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APPROACHES TO UPGRADING TURKEY'S CREDITWORTHINESS

A subject recently much discussed in economical circles is the downgrading of Turkey's credit rating by the international rating agencies.

In 1996, Turkey's **consolidated fiscal deficit widened** from 4,0 percent **to 8,8 percent of GNP**, while the **public sector borrowing requirement** rose from 5,4 percent **to 9,6 percent of GNP**. The primary surplus shrank from 3,3 percent of GNP in 1995 to **1,8** percent in 1996. The **budgetary debt service ratio** rose from 7,3 percent **to 10.1 percent of GNP** in 1996. All these changes were cited by credit rating agencies as reasons for downgrading Turkey's rating.

But what is interesting here is that these agencies insist that the decision to downgrade Turkey's rating does not reflect their view of Turkey's economic prospects for the rest of 1997. The international rating agencies specifically emphasize that although Turkey could theoretically overcome its economic problems, their downgrading reflects the persistence of fiscal imbalances, the lack of concerted efforts to correct the underlying structural weaknesses, and the unlikelihood that serious reforms will occur.

As a matter of fact, Turkey is assigned to the same rating category as countries like Mexico, Argentina, Chile, Brazil, and others, and our rating has been downgraded by comparison with theirs. But even though Turkey has received the same grades as many countries in different rating categories, Turkey's indicators are much better than theirs.

At this point, let me mention some of the major issues connected with **the methods of the rating agencies**.

Developments in the field of credit evaluation accelerated in the mid-1980s. The debt crash of the 1970s and the Mexican crisis of 1982 put the need for faster credit evaluation on the agenda of the international monetary system. The solution was to expand the role of rating agencies, both because the IMF and World Bank did not perform as expected, and because of the rapid growth and diversification of the financial system. Specific factors leading to the new reliance on rating agencies included:

- the acceleration of international capital movements and the emergence of new investment opportunities,
- the buying and selling of capital flows in the financial markets,
- increased interest in the financial markets on the part of large and small banks and the general public as bondholders; and
- the fact that the IMF could not guarantee that it would act as "lender of last resort" for countries;

all of which increased the importance of country risk ratings.

Risk rating is most simply defined as an index indicating the willingness and capacity of an obligor to make timely and full payment of interest and repayment of principal obligations. **The willingness and capacity to repay** are the key issues. Ratings can be produced for a single transaction, for a company or for a country. The general rule is to use adequate criteria permitting comparisons among rating categories. Similar activities are carried on by banks and non-bank institutions as well as by rating agencies. The basic philosophy is to **measure the risk factor in an onward-looking perspective,** using models that take account of data from the past 15-20 years.

The measurement of country risk generally takes account of economic and political risk factors and main indicators. The most important indicators for assessing economic risk are foreign exchange cash flow, overall debt structure, export growth, liberalization of the economy, the balance of payments, the ratio of short-term capital flows to reserves, the level of reserves, the rate of growth, total savings, the public sector deficit, the investment rate and the inflation rate.

For assessing political risk, the most important factors are the nature and the frequency of elections, foreign policy developments, the degree to which democracy is established, the political leadership and changes in the political agenda, the structure of coalitions, the attitude of opposition parties, and **the degree of autonomy of the central bank.**

In short, **rating agencies** and rating actions **have become a reality in recent years**. Countries that control and improve their domestic economies and political development are assessed accordingly and the assessment is reflected in their ratings. When borrowing from the international markets, countries assigned to the higher rating categories can receive better terms as regards interest rates, maturities, and amounts. This greatly helps the developing countries recover from their past fiscal dissavings.

For companies as for countries, higher ratings mean better terms. However, it has recently been debated that higher rating grades may prove disadvantageous to companies. The reason is that receiving a higher rating is thought to lead to a decline in profits and eventually to a decline in shareholders' income. In addition, a study made by Moody's suggests that the likelihood of default by companies assigned to the lower rating categories gradually decreases and the price discrimination disappears.

As for Turkey, these general observations indicate that Turkey is unfortunately rated much lower than it deserves. Political and economic events and uncertainties have caused Turkey to be categorized as a "high-yielding but risky" country. We cannot accept Turkey's present standing, even though being a "high-yielding" country is an advantage for lenders during a period when it is getting increasingly difficult to earn in the international finance system.

As to **what we should do** to escape this adverse situation, we are confronted with the reality of the measures we all knew had to be taken but could not implement for various reasons. These include measures to restore fiscal health and control public expenditures. Turkey's rating will naturally improve as these measures bring down inflation and ensure durable positive growth by restoring the balance of payments to health as well.

Let me touch briefly on these issues:

Above all, Turkey should **prepare a medium-term macroeconomic program** with high credibility and **implement it together with a program of structural reforms**. Turkey has already made progress with structural reforms in recent years. A free market system has long been established and is still producing positive results. Many countries in the world are only now putting into effect what Turkey has already accomplished in the structural realm. However, more remains to be done in Turkey, as outlined below:

- **It is imperative to enlarge the tax base**. Tax administration must be strengthened, more effective sanctions and incentives must be put in effect, preconditions for more equitable taxation must be established, tax evasion must be reduced by capturing unregistered economic activities, and the tax burden on production factors must be lightened.
- **Rigid budget constraints** must be imposed on the State Economic Enterprises, and **privatization** must be accelerated. The main goals of privatization are to boost productivity and promote competition by cutting costs, and prepare Turkey's economy for integration into the world economy by establishing market conditions throughout. Privatization will make it possible to extend the capital base to the public at large and speed up technological innovation. Privatization will also help reduce the fiscal deficit and bring down the public debt, thereby decreasing the pressure exerted by the public sector on the financial markets.
- **The social security and retirement systems,** with their large deficits, **should be radically reformed**. The financial balance sheets of the social security institutions have deteriorated seriously in recent years and their burden on the budget has rapidly increased. The social security system should be more rationally structured. It is essential for the social insurance institutions to be given administrative and financial autonomy and restructured so that they can create resources (by such means as collecting premiums more effectively, and raising the retirement age, which is very low in Turkey). These actions will lighten their burden on the budget.

In parallel with the above actions, the following measures should also be taken:

- **Public expenditures should be reallocated to assist the development of human capital**. Investments should be made as needed to improve the quality and quantity of information and the level of technology as basic ingredients for economic development.
- **The fiscal process should be made more transparent**. This will produce a consensus on budgetary discipline, the crowding out effect will disappear, and the policies that are implemented will have increased credibility.

- **The structural reforms have to be supported by appropriate monetary and foreign exchange policies**. The target of the central bank's basic monetary policy should include maintaining stability in the financial markets and bringing inflation down.

Instability is not a problem that can be solved by a single, definite stability measure. On the contrary, instability must be corrected by a process requiring research into ways of reducing fiscal deficits while boosting competition and confidence. If not checked, **instability** can inflict irreversible damage on the immunity of the economic and social system.

One of the most important principles for keeping high inflation under control is to prepare the budget with no thought of resorting to central bank resources. Instead of printing money to balance the budget, the government must obtain the needed resources from the capital markets. The financial structure of the public enterprises must also be put in order. Financial weakness in the public sector must no longer furnish an alibi for printing money.

The most important lesson to be drawn from the experience of other countries with stabilization programs is to note how long inflation had been eating away their economies. Another important lesson from these countries' experience is that fiscal consolidation and deficit reduction, undertaken as a remedy for public sector overspending, have gone far to restore general economic stability by removing fiscal sources of destabilization of many years' standing.

In a society where the inflation rate is high, introducing discipline into the private and public sectors has a special significance. The opening up of an economy, its liberalization, and the increase in domestic and external competition that accompanies privatization, create a perfect disciplinary mechanism for the private sector. For the public sector, the budget is the appropriate disciplinary mechanism. And **the financial system plays a key role by ensuring the transparency that is needed for the budget and the markets to be managed effectively.**

Maintaining a stable monetary policy gradually builds market confidence. Stable policies together with new instruments may result in the emergence of more sophisticated markets for public debt, and interest rates may go down. Interest rates can only be reduced by pursuing consistent fiscal arrangements that require a larger budget surplus, anti-inflationary policies, and strong and determined structural reforms. Where all these conditions are present, average debt maturity will lengthen and the costs of debt service can decrease.

One of the most important factors affecting a country's creditworthiness is its balance of payments, because the balance of payments is the most important indicator of the country's ability to repay its foreign debt. The balance of payments should react flexibly to domestic and foreign economic developments. This flexibility depends on the country's import-export structure. In other words, developments in the real economy will affect the balance of payments, whether directly or indirectly.

Above all, political authority should concentrate on privatization and structural reforms leading to the establishment of economic stability. Once these stability measures have succeeded it will become easier to implement other measures that had previously been too difficult politically, such as increasing tax revenues and straightening out the problems of the social security system. This in term will strengthen the domestic financial markets and build confidence in the Turkish Lira, which will stabilize the exchange rate and foreign currency flows.

In sum, for the short term Turkey's creditworthiness depends on going ahead with budget and social security reforms. These are the key to gaining the confidence of the financial markets and bringing down inflation.

In the medium term, upgrading Turkey's creditworthiness calls for a consistent and stable medium-term program aimed at reducing inflation. Such a program will have to be continued even after the inflation rate has fallen to single digit levels, because the macroeconomic programs that keep inflation from going back up will also protect Turkey's new creditworthiness and even improve it.

For the achievement of all these goals, political and economic stability is required. Any instability in these areas will cause Turkey's domestic and foreign creditworthiness to fluctuate.

Creditworthiness means confidence. It is easy to lose and hard to regain. Turkey has lived with this reality, with its ups and downs for the last 20 years. In that time, Turkey has accumulated the experience it needs to restore its creditworthiness to the level it deserves in a relatively short time. The process can begin as soon as the necessary structural measures are undertaken with serious and stable political determination, and are then effectively presented to the domestic and international markets.

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