Turkey* 1958, p. 30.

[14] The fact that State Economic Enterprises attempted to hold their prices down — below the costs of production — only added fuel to the inflation through money creation but also led to a reduction in the level of economic activity in the private sector; private firms were unable to compete with the State Economic Enterprises and were therefore forced to either curtail production or sell at black market prices.

sufficient supplies of materials and spare parts to insure adequate employment of existing productive capacity."[15]

The TL 2.80 = $1 rate was all but abandoned on August 1, 1958. Only opium continued to be exported at the official rate. Three categories of exports were created. Those in category A (tobacco, chromium and copper) received TL 4.90 per dollar. Category B exports (raisins, hazelnuts and figs) received TL 5.60 per dollar, while all other exports (Category C, of which the most important were cotton and other agricultural products) received TL 9.00 per U.S. $1. Similarly, all invisibles receipts and capital inflows were exchanged at the TL9.00 rate.

All imports, except for a few government transactions were also placed in the TL9: U.S. $1 category. It was announced that henceforth, all imports were to be made in accordance with the Import Programme the first of which was published in September 1958 and covered the last quarter of 1958.

Hence, the multiple rate system was totally abandoned for imports, continued to prevail (with some changes in the rates) on commodity exports until 1960 when the exchange rate was changed to 9:1 *de jure*. With the receipt of the first transfer of credit in 1958 the government was able to relax its virtual prohibition of imports somewhat. Quarterly import data are indicative of the degree of relaxation. Imports, already reduced in 1957, were about $100 million each quarter. By the third quarter of 1958, they fell to $59 million, and were $70 million in the fourth quarter. The inflow of imports allowed under liberalization did not begin to arrive in Turkey until early in 1959, because of the lag between orders and delivery. Imports rose to $116 million in each of the first two quarters of 1959, and over $468 million for the year, contrasted with $315 million in 1958 - almost a 50% increase.

The Stabilization Programme, although involving a major change in the trade regime, was primarily directed at stopping the causes of inflation. Import liberalization was one component of this attempt. More important was preventing further increases in the money supply beyond the level justifiable by increases in real GNP and increasing monetization of the rural sector. To this end, stopping the State Economic Enterprises' deficits was critical. As part of the Stabilization agreement, it was stipulated that the State Economic Enterprises should

[15] OEEC, *op. cit*p. 5.

raise their prices so that their deficits could be eliminated. This was done in the spring of 1959, with an average increase of 50 per cent in State Economic Enterprises' prices. These price increases not only enabled the State Economic Enterprises to reduce their deficits, but also permitted renewed economic activity in competing private sector firms.

Despite Stabilization Programme agreement, the government budget for 1959 envisaged another massive increase in expenditures. In fact, central government expenditures rose 33 per cent in 1959, partially as the result of a salary increase for civil servants (whose salaries had not been increased since 1954 despite the inflation). The money supply rose to 17 per cent which, while substantial, was less than the price increase resulting from the increased SEE prices.

By early 1960, some indications were already visible that inflationary pressure might once again result from the government sector. The two initial foreign credits were exhausted, and economic activity had not yet fully adjusted to the change in the regime[16]. The Revolution of May, 1960, however, intervened. The new Government negotiated a new foreign loan, and was able to keep money creation to an average 7 per cent annually for the period 1960-61. Government budget expenditures were increased, but at an average rate of 12 per cent annually over the period.

The Effects of Devaluation :

The period from August, 1958 to the end of 1961 -a period of three and one half years- can be characterized as the time of readjustment to changed incentives within the Turkish economy. This is a fairly lengthy interval, during which economic growth was slow. In retrospect, readjustment phase need not have taken so long: the lack of determination of the Menderes Goverment to carry out genuine economic reform was one factor leading to the revolution; simultaneously had the Government been more determined, the readjustment period would undoubtedly have been shorter. Also, it is probably the case that, the more rapid past inflation, the greater the difficulties of readjustment will be. In Turkey's case, inflationary expectations were firmly embedded, and there can be little doubt that a time interval of considerable length was required to break them.

[16] OEEC, *Economic Conditions in Turkey*, 1961, p. 5.

Despite the length of time required, the achievements of the 1958-to-1961 period are remarkable. First, and of great importance, the Turkish economy was transformed from one of rapid inflation to one of relative price stability. This was a precondition, not only for rational economic planning and an easier balance-of-payments situation, but also for increases in government tax revenue (which was and is inelastic with respect both to price and real income increases) necessary for development planning. The price level actually declined slightly in 1961, and rose at an annual rate of less than 5 per cent over the 1960-1965 period.

The short-term balance-of-payments response was excellent. Private capital began flowing into Turkey; black market activity was greatly reduced; exports rose from $249 million in 1958 to $353 million in 1959. In fact, when exports are partitioned into those whose exchange rate was raised in 1958 and those for which a lower rate applied until 1960, the export response is even more striking than these figures suggest. Export growth, moreover, continued into the 1960's - at a rate well in excess of that anticipated by the State Planning Office in the First Five Year Development Plan. The State Planning Office aimed at a four per cent annual rate of export growth; in fact, exports grew at 7 per cent annually over the First Plan period.

Moreover, export growth was accompanied by export diversification, as the following figures indicate[17] :

	Minor Exports	*Major Exports*
	(millions of U.S. dollars)	
1957	80	265
1958	64	183
1959	119	235
1960	133	188

Even these figures understate the diversification, because it was the incentives provided by the change in relative prices in 1958 which led to the rapid growth of cotton -now a very large export commodity-exports. Prior to the 1958 devaluation, cotton itself was a minor export.

[17] Major exports are taken to be : tobacco, cotton, wheat, chrome, hazlenuts and raisins.

The very rapid response of exports-and other balance-of-payments components- enabled the rapid increase of imports cited above. This, in turn, permitted increases in production levels of firms which had been hampered by lack of imports; simultaneously, the relatively free availability of imports stopped speculative pressure and also acted as a deflationary factor within the economy.

We conclude, therefore, that the 1958 devaluation and stabilization programme was remarkably successful in curing Turkey's major economic troubles: declining foreign exchange earnings and massive inflation. Moreover, the realignment in relative prices enabled rapid growth, without significant balance-of-payments or inflationary pressures, at least until 1964. We turn, therefore, to the late 1960's, and the devaluation of 1970.

III. THE TURKISH PAYMENTS REGIME : 1969

Contrast with the 1950''s.

Despite the fact that "foreign exchange shortage" plagued Turkish planners and government officials from 1964 onward, the degree of shortage and its causes were so very different from the 1950's that there is almost no comparison between the two periods. The devaluation of 1958 and the ensuing stabilization program appear to have been undertaken with the full support of the Turkish people; the previous economic policies had led to such disasters that there could be little dispute about them. The 1958 episode was preceded by economic policies that persons of virtually all political and economic persuasions could agree were unsound : the volume of short-term debt accumulated, by itself, indicates the degree of economic folly that was required to continue those policies until 1958. While there were good and sufficient reasons for devaluation in 1970, and those were probably valid from 1966 onward, the Turkish authorities did not wait, as they did in the mid-1960's, until the only alternative to devaluation was disaster. While the year 1969 was characterized by foreign exchange shortage and some speculative pressure on the lira, there was nothing comparable to the slowdowns in production which occurred in 1957-58. For these reasons, devaluation was undertaken in a completely different atmosphere. While it can be argued that, had devaluation not come, Turkey might have experienced the same sort of difficulties that were experienced in

1957 to 1958, there was no such comparable period. Hence, devaluation came at a time when economic growth was still continuing, and when neither the level of investment nor industrial production were yet seriously affected by a lack of imports[18].

Moreover, Turkish economic policy during the 1960's was rationally calculated. Despite the burden of debt-service and repayment on the foreign claims accumulated during the 1950's, which served as a net drain on Turkey throughout the subsequent decade, Turkish policy-makers made remarkable headway with Turkey's economic problems. For this reason, the need for devaluation in 1970 cannot be attributed, as it could in 1958, to unwise economic policies. Rather, the causes lie elsewhere.

Causes of Imbalance:

There can be no doubt that the lira, prior to devaluation, was overvalued. Two factors led to this overvaluation : 1) the gradual increase in Turkish prices, relative to those of major trading partners and 2) the presure on resources that eight years of development planning had caused.

As indicated above, there was a remarkable absence of inflationary pressure until 1965; the price level rose, on average, only about 4 per cent per year. After 1965, inflation accelerated somewhat, although the highest one-year increase was 13 per cent (from 1966 to 1967). For the period 1960 to 1969 as a whole, the average annual rate of price increase was 8.6 per cent, according to the consumer price index.

Inflationary pressure was not, by and large, suppressed, as it had been in the 1950's, which makes the 8.6 per cent rate even more of a contrast with the 1950's than simple comparison of the rates would suggest. The origins of inflationary pressure, which was much more moderate, were, however, similar: in attempting to attain the targets set forth in the Five Year Plans, Government expenditures rose rapidly, and incentives for private investment led to rapid growth of capital stock in that sector.

While Turkey's price level was rising in the latter half of the 1960's, other countries either experienced much greater price stability, or deva-

[18] It can be convincingly argued that, had devaluation not been undertaken in 1970, a slowdown in growth, and inflation, comparable to the mid-1950's would have resulted.

lued their currencies. Thus, Germany experienced a rate of inflation of about 1 per cent; even after the appreciation of the mark in 1969, Turkish prices had almost doubled relative to German prices over the decade. The British, with a 3 per cent rate of inflation, had devalued in 1967; some of Turkey's chief competitors -most notably Spain- went along. Hence, there was not a single, sudden, shift to overvaluation of the currency; rather, little by little, Turkish prices became more and more out of Jine with those of the rest of the world, and Turkish products became less competitive, or less attractive to produce in the first place. This is seen vividly in the first three columns of Table 3. The real exchange rate, which had improved so markedly after the 1958 devaluation, reattained its 1957 level by 1959; as such, the gradual, but steady relative price increases completely wiped out the altered structural relations achieved by the 1958 devaluation.

Of course, the Turkish inflation was generated by the Government's development effort, which resulted in **a** sustained 7 per cent growth rate. However, rapid growth led to further increases in the demand for imports, while simultaneously, the shift in the composition of demand accompanying rapid growth and the development plan, intensified the pressure upon the balance of payments. Although the Development Plans were oriented toward import substitution, the newly-established import-substituting industries required imported capital goods, for their initial development, and maintenance imports of producer goods, spare parts, and raw materials, for their continued output.

The Need for Devaluation :

The causes of overvaluation, as indicated above, lay in the gradual increases in Turkish prices relative to those of Turkey's trading partners. The government made some attempt to offset the gradual deterioration in relative prices through the introduction of, and then increases in, rebate rates on exports, special exporters' credit privileges, and so on. In addition, tourists and Turkish workers abroad were granted a special exchange rate of TL 12 per U.S. dollar. These measures partially allayed, at least for a time, the gradual deterioration in Turkey's competitive position. By 1969, however, there was little more that could be done, and the erosion continued.

TABLE 3

INDICATORS OF OVERVALUATION, 1960-1969

	Real Exchange Rate 1960= 100	International Export Prices 1960= 100	Turkish Wholesale Prices 1963= 100	Exports (million dollars)	Imports (million dollars)
1960	100	100	88	336	468
1961	97	101	91	365	509
1962	92	101	96	399	622
1963	89	102	100	395	690
1964	87	104	101	433	542
1965	81	105	109	479	577
1966	77	107	115	494	724
1967	72	107	123	522	690
1968	69	106	129	496	770
1969	63	110	138	536	754

Overvaluation of the lira gradually began to have serious consequences on the structure of the economy and Turkey's growth prospects. By mid-1969 there was a five-month delay in the granting of import licenses; whereas in June, 1968, pending applications totalled $68 million, in June 1969 there were $185 million. The black market rate for import licenses rose from TL 4 to 10 in 1967 to an estimated 8-30 TL in mid-1969, per dollar of license value. Under-invoicing reemerged from 1967 onward as a widespread phenomenon. For legally imported goods, the stamp duty and guarantee deposit repuirements had been raised, by 1969, to 25 per cent and 100 per cent, respectively, This meant that the actual taxes on a good with a nominal duty of 30 per cent were, in reality, 65 to 70 per cent.

Moreover, indications began to appear that the growth rate of exports was tapering off. As indicated in the fourth column of Table 3, exports declined in 1968. This decline was an across-the-board phenomenon, affecting almost all commodity groups. Although exports rose somewhat in 1969, the growth rate of exports in the 1967-1969 period was less than 4.5 per cent - far below that which had been achieved earlier in the decade.

Failure to sustain export growth would have implied a reduced rate of growth for the Turkish economy. In spite of import substitution, the economy remains dependent upon imports of capital goods, raw materials, and spare parts. Moreover, most of the "easy" opportunities for import substitution had been exhausted. Hence, as a practical matter, sustained growth requires a satisfactory growth rate of export earnings.

Even more fundamental, however, is the question of the nature of future growth. Throughout the 1960's, as imports became scarcer, and the import-substitution strategy continued with high levels of domestic demand, Turkish producers became increasingly sheltered from the international market. More and more goods were omitted from the list of permitted imports, and consequently, more and more Turkish industry found itself able to sell in a sheltered domestic market, with high profits regardless of production costs, and little competition from either domestic or foreign sources.

Consequently, Turkey's economic growth during the 1960's was characterized by rapid resource accumulation, with little attention to the rational utilization of resources. By the late 1960's, there was evidence that growth strategy was beginning to falter. Not only were new import-substitution projects increasingly high-cost relative to international prices, but opportunities for really significant increases in output through import substitution were becoming increasingly limited.

The alternative to growth through import substitution is growth through the development of export markets. Of course, the ideal development plan will combine elements of both strategies, encouraging import substitution and exports to the point where the marginal costs of earning or saving a dollar of foreign exchange are equal. However, with currency overvaluation such as had emerged in Turkey by 1969 and 1970, the prospects for growth of nontraditional exports were limited. Not only did producers find themselves able to sell in a sheltered, domestic market, but their costs of production were sufficiently high so that exporting was, by and large, unprofitable. Moreover, given relative prices and continuing Turkish inflation, it was doubtful whether very many firms would contemplate investing in capacity expansion far export; it simply was not profitable contrasted with the import-substitution alternatives.

Hence, the real need for devaluation arose, not from considerations of sheer infeasibility of continuing the regime, as in 1958, but rather from the economic consequences of not doing so, and the desirability of reorienting Turkish economic growth toward a more outward-looking posture.

Should the Government prove successful in adopting policies that will insure the continuation of the new relative prices within Turkey over a several-year period as readjustment occurs, the promise for Turkey is a new phase of rapid economic growth. Should this occur, it is likely that new export industries will develop -not across the board, and not overnight- which, by their nature, cannot be predicted. We turn, therefore, to considering the prospects for a successful transition.

IV. *PROSPECTS FOR THE FUTURE*[19]

Turkey changed her exchange rate in August 1970, from 9 TL per dollar to 15 TL per dollar. The tourist and workers' remittance special rates were also altered, so that all transactions now occur at a single exchange rate. Along with devaluation a number of other measuers were taken: the stamp duty was lowered, so that the net effect upon industrialists' costs is smaller than the magnitude of devaluation would suggest. Taxes were increased on a variety of goods, so that revenues might increase, and prices of some State Economic Enterprises' products were raised sharply.

There is no doubt that Turkey faces highly elastic demand for most of her export products. Turkish producers and exporters indicate stiff competition, and highly price-elastic demand for such items as fresh fruit and vegetables, canned foods, textiles, and many other products. For copper, cotton and olive oil, Turkey's share of the market is small enough so that the price elasticity of demand confronting Turkey is high. For chrome, hazelnuts, and dried fruits, Turkey's share of the market is larger, but those commodities have such close substitutes that the overall price elasticity of demand is high. Only for tobacco is the price elasticity of demand relatively low; here, a tax on exports should be imposed. In fact, a differential price was decreed for Turkey's traditional export items; tabacco, dried figs, hazel nuts, and cotton, such that exporters of these goods exchange their dollar earnings for TL 12 instead of TL 15, thus implicity being taxed 20 %.

[19] This paper is being written in Nowember, 1970; no post-devaluation statistics are yet available.

In addition to the micro-economic evidence, there is also the experience with the 1958-1960 devaluation: Foreign exchange earnings rose sharply. Hence, on microeconomic grounds, there can be little doubt that the preconditions for successful devaluation, increased foreign exchange earning, and hence liberalization are met.

The presence of the macro-economic preconditions for success are more questionable.

It is difficult to evaluate the magnitude of the devaluation. It is clearly large enough so that, in the absence of strong inflationary pressures, there will be a significant change in relative prices. However, available evidence suggests that Turkish costs and prices were, virtually across the board, considerably higher than those in other countries; whether the devaluation will be sufficient, even in the absence of inflation, for a genuine sustained liberalization, remains to be seen. There can be no doubt that the devaluation, if successful, can lead to a significant alteration in incentives. It could well enable the rationalization of Turkey's economy during the 1970's, and diversification of her foreign markets. Whether it will be an "equilibrium exchange rate", however, is not so certain.

As of November, 1970, there is some evidence that the short-term speculative response to devaluation has been forthcoming. Workers' remittances are about double their 1969 level, which would suggest that some funds, previously held abroad, are returning. Preliminary evidence also suggests that the backlog of import-license applications has been substantially reduced. Hence, it would appear the initial phases of transition are going well.

The critical question, of course, is what government policy will be during the transition period. As indicated above, some "pause" in the rate of economic growth is necessary, if revised expectations are to take hold. Moreover, there are undoubtedly many individuals in Turkey who expect that the 1970 devaluation will quickly be eroded; these expectations must be dispelled before the positive payoff from devaluation occurs. While some once-and-for-all increase in the price level is a natural consequence of devaluation, it must not be permitted to become an ongoing phenomenon. If Turkish prices increase less than, say 5 per cent, in 1971, after the adjustments of the last half of 1970, prospects for success of devaluation will be good.

Government policy, itself, has several aspects. Perhaps most important is the budget. Shortly after devaluation, a new personnel law was passed, raising civil servants' salaries. The effect of this on the Turkish budget is not yet known, but it seems clear that, unless additional taxes are levied or some other government spending programs are cut, the law will be inflationary.

In this regard, there has been one significant structural change in Turkey since the devaluation of 1958: that is the presence, and strenght, of labor unions. In 1958, unions were not a factor in determining the price and wage response to devaluation. In 1970, they are clearly an important one. This means that government policy will have to be relatively more deflationary in 1970, than it was in 1958-1959, for the simple reason that large wage increases could, in the absence of deflationary policy, trigger an inflationary spiral which would render nugatory the real effects of devaluation. As an offset, of course, the degree of inflation, prior to devaluation, was much less than it was before 1958.

The Government is clearly aware of the problems posed by the risk on inflation, and is attempting to combat them. Unfortunately, the evidence to date is that this effort is being carried out through attempts to impose price controls in various sectors by fiat. If this is done and affects the State Economic Enterprises' pricing policies, it could augur very badly for future prospects. In particular, with the new personnel law, and increased costs of imported inputs, not to mention increased prices from other sectors, if State Economic Enterprises do not increase their prices, deficits will follow. These will have to be financed. There is a risk that inflation could be triggered by Bank-financing of these deficits. Once-and-for-all increases in State Economic Enterprises' prices will probably be necessary for the success of devaluation.

The risk, that the government will attempt to hold down prices artificially, and the increased strength of unions, point to the importance of the government relying upon monetary and fiscal policy, rather than other measures, in an effort to prevent inflation. Successful use of fiscal and monetary policy will undoubtedly entail some unemployment and a temporary reduction in the rate of economic growth. Lack of determination on the part of the authorities, however, could result in an increased rate of inflation and a reduced rate of economic growth over a considerably longer period of time. In this regard, there is a real trade-off: the economic "medicine" needed now will not be painless; the alternative, however, is slower growth over a fairly long period of time.

ÖZET

TÜRK DEVALÜASYONU

Makalenin ilk bölümünde, ithalât ve ihracatın kontrola tabi olduğu bir ekonomide, devalüasyonun başarı şartları, teorik olarak tartışılmaktadır, ikinci bölüm 1958 Türk devalüasyonunu ve bunun doğurduğu sorunları ele almaktadır. Üçüncü bölüm, 1960-70 döneminde karşılaşılan ödeme dengesi açıklarını ve bununla ilgili sorunları incelemektedir. Son bölümde ise, 1970 devalüasyonunun başarıya ulaşması için ele alınması gerekli tedbirler gözden geçirilmektedir.