PROBLEMS WITH STABILIZATION PROGRAMS

AND AN OUTLINE FOR A TURKISH STABILIZATION

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INTRODUCTION

In a stabilization program, two important issues to be considered is timing and extent of stabilization, in view of the fact that stabilization is often postponed until extreme conditions prevail and that before stabilization actually succeeds two or three attempts actually fails. In fact, a policy maker will have a hard time indicating how much of a fiscal adjustment is enough to assure price stability and what exchange rate can be sustained without a doubt? Even if the proper dosage could be determined, this may not be enough. Any program can be undone with more or less difficulty by the next government. And this potential lack of persistence feeds back to the current policy actions required to make the program survive (Dornbusch,1991).

In fact, lack of credibility in announced policies or in permanence of these policies have destabilizing effects on the sustainability of adjustment programs. Inflation inertia may be quite strong because of the simultaneous interactions between policy actions and inflationary expectations which explains the repeated number of failed stabilization attempts in Southern Cone economies.

There are two reasons why a stabilization might fail. First is due to undertaking wrong policies, let us say price controls rather than fiscal adjustment etc. and second is uncertainty regarding the policy instruments, i.e. after the implementation of policy measures, a certain variable important for the success of the program may be realized as unfavorable, say because the response of tax yields to tax rates or trade flows to exchange rate regime may be random and hence as such hard to predict.

With this introduction showing how difficult it is to achieve a successful stabilization program, now we may go ahead in building one for Turkey, but before let us have a quick review of various stabilization programs and the associated problems.

In chronic inflation countries, ortodox stabilization programs, using money as a nominal anchor such as Chile in 1974-1975 and Argentina, Brazil and Peru in 1990, led to a deep recession and were not successful in reducing inflation on a sustainable fashion. In hyperinflations on the other hand, ortodox policies, relying on tight fiscal policy were more successful and relatively less costly in terms of less severe recession than the programs trying to decrease moderate inflations. In chronic inflation countries, if exchange rate based stabilizations is used however, even though initially a very short-lived recession is experienced, inflation reduction is achieved accompanied by expanding output. The main difficulty in applying stabilization programs to chronic inflation economies lies in the credibiliy of a disinflation policy. It is easier to be credible in hyperinflations since there is no other alternative than stopping inflation. However, chronic inflation economies have developed ways of living with inflation. In addition, lots of failed attempts to stabilize makes it difficult for a new program to be credible.

Under hyperinflations a shock program, where heterodox and fundamental (demand management) policies combined is the only solution since under such high inflation, gradualism with traditional demand management policies does not work due to the presence of inertia. Shock programs succeed also in cronic inflation conditions, if it is accompanied by structural fiscal reforms. However, if no such reforms take place, the result is a costly failure. In that condition gradualism may be the only alternative.

I. THE ROLE OF EXPECTATIONS AND USE OF NOMINAL ANCHORS

If stabilization is expected to be temporary, it may give a boost in aggregate demand in the early stages, by causing people to shift part of their future consumption to present since they believe that now with low inflation and exchange rate, the cost of holding money is lower, compare to future when inflation will resume. Nominal anchors in terms of either money supply or exchange rate fixing or moving them in a band are helpful in changing expectation formations.

a) Provided that the proper adjustement of the fundamentals is carried out, nominal anchors provide a tool for breaking inflationary inertia and demonstrate to the public that government can live without resorting to inflation and hence increase the credibility of their programs.

b) The larger the number of anchors used, the higher the credibility of the precommitment to fix the path of the price level (Israel 1985).

c) Commitment to the price level directly through fixing the components of price level such as exchange rate, if feasible, is more credible than precommitment through money supply, because the relationship between money supply and price level is subject to noise.

d) Exchange rate fixing has more immediate effects than money supply fixing.

II. STYLIZED FACTS ABOUT MONEY-BASED PROGRAMS (MBS)

a) MBS programs are recessionary in industrial countries.They were successful in bringing down inflation in the US and in UK the in the late 1970’s at the cost of lower growth and higher unemployment.

b) MBS programs are recessionary in chronic inflation countries as well (Argentina; Brazil and Peru in the 1990’s).

c) If exchange rate is allowed to float, recession is accompanied by a rise in real interest rates and a real appreciation mostly with trade balance improvement.

III. STYLIZED FACTS ABOUT EXCHANGE RATE-BASED PROGRAMS (EBS)

a) In general, economic activity expanded with the initiation of stabilization program.

b) All EBS programs were associated with deteriorating trade balance and current account balance because of the expansionary effect of the cycle.

c) Real wages increased with the upswing of economic activity and real exchange rates declined.

d) Consumption and Investment followed the expansion in output.

e) There was a sharp reduction in fiscal deficits in all succesful EBS programs along with the increase in aggregate demand.

IV. CRITICAL AREAS

a) Correct judgement of the inflationary process and its causes is essential in curing inflation. For example, a judgement that the cause of inflation is mainly inertial may call for the use of incomes policy in terms of price freeze, since its effects are more immediate, but without the complementary restrictive monetary and fiscal policy, the disinflation process will be short lived as was in Cruzado Plan. If inflation is generated by both excess absorption and inertial forces, a successful program should include, in addition to demand management policies, nominal policies which address expectations.

b) There is also the danger that the relative prices may be frozen at levels that were not consistent with a longer term equilibrium, i.e. frozen below their equilibrium levels again as in the Cruzado Plan. In that case, there will be quantity pressures as well as hidden price pressures which will manifest itself in terms of rising expectations and rising prices immediately after the lifting of controls.

c) With the decline in inflation, there will be an inflation-tax replacement problem, since inflation tax that finances part of the budget expenditure will decline with the decrease in inflation, creating the need to find other sources of taxation.

d) The decline in inflation, let us say due to price freeze, will lead to an increase in money demand. If this demand is not met by the increase in supply, it will lead to higher real interest rates, if accomodated however, it may endanger credibility of the program, since it may be perceived as inflationary.

e) There is the price adjustment problem, if the agents do not expect the anti-inflationary program to last and continue to raise prices on the basis of initially expected rate of inflation, inflation will not respond to demand contraction. Hence, with the policy of monetary restraint, the real money supply falls, the real interest rates rises and the economy contracts, this will lead to capital inflow and real appreciation which by lowering the prices of tradeables relative to nontreadables, will adversely affect tradeables goods industry. Besides, capital inflow in response to high interest rates will tend to increase money supply, moderating the anti-inflationary policy.

V. SOME FACTS ABOUT TURKEY

i) The Financial Sector

The first step in evaluating the strength of the banks is to determine relative riskiness of banks..The soundness of the banking system is measured by the ratio of capital base to risk weighted assets, which is minimum 8 percent by BIS standards. This ratio is 10.38 percent for the banking sector in Turkey as of June 1996, down from 12.61 from March 96, yet still above the BIS standards. However, when the banks are divided into groups, such as the state banks, the private banks, foreign banks and investment banks the situation changes. This ratio is -12 for state banks(capital base is measured by networth+profit), 18 for private banks, 38 for foreign banks and 25 for investment banks, excluding IMKB Takas ve Saklama A.?. as of March 1996 and is -19, 16, 46 and 31 respectively as of June 1996.

The ratio of nonperforming loans to total credits is 1 percent for public banks, 0.05 percent for private banks, 0.02 percent for foreign banks and 4 percent for investment banks as of June 1996. For March 1996 the ratio is the same as in June except for the foreign banks with 0.04 percent.

Foreign exchange positions of public banks as a share of their networths is -9 percent, while that of private banks is -65 percent and of foreign banks is -48 percent and of investment banks is -29 percent.

It may be also useful to look at the revenues from interest income to total income ratio to see how the banks will be affected with a decrease in interest rates.This ratio is 30 percent for public banks, 20 percent for private and foreign banks and 10 percent for investment banks.

ii) Public Sector-Public Finances

Main categories of tax revenues and social security premium collections as a share of GDP is much smaller in Turkey than EEC

A few reasons can be cited for this:

a) A large portion of the Turkish economy is thought to be unrecorded and hence tax base is not broad enough.

b) There are too many exemptions and exclusions in corporate, business income tax and VAT tax. Studies show that while the corporate income-tax is 46 percent, effectively only 10 percent is collected due to exemptions and exclusions.

c) Among the personal income tax payers only one third is subject to lump-sum tax, the rest is filing income taxes.

d) Although the number of business subject to corporate income tax increased three-fold between 1984-1991, the share of corporate income tax declined from 11.5 percent to 7.9 percent of the total tax revenue during that time (Tax-Statistics Annual 1982-1991).

e) Indirect taxes to GDP ratio has grown faster than that of the direct tax ratio, making the indirect taxes as the main revenue in the consolidated budget which is not conforming to EC standards where the direct taxes are the main revenue item.

f) Personnel and interest expenditures are 60 percent of the consolidated budget expenditures which is very high by any standard.

g) Increasing borrowing need of the public sector(PSBR) is causing high real interest rates, crowding out in financial markets and very high lending rates.

h) Deficits of social security system and subsidies on chemical fertilizers, improved agricultural seeds, agricultural support pricing and preferential credits' interest differentials which are met partly from the transfers of the consolidated budget and partly from the Fund for Price Stability and Support is a burden on the economy.

iii. External Conditions

In the first quarter of 1996, short term foreign debt increased 15 percent compared to the same period in 1995 and reached 21 percent of the total debt stock, while the long term foreign debt declined 2.5 percent and became 79 percent. In Turkey, short term debt since 1991 is concentrated mostly in US dollars, while long term debt since 1994 is concentrated in DM, therefore developments in the US economy is a greater concern in the short run for Turkey.

Expectations regarding the US economy are in the direction of recession or slower growth which will affect the US interest rates in a slightly decreasing direction. This will work in our favor in the sense that refinancing of short term debt will be cheaper with decline in US interest rates.

External help as in the case of Israel and Mexico, will probably not be materialized in case of Turkey. However, we have ample amount of reserves for public credibility of the announced program, provided that stabilization will start without waiting for a crisis to happen.

VI. A STABILIZATION PROGRAM FRAME FOR TURKEY

Experiences show that successful stabilization programs were successful because they created major discontinuities in the trends of main macroeconomic variables. Inflation can be lowered quite easily with incomes policy, but to keep it down requires fiscal restraint, both in terms of increasing tax revenues as well as cutting expenditures. In case of Turkey, in addition to short term goals like reducing inflation and fiscal and balance of payments improvement, a serious government which has a broad based political support which can commit itself no matter what to a 5 year medium term strategy, with a major tax reform, with priorities set up interms of expenditures and reform of the institutions and with firmness in distributing the cost of disinflation evenly and hence bringing the interested parties to a consensus, is a must for a successful stabilization program. Some suggestions for the short term while the fiscal reform is being carried out are:

a) Improving tax collection systems, lifting exemptions and exlusions from corporate income tax and value added tax, and going-back to the monthly VAT tax-return system rather than the yearly one can help in the short run. Tax indexation seems to be a useful tool in reducing tax evasion. Besides, after the implementation of the program with the decrease in inflation, government will be deprived of 3.4 percent of its revenues as a share of GNP, (Altynkemer, 1996) which it is collecting at the present as inflation tax and will be forced to replace them by other taxes.

b) Lifting of subsidies will decrease transfer payments from the budget and hence expenditures. Decreasing transfer payments is perceived as a permanent rather than a transitory cut in expenses.

c) Since aggregate demand restraint is not sufficient by itself to reduce high inflations with tolerable unemployment, in a chronic inflation country like Turkey, it will be necessary to use incomes policy such as exchange rate -price freeze temporarily to break away with past inflation. This will have success in a short amount of time in reducing inflation, even if there is resistance at first, especially if it is supported with a tight fiscal policy.

d) Since Turkey is an open economy with at least 50 percent dollarization, measured by M2Y/M2, it is advisable to use exchange rate based stabilization rather than money based one. Besides, money based one is more difficult to administer, since with decline in inflation money demand will increase and for the money supply response a knowledge of path of inflationary expectations during the stabilization program will be required, which is difficult to acquire. It should be noted here that just exchange rate freeze or control will not suffice in lowering inflation because, this will only affect the price of tradeables and not nontradeables which has a considerable weight in the Turkish economy. Hence, it will be neccessary to control prices as well, excluding the basic food staples.

e) Before, using the nonortodox elements such as wage-price -exchange rate freeze however, it will be necessary to make some adjustement in especially state sector prices due to lifting of subsidies and to make a devaluation larger than necessary so that during the temporary freeze, there will not be much overvaluation.

f) To assess the "entry" price before the freeze, shadow prices from input-output tables before (devaluation and lifting of subsidies) and after the price adjustment process can be compared and the resulting hypothetical inflation can be used.

g) One advantage of the price freeze is that it will cause an increase in real tax revenues, since in high inflation economies due to increasing lags in tax collection, tax revenues usually declines, with the decline in inflation, real tax revenues will increase, affecting expectations in a favorable way. The

magnitude of this effect, without any tax reform, is 1-2 percent of GDP in various recent cases (Dornbush and Simonsen 1987). In addition, if exchange rate fixing is credible, it will also help to reduce currency substitution and shift resources to domestic borrowing and to domestic money, which will help to reduce interest rates, both due to decreasing inflation expectations and also due to the fact that the Treasury will no longer be in a "disadvantegous monopoly" situation whose need to borrow is exploited by other players by increasing interest rates..The exchange rate freeze will put a halt on exchange rate speculation, at least for a while, and this will help to Treasury in turning to an "advantegous monopoly" who has a saying in the determination of the interest rates. Currency substitution is making monetary control difficult and is causing the economy to inflate much higher in order to achieve the same inflation-tax revenue, than the case with no currency subsitution (Altynkemer, 1996). Besides, by affecting inflationary expectations, it has adverse affects on the interest rates. Hence, even if no exchange-rate freeze is used, it is advisable to take some measures to prevent currency substitution such as increasing reserve requirements for shorter maturity FX deposits and gradually decreasing it for longer maturities and/or taxing the yield on shorter maturity FX deposits higher than the longer ones. At the present, there is no differentiation of required reserves between sight, 1 month, 3 month, 6 month or one year FX deposits.

h) It is important to note that the various instruments of incomes policy, i.e., exchange rates, wages, public sector prices and nominal money stock must be carefully matched, otherwise poorly aligned policy will lead to the failure of stabilization plan. It is especially advisable here not to forget the fact that wage contracts are indexed backward, i.e. even if inflation declines real wages will be increasing, because they are adjusted to the past higher inflation, implying cost increases leading to profit squeeze for firms. Hence, it will be necessary to introduce a wage deindexation mechanism. Here, consensus is necessary in convincing the labor unions to decrease the wage setting interval, let's say from 2 years to 6 months and adopt a forward index such as expected cost of living in setting wages.

i) While synchronization of price-exchange rate-wage freeze is necessary at the initiation of of the program, lifting up of the freeze, should be done gradually and sector by sector so as not to fuel inflationary expectations. For example, to prevent overvaluation, exchange rate freeze can be lifted after 6 months and exchange rate can be allowed to move within a band or if it already is overvalued, a crawling-peg, strategy, where the rate exchange rate will be depreciating at a rate that will maintain competitiveness can be preferred. Prices of some sectors that are affected by this development may be freed and move with the exchange rate, while other sectors may be still kept controlled, till the fiscal balances adjust.

j) Controls may be more effective in conditions of excess capacity and less costly to lift than in full employment conditions**.** The high real interest rates at the onset of the program due to declining inflation may encourage running down of inventories, however the high interest rates has to come down gradually with the increased credibility and the success of the program to prevent massive unemployment and output loss and to prevent worsening of the budget.

k) In such a stabilization context**,** there is no independent role for a monetary policy other than putting some upper limits on money supply and credit increase, since it is dictated by fiscal and exchange rate policy, i.e. money supply can be partly accomodative in the beginning of the program due to very high interest rates, due to capital inflows and also due to rising money demand. Otherwise, restrictive monetary policy will exacerbate high interest rates will lead to a depreciation expectations.

l) To administer price controls, full disclosure of prices should be mandatory.

VII) CONCLUSION

Stabilization cannot afford to be weak. Soft measures do not create hard currencies.

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