Turkey vs. Argentina: A Comparative Analysis With A Long Term Perspective

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The stories of Turkey and Argentina need to be viewed from three different perspectives to better understand the causes and trajectory of the crises experienced by the two countries: 1.The long term development path. 2.The major economic imbalances behind the crises 3.The actions of the policy makers before, during and after the crises. This article focuses on the first point, long term development, and attempts to link it to the other two. Main conclusions are that 1. economic stability in the medium term is dependent on the maintenance of the two major resource flow balances of a country - the fiscal position and the current account position, 2. a credible and rational mechanism must be in place to manage the resource allocation question and 3. when it is time to "pay the bill", delays only increase the damage.

The fates of Turkey and Argentina were among the most heavily debated economic events of 2001. After roller coaster rides for several months, Turkey avoided default on its public debt aided by a new floating exchange regime, extreme fiscal austerity and sizeable support from the IMF while Argentina defaulted, fueling widespread political and social unrest.

Interestingly, Turkey and Argentina are among the most exceptional economic development stories of the 20th century. It is perhaps fitting for two quite exceptional cases of economic development in the 20th century to present two exceptional stories for the first year of the new millennium.

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The second and third perspectives, the major economic imbalances and the policy actions, have been heavily commented on over the past few months. Searching the Internet one can find thousands of academic papers and tens of thousands of opinion pieces written on these two areas. However, despite the depth and complexity of the Turkey and Argentina crises, it is difficult to find analyses seeking the connection between the crises and the long-term development paths of the two countries. In this article I shall endeavor to do this.

This article is clearly not an academic paper, nor does it claim to find a clear answer to the question. However, I hope that it will provide some basic thoughts that will encourage people interested in economics, experts and laymen alike, to explore the long-term development angle further.

The development story of Turkey in the 20th century can be summarized as a metamorphosis, carrying a bankrupt rump of an empire a long way down the path of industrialization. Argentina's story, on the other hand, can be summarized as the descent of one of the brightest stars of the world economy into the leading example of populism and subsequently into a third world country.

Turkey's economic story can be better understood if split into two distinct periods: 1923 to 1980 and 1980 onwards. Between 1923 and 1980, Turkey followed several slightly modified versions of the "mixed-economy" model, inspired by the French, German and Japanese political and economic systems. While attempting to encourage a growing role for the private sector in the economy, the state took a leading role in long-term development and resource allocation, intervening explicitly and heavily in sectors where the private sector performance was deemed inadequate. During this period, under quite different governments, Turkey achieved one of the fastest industrialization performances of the century, with a long-term average annual growth rate of around 5.5%. In 1980, after a severe foreign exchange crisis which was the largest among a sequence of similar crises happening in 5 to 10 year intervals, Turkey decided to change track. The mixed-economy model was left behind in favor of a free market model. Surprisingly, Turkey became one of the few examples where deregulation and market reform did not increase the growth rate in the long term. The 1980-2001 average annual growth rate was only 3.5% and even this lower average long-term growth was accomplished with much higher variance.

From this perspective, Argentina's story is quite different. Argentina was a commodity exporter at the beginning of the century and remains a commodity exporter today. However, while free trade was embraced by Argentines at the outset of the century, it fell out of favor in line with the world protectionist trend in the 1930s and remained out of favor until as late as the 1990s. Despite the long protectionist period, Argentina did not develop very fast on the manufacturing front. Populist policies, inspired by the 1930s Europe and carried on by Peron and his followers after World War II appear to have played a strong role in this.

Argentina started the 20th century as a more liberal and democratic country than many in Europe. However, the political process became progressively more violent after 1930 fueled by class struggles. Inspired by the trends in Europe, less and less liberal governments came to power in Argentina, culminating with the dictatorship of Peron after World War II. After Peron, Argentina experienced several decades marked by frequent military interventions. Over this period, Argentina became more and more inward looking and isolated from the rest of the world. After the Falklands defeat in 1982 and the external debt default in 1986, Argentina embarked on a radical reform path. First, democracy was restored after several decades of military rule. Then, after several false starts, currency and macroeconomic stability were achieved through a currency board in 1992-94. Inflation was eliminated, after three painful decades. Argentina built on its success on the inflation front by embarking on a far reaching privatization

drive. Macroeconomic stability and privatization attracted large sums of foreign capital through the 1990s and Argentina appeared to be on the way to rejoining the first world.

What could have gone wrong in countries with as stellar performances as Argentina in 1992-1998 and Turkey after the 1999-2000 stabilization programme? One key point which requires careful analysis in assessing causes and consequences of these crises and their relationship with the long term development process is the resource allocation mechanism. In this respect, countries and companies are quite similar - they both need to achieve higher returns. There are many different organizational structures which can be used to tackle the resource allocation question of a country – the state, the public and/or private banking system, conglomerates, funds and any combinations of these. But whichever one a country chooses among these potential paths, historical evidence shows that conscious decisions made by well-informed economic players ensure stability and growth.

Turkey did indeed make conscious and well-informed decisions on resource allocation for the most part between 1923 and 1980 - there was a relentless drive towards industrialization under all governments that came to power. This policy was pursued sometimes very successfully and sometimes with a mediocre performance, but the ultimate aim never changed. Argentina on the other hand, never explicitly focused on industrialization. Most Argentine governments of the 20th century concentrated on distributional policies rather than long term development. Argentina gradually opened its markets to the world over the 1990s, but painfully learned that integration with the world is not sufficient for growth. Foreign investment is definitely a very positive factor for an economy. However, foreign investment is not sufficient to remedy large scale fiscal or current account imbalances in a country. Foreign investors add to the pool of available capital, but as independent private players they naturally focus on the risk management of their own investments over GDP growth maximization for the country they invest in over long periods. And ironically, they expect someone else to think about long-term growth maximization to allow them to enhance their return on capital.

If a state wishes to relinquish its role in resource allocation, another player or set of players need to take over this role. In developed market economies, a strong institutional investor base, carefully regulated by certain government agencies and guided by a rigorous acedemia manages to fulfill this role. However, with the lack of an experienced institutional investor base, weak regulation and weak market-academia co-operation, developing economies which opt out of a mixed economy find it difficult to create well functioning markets.

Turkey fell into exactly this trap after 1980. Free market reforms were good in theory, but when the state gave up the resource allocation decision, someone had to pick it up. The banking system was charged with the task, but was not

ready. The unfortunate result was corruption, mismanagement, false expectations, distortions in income distribution and random wealth transfers. The private sector was not properly prepared for the resource allocation responsibility and it failed. Both the public sector and the private sector slowly learned, but the process was quite wasteful for the economy and painful for the citizens.

Argentina also fell into this trap in the aftermath of the 1998 emerging markets crisis. In contrast to its successes in running a currency board, curbing inflation and attracting foreign direct investment, Argentina was not able to devise a long term sustainable solution for its fiscal balances.

Turkey's chronic problem for the last 50 years has been its current account balance. Dependence on external resources for its energy needs, the long term industrialization drive and the rising consumer expectations in a democratic society consistently fueled import demand and put Turkey under pressure on foreign trade. The significant increase in industrial exports over the 1980s was matched with increasing import demand associated with rising living standards. Turkish governments have learned through painful experiences that an overvalued currency leads to large current account deficits and eventually large devaluations to correct the overvaluations. Therefore, after the liberalization of the exchange regime in the late 1980s the Turkish Central Bank followed a managed float policy on the exchange rate, where the Central Bank intervened in the market to keep exchange rate movements and inflation close to each other. This policy had one downside - chronic inflation. In the attempt to prevent the currency from overvaluation, the Central Bank emphasized backwards indexation and strengthened the inflationary momentum.

In the early 1990s Turkey started to experience a second imbalance in the economy - the government financial position. Large budget deficits in the early 1990s coupled with the policy to finance deficits through the bond market rather than printing money led to extremely high real interest rates throughout the 1990s. As a result, the government debt burden increased in a snowball fashion and the government crowded out all other borrowers from the financial system.

Realizing the unsustainable trend in government finances, the Turkish government launched an ambitious initiative to reduce inflation and real interest rates in late 1999. The Turkish Lira was pegged to a U.S. Dollar / Euro basket with a gradually slowing crawling peg. The initial market reaction to the programme was very positive, and interest rates fell very rapidly during early 2000. However, the improvement in macroeconomic conditions also fueled domestic demand, and inflation remained significantly above the pre-determined currency depreciation rate, causing a rapid rise in the current account deficit. The absence of structural reforms and significant foreign direct investment left Turkey at the mercy of domestic and international fixed income investors. Confidence in Turkey, which saw a major boost in early 2000, declined sharply in

late 2000, leading first to a liquidity crisis and then to a run on the Turkish Lira leading to the abandonment of the crawling peg.

Argentina's macroeconomic imbalances were quite different from Turkey's in the last several decades. Being a very closed economy with a lower long term growth rate, Argentina managed to maintain a more stable current account than Turkey over the years. However, Argentina has always had a chronic fiscal problem: fiscal deficits. The Peronist tradition in Argentina has brought an undue focus on distributional policies over long term development. In attempting to appease different segments of the population with little interest to cooperate, Argentine governments consistently spent beyond their means and tried to cover the difference between the total demands of the population and the available resources by printing money or raising debt. The printing press route was abandoned after the 1989-93 stabilization years but the aggressive borrowing policy remained in place. Turkey, on the other hand, stayed in this vicious cycle only between 1990 and 1998.

At the beginning of 2001 domestic and international investors started to lose confidence both in Turkey and Argentina. However, the recent paths of the two economies were quite different. Argentina had never recovered from the 1998 recession, triggered by the Russian default. Several government attempts to cut fiscal deficits were rejected by the public and not implemented. Turkey on the other hand, had an extremely favorable 2000, due to an aggressive anti-inflation package based on a pre-announced currency peg. The Government turned complacent, ignored the external balance, did not keep an eye on the weak banking system. During the first crisis, liquidity injection could buy time until a proper restructuring but the opportunity was missed. Yields remained high and the equation was unsustainable.

In a final effort to save Turkey and Argentina from the brink, the IMF devised detailed plans and dispersed large support packages for both countries. The plan in Argentina did not work from the outset, and Argentina slowly declined to bankruptcy. Turkey on the other hand recovered rapidly in the three months after the crisis, deteriorated again over the summer of 2001, but recovered again after October 2001 at the back of a second major IMF support package.

The IMF program in Turkey included the following major themes:
- A genuinely floating exchange rate regime
- A clean-up, recapitalisation and rationalization of the banking sector
- Significant increases in indirect taxes to sharply increase the budget surplus
- Initiation of social security and agricultural sector reforms
- Reduction, simplification and rationalization of sectoral subsidies
- Reduction of public sector real wages

In a stark contrast with its track record, Turkey implemented the new IMF programme with a devotion that surprised domestic and international players

alike. Despite an 8% reduction of GDP in 2001, fiscal targets were met with ease. Structural reforms, delayed in the 1998-2000 period were all legislated at lightning speed and implemented to a surprising extent.

The IMF program in Argentina focused more on containing government deficits than structural reform. There were two main reasons behind this: Argentina had already completed its privatization effort in the first half of the 1990s, and neither the federal nor the state and local governments were very keen to embark on further structural reforms.

One key difference between Turkey and Argentina was the power of the central government to induce all domestic economic players to act in line with its stated policy. The Turkish government managed to maintain an enormous primary budget surplus despite a deep recession, kept wages low, passed the biggest series of legislation since the 1930s. Just like 1980-83 and 1995-96 Turkey improved its budget balance significantly over the last two years, delivering a primary surplus equal to 6.5% of GDP both in 2000 and in 2001. Argentina on the other hand failed to rally its states and local governments behind the central government plan and fell short in persuading the man on the street to make short term sacrifices willingly.

Which lessons may we derive from the experiences of Turkey and Argentina over the last couple of decades?

1. Economic stability in the medium term is dependent on the maintenance of the two major resource flow balances of a country - the fiscal position and the current account position
2. In addition to sustainability in the resource flow balances, a credible and rational mechanism must be in place (be it market-driven or government-led) to manage the resource allocation question
3. When it it time to "pay the bill", trying to postpone it causes much larger damage than paying it sooner

The first lesson is very easily observable from data: Argentina's fiscal deficits were the main driver of the 2000-2001 crisis while Turkey's current account deficits undid the 2000 stabilization programmes. Despite doing many things right, both countries failed due to a major resource flow imbalance.

The second lesson explains Turkey and Argentina's long-term stories and should be kept in mind while devising policies for the future. If the government's role in guiding the economy is to be significantly reduced, the corresponding decision making, research and monitoring mechanisms should be present in the private sector to enable the private sector to take over the government's role in resource allocation.

The third lesson pertains to the end game. Whatever mistakes one makes over a period of time, when the consequences of past mistakes catch up with one,

one should pay the bill sooner rather than later. This explains the diverging paths of Turkey and Argentina since mid-2001. When faced with the crisis, Turkey took almost all the steps necessary to address the main cause of the crisis. Argentina, on the other hand, hardly took any of the necessary steps. The bottom line is that countries need to live according to their means, and an improvement of their means is a matter that can be resolved only in the medium and long term.