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Turkey's Financial System on the Skids

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No sooner had international bankers, the International Monetary Fund, and relevant governments heaved a sigh of relief, that an emergency $20 billion IMF-led credit line had postponed a full-scale currency and economic crisis in Argentina, when Turkey was suddenly plunged into the most severe banking and currency crisis in its history.

Turkey's foreign debt is over $104 billion, and Turkey is a strategically critical nation, on the perimeter of the troubled Balkans, and is seeking full membership into the European Union (EU), giving the crisis an added unpredictable dimension.

Banks in Crisis

The Turkish Central Bank was forced to pump $4.3 billion of its scarce dollar reserves into its banking system, in a vain effort to stem panic selling of the Turkish lira for dollars. A national banking crisis was detonated by the release of a long-awaited report on Nov. 21, by the Turkish Banking Regulation and Supervisory Agency (BRSA), as part of a new law passed under pressure from the IMF.

The BRSA report examined the solvency of the nation's 80 private banks, with focus on 11 banks which are currently in de facto state receivership, though still operating. The report triggered a panic cut of all interbank credit lines to ten banks, resulting in a general depositors' panic which is far from over. The panic selling triggered a 9% crash on the Istanbul Stock Exchange, and a collapse of prices for lira-denominated Turkish bonds, on Nov. 22—a date that was dubbed "Black Wednesday" by the Turkish media.

The domestic overnight interest rates paid by banks for liquidity had skyrocketed to more than 220% by Nov. 29. "This is no more speculation," remarked one Turkish stockbroker. "It has evolved into a foreign currency and liquidity crisis. The situation will get worse, if the hard-currency demand remains this strong."

The BRSA wrote that at least $8 billion will be needed in order to bring the ten "brain-dead" banks into solvency. In 1999, these banks had combined losses of $1.8 billion, losses forced on taxpayers in an economy already severely hit by soaring dollar costs of oil imports, and exploding import costs from Turkey's peg to the dollar. To convince foreign investors that Turkey was a stable investment center, the government fixed the lira to the dollar in a "crawling peg," where the value can change up or down by only 1% per month, by law. To defend the lira at the end of November, the Central Bank reportedly spent $4.3 billion of its $21 billion in reserves.

The vast bulk of Turkey's imports of industrial and other goods, however, comes not from the United States, but from the European Union. Fully 21% of all Turkish exports go to Germany. As the European single currency, the euro, has lost 28% against the dollar since January 1999, the Turkish balance of payments deficit exploded, as EU import costs rose by 25%, forcing Turkey to cover the deficit with Eurodollar borrowings and foreign capital at high interest rates.

Enter, the IMF

In 1999, Turkey was devastated by the effects of Russia's August 1998 default on its government bonds, which led foreign investors to stampede out of all higher risk emerging markets. The same year, the country was laid waste by two huge earthquakes, causing tens of billions of dollars in damage. Gross Domestic Product growth plunged 5% in 1999, and the government was forced to turn to the IMF for emergency credit in December.

As usual, the IMF cure was worse than the disease it was supposedly designed to remedy. In its strict monetarist orthodoxy, the IMF demanded that Turkey slash its public spending and reduce the public deficit. In 1999, the public deficit had hit a staggering 14% of GDP. Interest payments to bondholders, mainly Turkish private banks, became the largest single budget expense: 42% of central government spending last year.

Then, the IMF demanded a clean-up of the troubled banking system. By severely reducing the supply of new government debt, in the course of meeting IMF demands on deficit reduction, the government also deprived its banks of their primary source of risk-free profits. Profits on lira bonds to the banks fell from 30% in 1999, down to 12% by this August. That loss of profit has severely hit all banks, but above all, those without solid foundations, especially the ten cited in the government's latest report. J.P. Morgan, in a report, predicted that "banking could prove to be the Achilles' heel of the Turkish adjustment effort." That was written, presciently, in October.

Desperately seeking to calm the crisis, the IMF and World Bank announced that they would make early release of various planned loans, totalling $1 billion, to begin in December. But that is a drop in a very big and empty bucket. On Nov. 30, the Turkish daily *Sabah* reported that the government of Prime Minister Bulent Ecevit plans to ask the IMF for an added $5 billion, to replace the funds that have fled the country since the crisis began.

The issue to watch next, will be whether the IMF continues to insist on savage austerity conditionalities, which will only aggravate what is already Turkey's worst-ever banking crisis. If it does, Turkey could well become the detonator of a much broader, global crisis.

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