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# Integration with Global Financial Markets and Domestic Political Reform: Comparing Poland and Turkey

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**INTEGRATION WITH GLOBAL FINANCIAL MARKETS AND DOMESTIC POLITICAL  
REFORM: COMPARING POLAND AND TURKEY**

by

©

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## ABSTRACT

This paper is about the political economy of policy reform in contemporary Poland and Turkey. It focuses on the period of 1980-97 in Turkey and 1989-97 in Poland during which the economies of these countries underwent significant structural changes and became integrated with global financial markets with the rise of the Warsaw Stock Exchange in 1991 and the Istanbul Stock Exchange in 1986.

The first part of the paper provides an overview of the contending theoretical perspectives on "Phoenix risen" and on how external and domestic economic factors influence domestic political reforms in countries where integration with international financial markets has taken place. In the second part of the paper, these propositions are then assessed against the Polish and Turkish experiences.

### I. INTRODUCTION

During the last decade, many developing countries have experienced a significant inflow of private capital as they became more integrated with international financial markets.<sup>1</sup> The amount of private capital flowing into these countries, including bonds and loans (\$54.8b), totaled \$167.1 billion in 1995 while official development assistance was \$64.2 billion.<sup>2</sup> The figure for private finance represent a significant increase from earlier periods, including bonds and loans, as indicated by World Bank figures: \$51.4 billion during 1977-82, \$34.9 billion in 1983-90, and \$142.7 billion during 1991-94.<sup>3</sup> With this increase in the flow of private capital into the emerging markets, scholars began to ask what factors contributed to this new phenomenon and what sort of relationship exists, if any, between the flow of private capital and domestic political reform (e.g., democratization) in the emerging market countries.

Emerging markets is a term that came out of the International Finance Corporation (IFC) of the World Bank Group. The term refers to those developing and more developed countries where one finds new stock markets. This definition is widely accepted by scholars and practitioners. However, there are different definitions of global finance. For the purposes of this study, we adopt a definition of global finance provided by Benjamin Cohen:

. . . global finance is assumed to encompass all types of cross-border portfolio-type transaction–borrowing and lending, trading of currencies or other financial claims, and the provision of commercial banking or other

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<sup>1</sup>World Bank, *Global Economic Prospects and the Developing Countries* (Washington, DC: World Bank, 1995), p. 12.

<sup>2</sup>International Finance Corporation, *Emerging Stock Markets Factbook, 1996* (Washington, DC: IFC, 1996), p. 6.

<sup>3</sup>World Bank, *Global Economic Prospects*, p. 12.

financial services. It also includes capital flows associated with foreign direct investment—transactions involving significant control of producing enterprises. Financial globalization (or internationalization) refers to the broad integration of national markets associated with both innovation and deregulation in the postwar era and is manifested by increasing movements of capital across national frontiers. The more alternative assets are closely regarded as substitutes for one another, the higher the degree of capital mobility.<sup>4</sup>

This definition of global finance presents a comprehensive view of the subject that lends itself for operationalization and testing. As capital mobility increases, international financial markets are expected to become more integrated. Accordingly, governments will presumably undertake various policy reforms to improve their respective economies' attractiveness to foreign capital. Similarly, the relationship between global finance and domestic political reform in the emerging markets is a contested topic among scholars. In the next section, different views on these relationships will be examined.

Poland and Turkey provide an excellent test cases for the above relationships. During the last two decades, different Polish and Turkish governments pushed ahead with the restructuring and further integration of the economy with global capitalism. These efforts followed the adoption of Poland and Turkey's most comprehensive austerity programs, sponsored by the International Monetary Fund (IMF), in January 1990 and January 1980 respectively. The result has been a thorough political and socioeconomic transformation of both countries that display a complex interplay of domestic and foreign forces.

## II. RISE OF THE GLOBAL FINANCIAL MARKETS: MYTH OR REALITY?

During the last decade there has been a growing body of literature that examines the expansion of global financial markets.<sup>5</sup> As Cohen asks "how can we explain the remarkable globalization of financial markets of recent years, and what are its economic and political

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<sup>4</sup>Benjamin J. Cohen, "Phoenix Risen: The Resurrection of Global Finance," *World Politics*, 48, 2 (January, 1996): 269.

<sup>5</sup>For example of such works see Benjamin J. Cohen, "Phoenix Risen," pp. 268-96; Stephen R. Gill and David Law, "Global Hegemony and the Structural Power of Capital," *International Studies Quarterly*, 33, (December, 1989); John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca, NY: Cornell University Press, 1992); John B. Goodman and Louis W. Pauley, "The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets," *World Politics*, 46, (October, 1993); Eric Helleiner, *States and the Remergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1994); Eric Helleiner, "The World of Money: The Political Economy of International Capital Mobility," *Policy Sciences*, 27, 4 (1994); Peter Isard, *Exchange Rate Economics* (Cambridge: Cambridge University Press, 1995); Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge: Harvard University Press, 1994); Peter Kurzner, *Business and Banking: Political Chance and Economic Integration in Western Europe* (Ithaca, NY: Cornell University Press, 1993); and Andrew C. Sobel, *Domestic Choices*,

implications?"<sup>6</sup> These questions go to the heart of the relationship which is now at the forefront of research in international political economy. However, we ought to be careful not to assume that this is a new phenomenon. It simply is not. What we observe is a more complex version of what has been a practice for a long time.

Markets for exchanging different monetary instruments are very old. Arrangements for exchanging gold and silver coins of different societies go back to ancient times. Moreover, the Sumerians were the first people to write a book on international business in 2,000 BC. It is ironic that we are discovering international business now! According to Charles Kindleberger "international banking developed simultaneously with local banking after the introduction of the bill of exchange by the Italians in the thirteenth century."<sup>7</sup> This was followed by a widespread use of paper instruments as means of payment in the fourteenth century and the rest is history.

In recent decades, as Peter Isard notes, "the institutional characteristics of markets for exchanging different monetary instruments have been influenced by another profound transformation in the means of settling transactions."<sup>8</sup> With the onset of telecommunications and computer technology revolutions, the practice of using paper instruments to settle international transactions has for the most part become obsolete. Now, international payments can be made through rapid transmission via telecommunication instruments. The works cited above (fn. 5) address the causes of these changes.

According to Benjamin Cohen, scholarly works identify three sets of factors responsible for the rise of financial markets: systemic or structural, state or domestic, and cognitive or ideological—similar to the notion of Waltz's three images.<sup>9</sup> In this regard, Eric Helleiner notes two sets of causal interpretations: the impact of technological changes and market forces that work at the expense of states' roles and the autonomy of the states.<sup>10</sup> For Helleiner, the answer lies in the autonomy of the states as governments enter into a competition of deregulation in order to attract foreign capital.

Philip Cerny, on the other hand, argues for a combined effects of three sets of explanations—the market forces, institutional and technological advances, and political processes.<sup>11</sup> The last component of Cerny's classification is further refined to reflect the

*International Markets: Dismantling National Barriers and Liberalizing Securities Markets* (Ann Arbor: University of Michigan Press, 1994).

<sup>6</sup>Cohen, "Phoenix Risen," p. 268.

<sup>7</sup>Charles Kindleberger, *A Financial History of Western Europe*. (London: George Allen & Unwin, 1984), p. 39.

<sup>8</sup>Peter Isard, *Exchange Rate Economics*. (Cambridge: Cambridge University Press, 1995), p. 13.

<sup>9</sup>Cohen, "Phoenix Risen," p. 274. For the three images argument see, Kenneth Waltz, *Man, the State, and War*, (New York: Columbia University Press, 1959).

<sup>10</sup>Helleiner. *States and the Remergence*, p. 1.

<sup>11</sup>Cerny, "The Deregulations and Re-regulation," as cited in Cohen, "Phoenix Risen," p. 274.

dynamics of domestic interest groups politics and the relative autonomy of the state. One other work which deserves special notice is Andrew Sobel's book on the international securities markets. According to Sobel, three sets of explanations can be made for explaining the rise of international financial markets. The first two explanations, systemic changes and foreign policy consideration, fall into the category he calls the "outside-in" group. The third explanation, domestic pressures, represent the "inside-out" factors.<sup>12</sup> The former includes competition among national markets, changes in technologies, and power politics, meaning the exercise of power as foreign policy tool, between states. The result is that national governments respond to these external pressures and reform their policies to enhance flow of financial capital. In contrast, the inside-out explanation focuses on the stimuli for change coming from increased competition between organized interest groups within domestic political economies.<sup>13</sup> Sobel maintains that it is the domestic, or the inside-out, considerations that have had a spillover effect in the international financial markets.<sup>14</sup> He further argues that the inside-out explanations require important components: (1) that contradictions must exist in that forces can be mobilized for political action, and (2) that "contextual shifts restructured the policy area sufficiently to overcome the status quo and past obstacles to regulatory change."<sup>15</sup>

Based on these alternative explanations, Cohen proposes four models (which he refers to as hypotheses) for investigation: (1) the impact of competition and innovation in the financial market place based on the neoclassical economists' arguments, (2) the role of policy rivalry among governments in an insecure world based on the realist view, (3) the role of domestic politics and institutions in driving international development based on the pluralist paradigm, and (4) the role of belief systems and epistemic communities as catalysts for change based on the cognitive model.<sup>16</sup> These alternative approaches provided the basic framework for a systematic analysis of the problem. However, Cohen's models exclude the alternative formulations put forth by radical economic thought like the dependencia, neo-Marxist, and the world system analysis literature. According to these views, one can hypothesize that the rise in financial markets is due to one social class' desire to increase its profit base by making the world market its domain. Moreover, we can further refine the research question by distinguishing between the interests of the foreign

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<sup>12</sup>Sobel, *Domestic Choices*, pp. 13-16. It should be noted that the terms "outside-in" and "inside-out" come from Kenneth Waltz's earlier study, *The Theory of World Politics*, (Reading: Addison-Wesley, 1979). Cohen in his review of Sobel's work makes this observations.

<sup>13</sup>Ibid., p. 16.

<sup>14</sup>Other scholars support this observation. For some examples see, Jagdish Bhagwati, *Protectionism* (Boston: MIT Press, 1989), I. M. Destler and John Odell, *Anti-Protection: Changing Forces in United States Trade Politics* (Washington, DC: Institute for International Economics, 1987), and Helen Milner, *Resisting Protectionism* (Princeton: Princeton University Press, 1988).

<sup>15</sup>Sobel, *Domestic Choices*, pp. 88-89.

<sup>16</sup>Cohen, "Phoenix Risen," p. 274-75.

industrialists and financiers as these respective groups of investors look for opportunities for investment.<sup>17</sup>

Other works take this topic of financial market's rise to prominence and apply it to the recent political reforms in the emerging markets. The aim is to examine whether or not there exist some causal relationship between the rise of emerging markets, more specifically their integration with global financial markets, and domestic reforms in the form of democratization. Until recently, studies of the political economy of foreign investment in the Less Developed Countries (LDCs) and/or the Newly Industrialized Countries (NICs) indicated that the decade of 1970s can be seen as one of rapid debt accumulation, the 1980s of economic reorientation under the IMF and World Bank supervision, and the 1990s as the decade of growth and integration with global financial markets. In this last stage, we observe varying degrees of domestic reforms (e.g., Argentina, Chile, Mexico, and Turkey) and challenges to authoritarian state by organized interest (e.g., China and Russia). Though there is no empirical proof that integration with global financial markets results in democratization in these countries, the probability of the relationship carries important theoretical and policy implications. If the relationship exists, this would negate the earlier findings that demonstrated a causal relationship between economic austerity, flow of foreign investment, and the rise of authoritarian regimes.<sup>18</sup>

This plausible relationship between financial markets and democratization goes to the heart of the basic assumptions one finds in the traditional literature on markets and politics.<sup>19</sup> Furthermore, the relationship, if exists, refutes the long standing assumption in North American political science and economics that economics and politics are separate and to a large extent unconnected. As Milton Friedman explains, this view basically holds

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<sup>17</sup>For examples of radical economic thought see T. DosSantos, "The Structure of Dependence" *American Economic Review* 60 (May, 1970): 231-236; Joan Robinson, *Aspects of Development and Underdevelopment*. (Cambridge: Cambridge University Press, 1979); Samir Amin. *Unequal Development*. (New York: Monthly Press, 1980); Fernando H. Cardoso "Dependency and Development in Latin America." *New Left Review*, 74 (July-August, 1972): 83-95; Ronald Chilcote (1985). *Theories of Development and Underdevelopment*. (Boulder: Westview, 1985).

<sup>18</sup>For some examples see Henri J. Barkey, *The Politics of Economic Reform in the Middle East* (New York: St. Martin's Press, 1992), David Collier, ed., *The New Authoritarianism in Latin America* (Princeton: Princeton University Press, 1979), Dharam Ghai, *The IMF and the South: The Social Impact of Crisis and Adjustment* (London: Zed Books, 1991), Joan Nelson, ed., *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World* (Princeton: Princeton University Press, 1990), Robert Kaufman, "Democratic and Authoritarian Responses to the Debt Issue: Argentina, Brazil, and Mexico," *International Organization*, 39 (1985), pp. 473-503, Guillermo O'Donnell, *Modernization and Bureaucratic Authoritarianism* (Berkeley: University of California Press, 1979), and Birol A. Yesilada and Mahir Fisunoglu, "Assessing the January 24, 1980 Economic Stabilization Program In Turkey," In Henri J. Barkey, ed., *The Politics of Economic*, pp. 183-212.

<sup>19</sup>See for example Anthony Downs, *An Economic Theory of Democracy* (New York: Harper and Row, 1957), Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1960), Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1947) and Hirschman, *Exit, Voice, and Loyalty* (Cambridge, Mass: Harvard University Press, 1970), and Charles Lindblom, *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books, 1977) and Lindblom, "Market and Democracy—Obliquely," *PS: Political Science & Politics*, 27, 4 (1995), pp. 684-688.

that "individual freedom is a political problem and material welfare an economic problem; that any kind of political arrangement can be combined with any kind of economic arrangement. ... Such a view is a delusion, that there is an intimate connection between economics and politics, ... only certain combinations of political and economic arrangements are possible, and that in particular, a society which is socialist cannot also be democratic, in the sense of guaranteeing individual freedom."<sup>20</sup> According to Friedman, economic freedom is an end in itself and also a prerequisite for political freedom.

This possible relationship between markets and democratization was recently the topic of a conference at Brown University in November 1995, where scholars and financial officials discussed the ramifications of these issues. Participants presented various ideas pertaining to this topic and attempted to build in the works of current researchers in this field.<sup>21</sup> However, there is a fundamental weakness in the way most researchers are tackling this topic. The most common approach is to look at the relationship between markets and politics in a linear fashion by identifying a dependent and various independent variables. It is highly likely that such approaches miss the crucial complexity of the existing relationships between markets and politics and also with the social dimension of economic/political development. This methodological issue is related to the powerful dialectic relationship John Goodman and Louis Pauley raise in their study of global markets and capital controls. They argue that there exists a powerful dialectic relationship between market forces and public policy where government actions result in increased capital mobility which, in turn, increases pressures for further liberalization of the policies.<sup>22</sup>

The conclusion of the works on emerging markets fall into two classes—those which find some degree of causality between increased integration of the financial markets and democratization and those which maintain that the opposite relationship is crisis. In this regard, the study by Leslie Armijo is highly relevant. Armijo provides two sets of hypotheses for direct and indirect links between foreign capital inflows and democracy and evaluates them in Brazil, India, and Mexico. Although the analysis is far short of a rigorous empirical testing, Armijo's study is rich in data and provides the following observations:

[results provide] a partial return to two of the crucial insights of dependency theory. First, dependence on foreign capital for industrial investment tends

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<sup>20</sup>Friedman, *Ibid.*, pp. 7-8.

<sup>21</sup>Leslie Elliot Armijo, "Mixed Blessings: Foreign Capital Inflows and Democracy in 'Emerging Markets'" Paper presented at the Workshop on Financial Globalization and Emerging markets: Policy Autonomy, Democratization and Lessons from Mexico. Watson Institute of International Studies, Brown University, November 18-19, other papers include Thomas Biersteker and Christine Karnet, "International Sources of Contemporary Democratization," Michael Gavin, Ricardo Hausmann and Leonardo Liederman, "The Macroeconomics of capital Flows to Latin America," and Sylvia Maxfield and Joshua Hoffman, "International Portfolio flows to Developing/Transitional Economies: Impact on Government Policy Choice."

<sup>22</sup>John B. Goodman and Luis W. Pauley, "The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets," *World Politics*, 46 (October, 1993).



to bring with it increased direct or indirect influence for foreign governments and/or business into the process of national economic policy choice, in most diversions of democratic theory normatively understood as the exclusive province of resident citizens. Second, reliance on most of not all forms of foreign capital brings with it an anti-egalitarian bias, in that those private actors involved (and direct beneficiaries of) international financial intermediation, whether as borrowers or lenders, tend to be big rather than small businesses, and already wealthy rather than low-income individuals.<sup>23</sup>

Armijo further concludes that while the causality in this relationship is rather murky, at the very least, economic growth makes "the consolidation of democracy, once established, easier than it otherwise would be."<sup>24</sup>

In her review of these conclusions, Mary Ann Haley argues that there is a very important factor overlooked by Armijo. According to Haley, Armijo fails to consider the fundamental role played by institutional investors (money managers of pension funds, insurance companies, banks, brokerage firms, and large multinational corporations) in influencing policy decisions.<sup>25</sup> This is an important observation and to establish the relationship the researcher needs to carry out a micro-level search to see the relationship between the representatives of the investors and the governmental decision-makers.

Based on the above review, we will consider the following questions of theoretical and policy significance to analyze the relationship between financial markets' integration and domestic reform in Poland and Turkey:

- Q1. What is the nature of the relationship between market reforms and democratization in Poland and Turkey?
- Q2. Is there a causal relationship between Poland and Turkey's integration with the global financial markets and democratization?<sup>26</sup>
- Q3. What are the foreign factors involved in these relationships?
- Q4. What was the nature of the stabilization and adjustment policies (neoorthodox, heterodox, or a combination) in Poland and Turkey?

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<sup>23</sup>Armijo, "Mixed Blessings," p. 36.

<sup>24</sup>Ibid., p. 37.

<sup>25</sup>Mary Ann Haley, "Freedom and Finance: Institutional Investors and Democracy in Emerging Markets," paper presented at the 1996 Annual Meeting of the Western Political Science Association in San Francisco, March 12-16, pp. 9-10.

<sup>26</sup> This question is aimed at determining the nature of democratic reforms in Poland and Turkey. It is interesting that when these countries and other emerging market economies first attempted export oriented growth during the 1970s and early 1980s, they often experienced authoritarian political rule. However, as these countries' economies began to integrate with global financial markets, we observe domestic political reform in the direction of democratization. Why is this happening? What are the domestic and foreign factors affecting democratic reform? Is it the international financiers' interests in having highly liberalized markets that is spilling over into the political domain in the form of democratic reforms? Is there a difference in the interests of foreign financiers and the industrialists

### III. TYPES OF CAPITAL FLOWS INTO THE EMERGING MARKET ECONOMIES

As we explained above, systemic and technological changes in the world resulted in increased financial flows between the mature and emerging market economies. Table 1 provides figures on the type of such flows. The data clearly show the growing importance of the emerging markets for global investments. Among the investment types, private capital, specially in the form of portfolio investments, is becoming a key factor in this picture. As portfolio investments increased, stock markets of these countries became important sites for profit making/losses for the global investors. At the same time, the impact of these flows on the macroeconomic indicators of the receiving countries has been significant. Private capital flows provide important source of capital in balancing the current account of the countries - that is, if there is a net flow. Furthermore, the recipient country's inflation rate and foreign exchange reserves can benefit from these investments. However, none of these benefits can be achieved unless the government adopts realistic monetary policy and carries out the needed structural reforms in the economy. This is the crucial juncture for public policy and market performance.

In addition to their macroeconomic impact, such flows provide incentives for governments to carry out structural and financial reforms and to adopt stable monetary policy. In this sense, such financial flows represent the outside-in pressures for reform in the emerging markets. Failure to carry out the necessary reforms carries with it the danger of market speculation, foreign exchange crisis, and dangerous volatility of the stock markets (e.g., the foreign exchange crisis of Mexico and Turkey in 1994 and the subsequent market falls). The results of such events could be catastrophic as we witnessed in Mexico in the form of massive flight of capital. In sum, inflow of foreign capital can provide benefits as well as risks for the emerging market countries.

In addition to their effect on macroeconomic stability/instability, financial liberalization also reduces the ability of the public officials to carry out public policy in this sector. Monetary substitutes create a tremendous problem for public officials. As soon as a country begins to experience macroeconomic imbalances, individuals can shift their demand for money from the local currency to hard currencies. When this occurs, it becomes difficult for governments to reestablish macroeconomic balance and, as a result, inflation begins to get out of control and foreign exchange rates start to climb. This highlights the important effect of financial liberalization on monetary policy in a country.

As monetary policy and foreign exchange markets become highly interdependent, the central bank's role in determining the country's monetary policy becomes more and more significant. The recent trend in this area is that the central banks are becoming more

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(who earlier invested in these economies for import substitution and later export-oriented growth, and allied themselves with domestic authoritarian forces)?

independent. The structural reforms demanded by foreign institutions like the IMF and the World Bank also reflect this pressure. Under such conditions, governments find it more and more difficult to go to the central bank and manipulate the money supply to satisfy their economic policy targets. These crucial developments in demand for money, monetary substitutes, and foreign exchange policies coupled with pressures to reform the relevant economic structures represent the inside-out pressures for reform. Under financial liberalization individuals can resort to monetary substitutes with relative ease (inside-out pressure). Subsequently, failure of public officials to establish macroeconomic balance can have dramatic effects on the economy. A sensible response would be to provide for central bank autonomy and allow professional technocrats the capacity to determine monetary policy of the country in accordance with market conditions. Yet, in many emerging markets, governments find it difficult to surrender this politically crucial instrument to non-elected technocrats.

**Table 1: Aggregate Net Long-Term Resource Flows to Emerging Markets (\$US b.)**

<i>Type of Finance</i>	<u>1985-89</u>	<u>1990-92</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
<b>Official Developmental</b>					
<b>Finance</b>	209.1	178.4	53.0	48.6	64.2
<b>Private Debt Flows</b>	67.9	73.9	40.3	43.8	54.8
commercial bank	22.8	18.0	-4.9	9.2	17.1
others	23.4	26.9	6.9	2.4	4.0
portfolio, bonds and debt	15.6	29.0	38.3	32.2	33.7
<b>Portfolio, Equity</b>	6.0	25.4	45.6	34.9	22.0
<b>Direct Foreign Investment</b>	82.9	106.6	68.3	80.1	90.3
<b>Total Private</b>	157.2	205.9	154.2	158.8	167.1
<b>Aggregate Net Resource</b>					
<b>Flows</b>	366.2	384.3	207.2	207.4	231.3
of which official (%)	57.6	47.9	25.6	23.4	27.8
of which portfolio, equity	1.5	6.1	22.0	16.8	9.5

Source: IFC. *Emerging Stock Markets Factbook*, 1996. p. 6.

#### IV. THE POLISH AND TURKISH CASES

##### Polish Experiment With Reform

Due to prolonged economic crisis of the late 1980s and widespread direct appeal to the public of the Solidarity movement, the parliamentary elections in June 1989 resulted in Solidarity winning all available 161 seats in the lower house, and 99 out of 100 in the Senate. In August the first non-communist Solidarity-led government of prime minister Tadeusz Mazowiecki took office. Its comprehensive economic program was developed by an economic team formed by the deputy-prime minister and finance minister Leszek Balcerowicz. Although Mazowiecki, after losing his bid for presidency to Walesa in November 1990, was replaced by Jan Krzysztof Bielecki in January 1991 (a second Solidarity-led government), the economic team remained intact with Balcerowicz remaining on both of his government positions.

In October of 1991, the first completely free parliamentary elections were held. Although the anti-Solidarity opposition remained relatively weak, the honeymoon season for the government was quickly evaporating. The public was increasingly becoming impatient with the harsh reforms and with fragmentation of the post-Solidarity parties. The elections resulted in a new center-right government

of prime minister Jan Olszewski. Since Balcerowicz left the government, and new president Walesa was gradually losing his charismatic appeal, there were hardly any leaders with a vision of reforms and alternative economic program at the top of Polish politics. Quickly the political issues took precedence over economic considerations. Politicking in parliament resulted with the Solidarity leaders losing public approval.

As we see in Table 3, about mid-1992 the honeymoon period for the Solidarity-led governments was over. At that time prime minister Olszewski was succeeded by Waldemar Pawlak, who for a month was not able to form government and was subsequently replaced by Hanna Suchocka from Democratic Union (DU)<sup>27</sup>. Despite the introduction of constitutional amendments enabling governments to bypass legislative procedures and decide on economic issues by decree, the fragmentation of the legislature was perceived as such an obstacle for efficient governing that president Walesa dissolved the parliament in mid-1993. Soon thereafter, in August, the Suchocka's government resigned after a vote of no confidence. The widespread direct appeal of Solidarity to the public came to an end.

New elections were held in September (with 5 % threshold substantially reducing the number of parties in the parliament), resulting in former communists, the Democratic Left Alliance (SLD) receiving the most votes (more than 20 %) and 173 seats in the parliament, and the Polish Peasants' Party (PSL) ranking second with 130 seats (and more than 15 % of the vote). The urban-based SLD was pro-market reform oriented, whereas the rural PSL favored substantial domestic protectionism (especially in terms of financial supports for farmers, wide preservation of nationalized industry, and tariff shields against subsidized agricultural imports from the EU). A new government of prime minister Waldemar Pawlak (PSL) was formed in October 1993, and lasted until March 1995, when he was replaced by Jozef Oleksy (SLD) who became the seventh prime minister since August of 1989. In the period of 1993-1995, president Walesa remained the main opposition figure to the ex-communist government and proceeded to undermine it whenever possible at the cost of substantially losing personal popularity. Subsequently, in November 1995, he lost his bid for reelection to Aleksander Kwasniewski (SLD). Following increasing accusations of spying for the KGB at the end of 1995, prime minister Oleksy resigned and was replaced by Włodzimierz Cimoszewicz (SLD) on 1 February 1996.

The last communist government before 1989, was reluctant to take tough stabilization measures to restore Poland's macroeconomic stability. It left the legacy

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<sup>27</sup> DU transformed later into Freedom Union.

of excessive wage increases, irresponsible monetary policy (with inflation increasing at a monthly rate of 10% at early 1989), and budget deficit (reaching 10 % of Gross Domestic Product (GDP) for the first nine months of 1989)<sup>28</sup>. One of the main policy goals of all of the governments in the 1990s was to establish the foundations for sustainable economic growth, as expressed by the first Polish Letter of Intent to the IMF: “the sustained growth of output and living standards and the strengthening of our external position over the medium term...are the ultimate goals of our efforts”<sup>29</sup>.

The first step towards that end was the implementation of radical economic reforms in January, 1990 - the so-called *Balcerowicz plan*<sup>30</sup> or more commonly known as the *Shock Therapy*<sup>31</sup>. This stabilization and adjustment program was a mixture of restrictive financial policies that included a drastic devaluation of the zloty. The overall goal was to stop hyperinflation and liberalize the economy. Although such policies contributed to relatively high unemployment<sup>32</sup> and to an overall economic recession, the first governments were committed to promoting a more equal distribution of income along with improving overall economic conditions and furthering structural reform. The program resulted in a spectacular capping of hyperinflation and balancing of both foreign trade and the government budget. As Jacek Osinski and Andrzej Slawinski point out it, also, produced “A favorable currency substitution. Demand for money shifted back toward domestic currency in the previously ‘dollarized’ economy”<sup>33</sup>.

[Tables 2 and 3 here]

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<sup>28</sup> James Bjork "The Uses of Conditionality: Poland and the IMF", *East European Quarterly*, XXIX, No.1 March 1995, pp.95-96.

<sup>29</sup> LOI, December 22, 1989, p.1.

<sup>30</sup> The *Balcerowicz plan* was announced in September 1989 to both the IMF and the World Bank and revealed the finance minister's desire to go even further than IMF required. The plan's priorities were:

- rapid price liberalization,
- sharp devaluation and complete convertibility of Polish currency,
- stabilization of the exchange rate,
- elimination of government subsidies,
- substantial increase of interest rates,
- taxation of excessive wage increases,
- removal of barriers to private entrepreneurship,
- privatization of most state owned enterprises (SOEs),
- IMF and World Bank lending to Poland,
- establishment of a stabilization fund for the Polish currency, and
- substantial debt relief. (Bjork "The Uses...., p.98)

<sup>31</sup> As used interchangeably with the *Balcerowicz plan*, *Shock therapy* describes a series of radical market-oriented reforms to overcome the severe economic problems inherited from the command economy. It consisted of the IMF- supported program which focused on trade and exchange rates liberalization, privatization, and monetary/fiscal reform.

<sup>32</sup> Unemployment reached its highest in 1994 - about 17% of the total workforce (Poland: March 1996, Barclays Bank Country Report, 1996 Quest Economics: Janet Matthews Information Services, March 1, 1996.)

<sup>33</sup> Jacek Osinski and Andrzej Slawinski, *National Bank Of Poland And Open Market Operations*, Warsaw, 1994, p.4.

The information in Table 2 shows that the implementation of market-oriented reforms was successful in a vast majority of policy issues. A "yes/no" indicates, in majority of the cases, that the governments were just not eager to speed up progress in a given issue area, but by no means did they stop or reverse the advancements that had already been done. Sometimes, even during such slowdown periods, major pieces of pro-market legislation passed the legislature (for example the mass privatization laws during the Pawlak government), but were not readily implemented by the government.

As documented in Table 2, the very first Solidarity-led governments abolished the bulk of the quantitative trade restrictions and of export subsidies. Subsequent governments somehow revised that policy, by imposing some protectionist barriers in several sectors (for example automobiles). Along with removing trade restrictions, the limitations on the availability of foreign exchange for current account transactions have been largely eliminated<sup>34</sup>. The Mazowiecki government introduced in 1989 an enterprise income tax, with a uniform rate of 40 %. Next year it instituted an unemployment insurance scheme (Labor Fund), financed by a 2 % payroll tax (increased to 3 % in 1993). In 1992, a personal income tax was launched with a top marginal rate of 40 % (raised to 45 % in 1994). These developments were followed by a value added tax (VAT), which came into existence in 1993, with a standard rate of 22 % and a reduced rate of 7 %. The payroll tax to finance the Social Insurance Fund was at 38 %, but was raised to 45 per cent in 1992<sup>35</sup>. The first governments applied for the state enterprises, a tax to the excess of average wages over a predetermined norm (the so-called "Popiwiek"). Although it ceased to exist in April 1994, it was re-introduced on 1 August 1994, during the term of Pawlak government.

An essential part of the economic stabilization policy was the containment of the fiscal deficit. In both 1991 and 1992 the deficits were about 6 % of GDP, in 1993 and 1994 they went under 3 %. This improvement was due to the introduction of a new income tax regime, the broadening of the tax base, the imposition of a value added tax and strong recovery in economic growth in both years (which added to budget revenue)<sup>36</sup>.

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<sup>34</sup> Until May 1995, the exchange rate was set up to follow a crawling peg to a basket of currencies. In 1995 the National Bank of Poland (NBP) re-adjusted that policy by introducing a managed float for the currency, under which domestic banks freely set their exchange around the central bank's rate. Such rate is set daily by the NBP after considering world market rates and devaluation of the zloty. The devaluation of the new zloty against its basket - consisting of the US dollar (45%), the DM (35%), the pound sterling (10%), the French franc (5%) and the Swiss franc (5%) - was reduced from 1.2% per month to 1.0% in January 1996. The central rate is adjusted under a crawling-peg regime, and the zloty can fluctuate within margins of +/-7.0% around the central rate. A new Foreign Exchange Law, which took effect from the beginning of 1995, removed some exchange restrictions on current international transactions. (Poland: March 1996, Barclays Bank Country Report, 1996 Quest Economics: Janet Matthews Information Services, March 1, 1996.)

<sup>35</sup> POLAND: Transition indicators, EBRD Transition Report, Janet Matthews Information Services, October 1, 1994.

<sup>36</sup> Poland: March 1996, *Barclays Bank Country Report, 1996 Quest Economics*: Janet Matthews Information Services,

The Mazowiecki government formulated its mass privatization program in 1990. It aimed to sell 50 % of state enterprises (some 8,000) within a period of five years. The implementation was slow and resulted mostly in passing the relevant legislation by the parliament in 1993. The legislation also designed the creation of privately managed National Investment Funds (NIFs). The majority of shares introduced through privatization of State Owned Enterprises (SOEs) will be held by the NIFs, with the balance going to the Treasury and employees of respective companies. A comprehensive privatization program was introduced in 1994. Its first stage covered more than 400 large SOEs valued at \$US 2.6 billion (additional 100 companies were added to this phase in 1995). The privatization of the banking sector has been slow, and privatization of strategic industries (fuel, power, coal mining and shipyards) remained politically sensitive<sup>37</sup>.

As Table 2 shows, Poland's leftist governments have set tight fiscal policies, despite campaign pledges to reduce the social cost of economic reform. In July 1994, the finance minister presented the 1995 budget which estimated a 5 % growth in GDP, a 22 % inflation and a substantial reduction in the devaluation of the zloty. It also provided for lower income tax in expectation of increased profitability of state enterprises and increased incomes from customs and indirect taxes<sup>38</sup>. As indicated in Table 6, the economic outcomes of 1995 proved it to be a realistic strategy.

The strong inflow of foreign exchange resulted to a large extent from rising export revenues in the unrecorded sectors of the economy and from speculative capital inflows taking advantage of relatively high yields on the zloty deposit accounts. Monetary policy was tightened during 1995. Interest rates were increased in early 1996, but were subsequently reduced as monthly inflation slowed. Relatively high interest rates continued to encourage capital inflows, contributing to money supply growth and aggravating inflation<sup>39</sup>. In order to limit the inflow of foreign exchange, the National Bank of Poland (NBP) abandoned the so-called "internal convertibility" and floated the Polish zloty (PLZ) on May 16, 1995. PLZ became also current account convertible on June 1, 1996.

As mentioned earlier, in October 1994, prime minister Pawlak decided to start a Mass Privatization Program (MPP), involving the transfer of 60 % of the equity of 444 companies to 15 NIFs. Shares in the NIFs will be sold publicly on the Warsaw stock Exchange (WSE). Another 30 % of the equity will be distributed free to

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March 1, 1996.

<sup>37</sup> Poland: March 1996, *Barclays Bank Country Report, 1996 Quest Economics*: Janet Matthews Information Services, March 1, 1996.

<sup>38</sup> POLAND: Review 1996, *Europe Review World of Information, Quest Economics*: Janet Matthews Information Services, March 1, 1996.

<sup>39</sup> Poland: March 1996, *Barclays Bank Country Report, 1996 Quest Economics*: Janet Matthews Information Services, March 1, 1996.



employees, pensioners and social funds, with government securing the remaining 10 %<sup>40</sup>.

The government's economic policies of the last three governments were contained in two documents prepared by the finance minister Kolodko: "Strategy for Poland" (for years 1994-97) and "Package 2000" (adopted by the governments in 1994 and 1996 respectively). If the targets in the new program were met, Poland might be considered as the new EU member state. One of the goals is to bring the budget deficit down to 1.7 % of GDP and inflation to 4.9 % in 2000, with the annual growth at above 5 %. According to the program, the average annual real GDP growth would be at 5.7 % over the next five years<sup>41</sup>. GDP growth is forecast to slow to 5.5 % in 1997, 5.3 % in 1998 and 5.1 % in both 1999 and 2000. Consumption would decrease to 3.2 % in 1997 and 1998, and 3.1 % in both 1999 and 2000. Investment is forecast to increase by 8.5 % in 1997, and by 9 % per annum in the following three years. Exports and imports are expected to increase (respectively) by 12.4 % and 8 % in 1997, 10 % and 7 % in 1998, 8.4 % and 6.5 % in 1999, and 8.3 % and 6.5 % in the year 2000<sup>42</sup>.

One of the key challenges remained to be confronted by the Polish governments is the reform of the burdensome social security system, especially the pension requirements, which account for some 15 % of GDP. Another remaining problems are to improve the financial and banking systems and reduce inflation to single digit figure. The latter one remains to be the key element of the monetary policy. Although the inflation dropped from about 555 % in 1990 to about 30 % in 1994, it still remained relatively high at 22 % in 1995 and 1996. Government's plans are to reduce it to a single digit number in 1997, but among the obstacles in achieving that are the indexing of both wages and pensions as well as substantial inflows of short-term capital<sup>43</sup> (especially foreign currency deposits that were induced by relatively high interest rates and stability of the zloty since 1991). Initial reforms of the social security system are to begin by the second quarter of 1997. They will probably consist of introduction of private pension funds with tax-deductible contributions and minority stakes in SOEs, as well as of reduction of special pensions for some categories of the workers. The issue, however, is going to a hot one, marked with tensions and populist election campaigning.

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<sup>40</sup> POLAND: Review 1996, *Europe Review World of Information, Quest Economics: Janet Matthews Information Services*, March 1, 1996.

<sup>41</sup> There are two scenarios under the program: optimistic when GDP could increase by 8.0% and pessimistic when it is below 3.0%.

<sup>42</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>43</sup> It is estimated that total money supply grew about 32 % in 1994, 39 in 1995, and some 25 in 1996 (Poland: January 1996,

### **The Turkish Experiment With Reform**

Much has been written about economic reorientation of Turkey since the military coup of 1980.<sup>44</sup> Economic policy reform in Turkey began in 1980, following the adoption of the IMF sponsored stabilization and adjustment program and continues to this day. During this period, different governments pushed ahead with reforms with varying degrees of success and failure but political transformation from authoritarianism has significantly lagged behind its economic counterpart. With regard to economic liberalization two important dates are crucial to remember.

The first is January 24, 1980, when the coalition government of Süleyman Demirel announced a wide sweeping reform package under the IMF guidance.<sup>45</sup> These reforms were in response to the bottleneck problems the Turkish economy experienced during the second half of the 1970s as it industrialization reached a crucial point and transition to export-oriented growth became essential. However, the government was unable to implement these policies due to social and political unrest in the country. Therefore, the task of policy implementation fell into the lap of the generals following the coup of September 12, 1980. Reform began with the generals and got underway under Özal's government following return to civilian rule in 1983. The 1980 program identified two major goals, stabilization and structural transformation which are still underway today. The second important austerity package is the policy response of former Prime Minister Tansu Çiller to currency crisis of January 1994. Once again, the Turkish government visited the IMF and announced harsh economic austerity to stabilize the Turkish lira and the financial markets. Taken together, the period between 1980-97 can be summarized according to criteria recommended by Yavuz Canevi in evaluation of the specific components of reform packages. Table 3 compares these policies against the various governments which were in power during this period.

[Table 4 here]

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*Bank of America WIS Country Outlooks, Janet Matthews, Information Services.)*

<sup>44</sup> Some suggestions for this reading include Yavuz Canevi, "Turkey," in John Williamson, ed., *The Political Economy of Policy Reform* (Washington: Institute for International Economics, 1994); C. H. Dodd, *The Crisis of Turkish Economy* (Hemingford Grey, UK: Eothen Press, 1990); Atila Eralp, Muharrem Tünay, and Birol Yesilada, eds., *The Political and Socioeconomic Transformation of Turkey* (Westport, Mass: Praeger, 1993); William Hale, *The Political and Economic Development of Modern Turkey* (London: Croom Helm, 1981); Z. Y. Hershlag, *The Contemporary Turkish Economy* (London: Routledge, 1988); Anne O. Krueger and Okan H. Aktan, *Swimming Against the Tide: Turkish Trade Reform in the 1980s* (San Francisco: International Center for Economic Growth, 1992); Ziya Onis and James Riedel, *Economic Crises and Long-Term Growth in Turkey* (Washington: World Bank, 1993); Dani Rodrik, "Comment," in John Williamson, ed., *The Political Economy*; Birol Yesilada and Mahir Fisunoglu, "Assessing the January."

<sup>45</sup>Yesilada and Fisunoglu, "Assessing the January ," p. 187.

The information in Table 4 show that the track record of the Turkish governments on reform have been mixed. A “yes” means that there were efforts made to implement reforms in the specified area, “no” means that the issue was not addressed and a “yes/no” indicator simply means that reforms remained on paper only. The nature of the coalitions and strong opposition from other political parties and organized labor often limited the capacity of governments to tackle such difficult issues as privatization and prioritization of public expenditures. Often, it is the case that new governments enjoy a brief period of “honeymoon” with the opposition and able to carry out reforms. However, there is more involved in examining the record of these governments. One needs to look at the nature of the opposition, quality of the government’s economic think tank, leadership of its Prime Minister, and the nature of its reform program (including the items cited in Table 4). John Williamson provides a series of hypotheses, or a check list, for examining this aspect of the problem (see Table 5).

[Table 5 here]

In evaluating these hypotheses similar notations are used as in Table 4. Once again, the track record of the governments is mixed. One important observation is that every government came to power with a commitment for a comprehensive policy reform. One exception to this is the former Çiller-Yılmaz coalition of 1996. Nevertheless, in each case, the comprehensiveness of the respective programs remained on paper only. Even under the IMF sponsored austerity packages, in 1980 and 1994, the governments swayed away from their goals for political reasons. Only two leaders, Turgut Özal and Necmettin Erbakan, had a clear vision for the future of Turkey’s economy. Özal’s vision reflected the widely accepted economic doctrines of capitalism whereas Erbakan’s views clearly follow the Islamist doctrine. We will return to the latter’s views at a later section.

The “yes” notation during the military rule period is also due to his presence as the economic advisor to the coup government. He was the architect of the January 24, 1980 austerity package and continued to adhere to its principles during his rule in 1983-91. However, one should be careful in distinguishing between Özal’s early years and his last years in office, in the late 1980s. After the 1987 national elections, the Özal government slacked off in pushing for privatization and to control public spending. Nevertheless, Özal's economic reforms, resulting in complete reorientation of the Turkish economy from an inward oriented market to integration with global capitalism was the first economic revolution since Atatürk's time.

During the 1980s, Turgut Özal, who was the visionary leader similar to the first image criteria found in the formulations of Cohen and Cerny, reformed the Ministry of Finance and in 1983 absorbed the Treasury Department. He also created the Undersecretariat of Treasury and Foreign Trade. According to Yavuz Canevi "in this way,

the Prime Minister consolidated his direction of all the major agencies of economic and finance management; the Undersecretariat of Treasury and Foreign Trade, the Central bank, the Undersecretariat of the State Planning Organization, and the newly established Extra-Budgetary Fund Administration."<sup>46</sup>

He also established the Monetary and credit Committee as the technical forum to discuss policy issues and to be chaired by the Minister of Finance. The Economic coordination council, headed by the Prime Minister, was the corresponding political forum and attended by the key ministers of the cabinet and technocrats. These two bodies considered short-cuts to the long political decision-making processes of the government and the national assembly. This way, the Prime Minister got his decision implemented very quickly and often without legislative oversight. With these institutional changes, Özal embarked upon a series of reforms aimed at liberalizing the Turkish investment, foreign trade, exchange rate, and fiscal regimes. Some privatization also took place. Without going into details of these efforts, one can summarize the achievements of Özal as:

On the positive side . . . as a result of more realistic exchange rates and the government's export-promotion policies, export earnings increased significantly and, by the end of [1980s], the current account balance finally emerged out of its perennial deficit. . . . the share of industrial products increased from 36 % to 78 % of total exports. Also, the share of total trade in GDP doubled . . . liberalization of the investment regime attracted a sizable stock of foreign investment into the Turkish economy. On the negative side . . . (1) The export-oriented model failed to eliminate trade deficits; (2) The money supply (M2) has shown a steady increase since 1980; (3) The high inflation rate has almost returned to its previous levels; (4) Real wages of workers and bureaucrats have declined significantly; (5) The income-distribution pattern worsened as relative factor shares in national income shifted away from popular sectors to profits, interest, and rents income; and (6) Özal government's reliance on excessive borrowing from abroad resulted in a very large external debt.<sup>47</sup>

In another evaluation of stabilization and adjustment in Turkey, Dani Rodrik explains that the problem of unfinished reform is due to the governments' failure to capitalize on timing:

In some sense, Turkey's real political economy story is its failure to deal adequately with the public-sector deficit (and the problem of state enterprises in particular) when the government had a real window of opportunity. . . . In 1980-81, the generals did not do it [and] capital inflows from abroad hid the need for fiscal reform. In late 1983, when Özal won the elections (thanks to a change in electoral laws), he spent too much energy on microeconomic reforms such as trade and financial sector liberalization. . . . overall result; the Turkish macroeconomy remains rife with

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<sup>46</sup> Yavuz Canevi, "Turkey" pp. 185-186.

<sup>47</sup> Yesilada and Fosunoglu, "Assessing the January," pp. 206-207.

instability, with the public-sector-borrowing-requirement hovering above 10 % of GDP, and inflation at an annual rate of around 65-70 %.<sup>48</sup>

The significance of the above observation is that the post-Özal governments inherited unfinished reforms. Under such conditions, like coalition governments, the new leadership had to cope with increasing economic pressures, both outside-in and inside-out, to complete the necessary reforms as the Turkish economy became more integrated with global financial markets.

During the last few years, different Turkish government coalitions continued to press ahead with restructuring of the economy which had begun in 1980. However, the coalition governments of Süleyman Demirel and Tansu Çiller (first with Yılmaz and later with Erbakan) failed to maintain tight monetary policies, allowed inflation to run at an average rate of 60-90 % per year, and borrowed heavily in foreign markets. At the end of 1996, foreign debt rose to \$78 billion. This represented a major rise in foreign debt which stood at \$38 billion in 1988 and \$16 billion when the 1980 austerity measures were introduced.<sup>49</sup> Çiller, the first female Prime Minister, paid for this irresponsible practice when she was faced with downgrading of Turkey's long-term debt rating by the Moody's, from BAA to BA1 (considered a "junk" rating) and a serious speculative attacks on the Turkish lira in 1994. Following the Moody's action, the Standard & Poor's revised its long-term foreign currency rating for Turkey from BBB to BBB minus. In an attempt to prevent economic collapse and to avoid knocking on the doors of the IMF for assistance, Çiller's government undertook series of economic decisions aimed at restoring confidence in the economy.

The first such decision was the announcement of a new program of tax changes designed to close the country's budget gap and offset expected losses from the move to a customs union with the European Union (EU) in 1995. These measures, however, failed to prevent the further downgrading of Turkey's credit by the agencies Moody's and Standard & Poor. Following this announcement, the lira went into a chaotic fluctuation against major currencies. As pressures mounted, the central bank announced on April 5, that it will no longer intervene to support the lira and declared the official exchange rate to be 32,050 TL per one US dollar-representing a 38 % devaluation from the previous day. On the same day, the government disclosed a new austerity package to stabilize the economy.

The first part included the stabilization measures. These were price increases on government-controlled commodities, an investment freeze and one-off tax charges on the rich (\$2.1 billion), a 15 % real wage cut in the public sector, laying off 30,000 state workers, and reform of the farm support policies to underpin a fiscal program to slash the budget deficit from TL47,000 billion to TL9,000 billion during the second quarter of 1994. The second part was comprised of adjustment policies which included faster privatization of

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<sup>48</sup> Rodrik, "Comment," pp. 213-215.

<sup>49</sup>Ibid., p. 201

state enterprises (to raise \$3.5 billion), closure of the nonprofit making state enterprises, and reform of the Central Bank by increasing its autonomy and reducing the extent to which it provided funds to help balance the budget.

Despite the tough austerity measures of the Çiller government, Turkey was unlikely to get through these economic crisis alone. Much depended on an agreement with the IMF because without the Fund's approval Turkey could not return to international capital markets to secure foreign credits. Therefore, the government went back to the IMF for approval.

The outcome of going to the IMF was once more a return to orthodoxy in Turkey. The subsequent signing of the letter of intent represent the cooperative nature of the game in that the two sides agree on a set of binding agreements which are enforceable. This letter was necessary for releasing of \$250 million from the Fund to support Turkey's balance of payments and send a signal to international lenders that the country was once again creditworthy.

All in all, the IMF agreed to a two-year \$756.2 million stand-by loan in July 1994, and the Turkish government approached the World Bank for loans to support economic restructuring, particularly in the public sector. According to the World Bank officials who assessed the days of these negotiations, "Turkey had to consider privatization of her state owned economic enterprises, eliminate state subsidies, modernize the tax and social security system, and sweep away bureaucratic red tape. Determination, or the lack of it, to pursue public sector reform will shape Turkey's business environment in the years to come."<sup>50</sup> As we will discuss in the next section, the overall outcome of Turkey's stabilization showed mixed results in 1994. The government's decision to practically stop all purchasing and payments during the second and third quarter, helped ease the balance-of-payments problem. Productivity slowed down, money supply shrunk, and the lira lost ground against other hard currencies making Turkish exports attractive in foreign markets. By the end of the year, the economy showed a negative growth rate of 6.0 %. However, despite the initial monetary discipline, the government failed to meet the target rates in controlling the inflation, and initiating the much needed privatization program.

With growing domestic opposition and the inability of the government to meet some of the target specified in the 1994 letter of intent, the Çiller government found it necessary to go back to the IMF to renegotiate a new letter of intent in 1995. The minister of state, Aykon Dogan, submitted a new letter of intent to the IMF on February 24, 1995, following eleven days of talks with the Fund's officials in Ankara. The major aim of the letter of intent was to obtain a six-month extension on the stand-by agreement.

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<sup>50</sup>Interviews with Christian Poortman, Tanju Yürükoglu, and Suman Mehra of the World Bank. June 30, 1995.

The new letter of intent raised the target for annual average inflation for 1995 from 43 % to 70 %; increased the central government budget deficit by 11 % to 220 trillion liras from 198 trillion liras; planned for a public-sector-borrowing-requirement around 6.0 % of GDP (an expected decline from 10 % in 1994); targeted a current-account surplus of \$1.4 billion; a target GNP growth rate adjusted to 3.8 % from the earlier projection of 4.4 %; and serious privatization efforts.<sup>51</sup>

The IMF approved the letter of intent on March 9, 1995, and extended Turkey's stand-by agreement for another six-months. As a result of this decision, the stand-by financing increased by \$157.5 million bringing the total from the facility to SDR 610.5 million (\$952.4 million). The acting managing director of the IMF, Stanley Fisher, announced that these policies strengthened Turkey's external position and that the Fund expected inflation to come down and provide for sustained economic growth in 1995. Despite the IMF's approval of the letter of intent, the Turkish government suffered a serious setback in its efforts to maintain the support of the World Bank in Turkish structural reform policies. The World Bank withdrew its support for structural reform in Turkey because of the government's inability to carry out meaningful privatization policy and its weak political capacity to initiate civil service reform and the overhaul of the social security system.<sup>52</sup>

Following December 1995 national elections, Çiller and Yılmaz formed another coalition aimed at keeping the Islamist Welfare Party of Necmettin Erbakan from forming the government.<sup>53</sup> This coalition's economic reform program was basically followed the previous Çiller-led coalition governments and were short lived as the alliance fell apart within three months. Following this split, Çiller then formed another coalition government with the Islamist WP in July 1996.

Although the new coalition endorsed Çiller's economic program the WP has its own hidden agenda to advance their Islamist cause based on its *Milli Görüş* (the National View) and *Adil Düzen* (the Just Order) views.<sup>54</sup> With this problem aside, the new coalition did

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<sup>51</sup> EIU, *Country Report: Turkey, 2nd Quarter*. (London: EIU, 1995), pp. 17-19

<sup>52</sup> According to Christian Poortman, Division Chief for EC 1 (Turkey, Bulgaria, Cyprus, FYR Macedonia, Portugal, and Romania Department) of the World Bank, the World Bank did not see Çiller's current program sustainable. The government quietly indicated that it could not accept the tough measures for public sector adjustment (civil service reform, comprehensive privatization of the state enterprises, and social security reform) due to political conditions in the country and the weak nature of the government coalition. Thus, the World Bank pulled out of supporting the government.

<sup>53</sup> For a detailed discussion of this period see Birol A. Yesilada, "The *Refah* Party Phenomenon in Turkey," unpublished conference paper.

<sup>54</sup> National View and Just Order are two comprehensive "reform" packages that the WP wants to install instead of the IMF-prescribed orthodox economic reforms. According to these two packages, Turkey's problems can be solved as follows: (1) "Single Solution:" (i) Reject Western imitation and adopt *Milli Görüş*, (ii) reject Western capitalism and apply *Adil Düzen*, (iii) develop moral and material well being of citizens, (iv) reject Western dependency and promote Islamic unity, and, (v) realize Islamic justice [in Turkey]; (2) Stop the expansion of Western style political parties; (3) Instate *Adil Ekonomik Düzen*; (4) Adopt an independent foreign policy for Turkey, and; (5) Promote Islamic unity. *Milli Görüş* emphasizes five important points: (1) Domestic peace; (2) Unity between the State and nation (*Devlet-Millet Bütünlüğü*); (3) Revival of the "Great Turkey" (*Büyük Türkiye*) torch; (4) Spiritual

put into effect two important policies which had remained on paper during the previous coalition periods - public expenditure prioritization and privatization. The most significant privatization news came in January 1997, when the Constitutional Court rejected appeals to stop the privatization of Turk Telekom. Furthermore, the Williamson Hypotheses show major differences between the current coalition government and the previous ones. The most dramatic difference between the current Erbakan-Ciller coalition and the previous ones (except Özal) is that the WP-wing of the coalition does have a leader with a vision. It also has a direct appeal to the public, and favors liberalization of economic regimes. However, the coalition's economic program does not include fiscal discipline, a tax reform, or reform of property rights.

### **THE EFFECTS OF FINANCIAL FLOWS ON THE POLISH AND TURKISH ECONOMIES AND POLITICAL SYSTEMS**

In discussing the policy outcomes of the recent austerity and reform measures in Poland and Turkey, we will first present a brief overview of the macroeconomic outcomes, discuss developments in business and finance and assess the possible links between integration with international financial markets and domestic.

#### **Macroeconomic Trends in Poland**

Poland's economic stabilization and reform programs, of the early 1990's have proved successful and the country seems to be now in the process of a strong economic recovery.

[Table 6 here]

Tax revenues and savings in public spending reduced substantially the budget deficit. Inflation is falling gradually, balance of payments stabilized, and there were large inflows of short-term foreign capital. Polish exports increased sharply (continuing since 1992, but especially in 1995, due to strong demand on the European markets that year), followed by surge in foreign exchange reserves. In June 1995 Poland reentered global capital markets, which resulted in increase of

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growth, and; (5) Economic Growth. As it can be seen, the WP does have a very comprehensive program, and its leader - a seventy-four-year-old veteran leader - has been leading the WP and its predecessors for more than twenty years. The WP, in addition, has been very successful in directly appealing to public. It has a very peculiar party structure and party organization which share similarities with Duveger's 'branch party,' 'cell party,' and 'militia party.' Through many *tarikats* (religious order), the WP branches down to large numbers of people. In addition, just like cell parties, it permeates all aspects of its members' lives from work to recreation. Hence, the party ideology is a philosophy that extends beyond the political realm, and provides its members a way to discover truth and frame their decision making. Furthermore, the radical faction of the WP is similar to Duveger's militia party with armed militants. The only reason for their participating into the regime is to try to bring about its demise. For more information see Yesilada, "The *Refah* Phenomenon."



foreign capital. Unemployment, although dropping, still remains high.

The original reforms focused on lowering various consumer subsidies and entitlements, with direct consumer subsidies being cut from 10 % of GDP in 1988 to less than 1 % in 1995. But, government spending on unemployment and pensions remains high and drives total government spending to some 51 % of GDP<sup>55</sup>. As a result of the radical stabilization program, the economy had started to expand in 1992. Government attempts to slow inflation are likely to be frustrated by continuing high inflationary policies of pensions and wage indexation, as well as substantial increase of money supply related to foreign capital inflows. International reserves (excluding gold) increased substantially by over \$US 9 billion in 1995 to almost \$US 15 billion in 1996, which is due mainly to speculative short-term capital inflows precipitated by the Treasury-bill market, Foreign Direct Investment (FDI) and unrecorded trade inflows<sup>56</sup>. The net foreign exchange reserves in August 1996 were estimated at \$US 21,930 million, and official foreign exchange reserves at \$US 17,970 million. Although exports are increasing, reducing the debt-to-exports ratio, the current account deficit is decreasing<sup>57</sup>.

Due to increasing economic activity and reduced import tariffs, imports doubled between 1994 and 1996, driving the current account deficit from \$US 900 million in 1994 to \$US 1.9 billion in 1995 and 7,7 billion in 1996<sup>58</sup>. The tendency of strong import is likely to continue due to further reduction of custom duties. It is forecast that Poland's capital accounts will strengthen and that it will not seek a further standby agreements with the IMF. Also, borrowing from other official agencies is to go down to less than \$US 600 million, compared with \$US 900 million raised in 1995 and \$US 1.5 billion in 1994. FDI is anticipated to accelerate due to a substantial capacity of Poland's domestic market and awaited speed up of privatization<sup>59</sup>.

As Table 6 shows, in 1996 Poland returned to its output levels from 1989, after achieving real GDP growth of 3.8 % in 1993, 5 in 1994, 6.5 in 1995, and 5.5 in 1996. In \$US terms growth has been even greater than in the zloty terms. GDP in 1990 was equivalent to \$US 59 billion, in 1995 it went up to \$US 115 billion (PLZ 275 billion), in 1996 to \$134.5 billion, and is estimated to be \$149.4 billion in 1997<sup>60</sup>. The government plans for budget deficit in the next four years estimate to

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<sup>55</sup> Poland: January 1996, *Bank of America WIS Country Outlooks, Janet Matthews, Information Services.*

<sup>56</sup> Poland: March 1996, Barclays Bank Country Report, 1996 Quest Economics: Janet Matthews Information Services, March 1, 1996

<sup>57</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>58</sup> Sources: Poland: January 1996, *Bank of America WIS Country Outlooks, Janet Matthews, Information Services*, and *The Financial Times*, March 26, 1997.

<sup>59</sup> Poland: January 1996, *Bank of America WIS Country Outlooks, Janet Matthews, Information Services.*

<sup>60</sup> Sources: Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*,

be within the challenging Maastricht boundaries of less than 3 % of GDP<sup>61</sup>.

Despite both IMF and World Bank made increasing privatization a condition of financing the London Club debt reduction, and of lending \$US 790 million for a 19-month extension to the standby agreement of August 1994, the privatization of 8,000 of public enterprises has been very slow since 1990<sup>62</sup>. Under the MPP, 512 firms have been distributed among 15 NIFs. Over 20 million people bought vouchers worth PLZ 20, which are exchanged for one share in each of 15 NIFs. The funds have control over those firms whose total book value is estimated at PLZ 6.3 billion (\$US 2.5 billion). Capital privatization is also being pursued with 2,000 new companies designated for sale under a new privatization law in the near future. Initially, such privatization was expected to raise PLZ 2.5 billion as part of a total PLZ 6 billion from privatization revenues in the budget. However, since privatization remains a source of tension between the coalition partners as well as a hot issue in the upcoming elections, the immediate privatization plans remain uncertain.

The original Kolodko's "Strategy for Poland" targeted a reduction in unemployment in 1997 to 14 %, which is likely to be met. He was forecasting that rate will drop to 10-11 % in 1997, despite more tight requirements for unemployment benefits currently in place.<sup>63</sup> However, until now, economic growth has contributed to only a marginal decline in unemployment (it was at 14.3 % in mid-1996 and 14 % at the end of the year), down from a peak of 16.4 % in 1993. It is forecast that the rate of unemployment will decline slowly because the significant business activity should generate new jobs. But, job losses will also rise due to reductions in the public sector and continuing industrial restructuring (mostly in traditional industries such as shipyards and coal).

### **Financial Services**

In 1989, nine commercial banks were established from branch offices of the National Bank of Poland. The Banking Law of 1989, the Act on the National Bank of Poland of 1989 (both amended in 1992), and The Law on the Financial Restructuring of Enterprises and Banks of 1993 provided the regulatory framework for banking operations. After recapitalization, the branches of NBP were deemed for privatization.

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October 1, 1996, and *The Financial Times*, March 26, 1997.

<sup>61</sup> Originally, the government targeted a deficit of 2.3% of GDP in 1997, but the projections have been raised twice to 2.6 and 2.8%, due to the government-proposed tax cuts in October. The finance minister, Kolodko, wanted to reduce present income tax rates from 21%, 33% and 45%, to 20%, 30% and 40% respectively, but the cabinet overruled him, and proposed them to be at 20%, 31% and 43%. Despite these proposals, the parliament voted for income tax rates of 17%, 20%, 33% and 45%, which is likely to put the 3% goal into jeopardy. The corporate tax has been cut by the parliament from 40 to 38% as well. (Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics*, *Janet Matthews Information Services*, October 1, 1996.)

<sup>62</sup> POLAND: Review 1996, *Europe Review World of Information*, *Quest Economics: Janet Matthews Information Services*, March 1, 1996.

<sup>63</sup> Kolodko resigned as minister in February 1997.

First two state banks, which were in a better financial situation, were privatized in 1993 and early 1994<sup>64</sup>. Privatization of the banking sector remains under the control of the finance ministry, and is expected to progress<sup>65</sup>. New policies, after recapitalization, included adoption of tougher supervision and tighter liquidity requirements. Also, the government has developed a plan to consolidate the weaker and smaller banks before, in 1998, the Polish banking market fully opens to foreign competition<sup>66</sup>.

### **The Warsaw Stock Exchange**

The WSE was reopened in April 1991. Figure 1 provides an overview of the WSE (or the WIG as it is referred to in Polish). Marked points (e.g., A, B,...) indicate important points in time when events occurred that may have impacted on market performance. A long term economic recession and political instability created a very unfavorable climate for investment in the first two years of trading. In 1991-1993, prices of shares remained relatively stable. Although high interest rate on bank deposits discouraged domestic and foreign investment, the third quarter of 1992 brought a growing interest of foreign investors in the Polish market. Indeed, in the last quarter of 1992 the Polish economy continued to recover (despite the inflation rate around 40 %). Relative political stability encouraged first bullish trends in the stock market. A first unprecedented boom on the WSE was recorded during fall of 1993 and the first quarter of 1994 (A). The most important factors contributing to that were:

- (a) Positive reports on the Polish economy by foreign financial institutions at the end of 1993 and early 1994;
- (b) Growing private sector (in September 1993 accounting for 46 % of employees);
- (c) Increasing industrial production in 1993-4;
- (d) Decreasing inflation at the end of 1993;
- (e) Good financial results of the listed companies (markedly above those of the economy);
- (f) Passage of the new budget in the Sejm on February 15, 1994; and
- (g) The NBP lowering its main interest rates by 3 % on February 22, 1994 (which induced the commercial banks to greater reduce their interest rates).

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<sup>64</sup> POLAND: Transition indicators, EBRD Transition Report, Janet Matthews Information Services, October 1, 1994.

<sup>65</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>66</sup> Poland: July 1996, *Bank of America WIS Country Outlooks, Quest Economics: Janet Matthews Information Services*, July 1, 1996.

[Figure 1 here]

In March 1994 the WSE values hit their all-time high. Despite good performance of the Polish economy, the rest of 1994 and the beginning of 1995 witnessed a prolonged recession (the fifteen-month lows were noted in March, 1995)<sup>67</sup>, and the stock market became very volatile (B). The most important socio-economic event at the turn of the 1995 was the re-denomination of the Polish zloty (at the rate of 10,000 to 1). In the second quarter of 1995 WSE recovered from the protracted slump of the previous year (C). Rapidly raising foreign currency reserves led the NBP to introduce in May a flexible foreign currency exchange rate which resulted in appreciation of the zloty's value, subsequently ameliorated by the NBP's 4 % cut in interest rates.

The WIG index lost 11 % at the end of 1995, the greatest monthly fall in the value of index since January 1995, as tensions increased by the intensifying presidential election campaign (D). Investors fears were intensified by two additional factors: numerous new listings of companies listed on WSE and the inauguration of sale of privatization certificates through the MPP. In the first months of 1996 Polish macroeconomic situation continued to be good and the first quarter of 1996 was one of the most profitable periods on the WSE since 1994. When the NBP lowered interest rates in early January, the WIG gained 16 % over the first ten-day period of the month. At the end of January WIG gained 37 % (E). The January rise was mainly the result of growing interest in acquiring stock by large, very often foreign, investors. Economic growth remained high in 1996, resulting in each of the three official WSE indices gaining more than 80 % in the first six months (F). As of the third quarter of 1996, the total stock market capitalization of \$US 9 billion equaled 7 % of Poland's GDP.

### **Foreign Debt**

In September 1989, before launching his reform plan, Balcerowicz requested a substantial reduction of Polish debt at his speech for IMF and World Bank<sup>68</sup>. His aim was to seek a massive debt relief instead of asking for countless refinancing agreements<sup>69</sup>. A year later in similar address to the IMF and World Bank he emphasized the successes of Polish economic reform and pressed for the debt reduction again. Initially, the Polish government was seeking an 80 % reduction.

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<sup>67</sup> *FPO* - Updater, August 1995, p.27.

<sup>68</sup> The Paris Club controls Poland's debt owed to the Western governments, whereas the London Club the debt owed to the commercial lenders.

<sup>69</sup> Bjork "The Uses...", pp.100-101.

Later it reduced its demands to 40 %. As the data in Table 7 show, at the end of 1990 Poland's external debt in convertible currencies was about \$US 49.5 billion.

[Table 7 here]

In March 1992 the Western governments (the Paris Club) reached a compromise and agreed to forgive 50 % of Poland's official debt. Shortly after that compromise, the U.S. unilaterally wrote-off an additional 20 %, followed by France's 10 %<sup>70</sup>. Final agreement of May 1994 with the Paris Club laid ground for a settlement with the London Club of commercial bank creditors in September of the same year. It reduced debt by about 43 % (\$US 6.6 billion), restructuring it into long-term bonds<sup>71</sup> (valued at some \$US 2.4 billion) which were bought back by Poland for 41 % of the value and the remainder exchanged for 30-year bonds at a value of \$US 4.6 billion<sup>72</sup>. Debt reduction under these agreements reduced Poland's external debt from \$US 48.7 billion in early 1993 to \$US 44 billion in 1994<sup>73</sup>. The decline in debt, coupled with economic growth, improved Polish debt/GDP ratio to some 35 % in 1995, from 45.9 % in 1994<sup>74</sup>. Polish external debt declined further to \$US 42 billion in 1995 as a result of a mutual debt cancellation between Poland and Russia. Renewed borrowing in 1996 increased Poland's external debt to \$US 43.1 billion in 1996, but as a percentage of GDP, the debt fell from 35 % in 1995 to 33 % in 1996, and is projected to fall to 31.6 in 1997<sup>75</sup>.

### Political Outcomes

Since 1989, the political situation has been characterized by the competition between the movements/parties having roots in the anti-communist Solidarity and the former communists. The Solidarity-based parties become highly factionalized and unable to form larger and stable coalitions. The ex-communists, although consisting of a number of small groupings, remained united and centered on the ex-communist Social Democracy of the Republic of Poland (SDRP), DLA (SLD). The economic austerity programs of 1990-1992 fostered widespread social dissatisfaction

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<sup>70</sup> In response Japan blocked its \$US500mln loan to Poland.

<sup>71</sup> The London Club unprecedentedly reduced both the outstanding principal and unpaid interest on the debt. (Bjork "The Uses..., p.117)

<sup>72</sup> The agreement will reduce Poland's annual interest payments to \$US400 million. The \$US1.9 billion cost of the buy-back is to be financed through loans from the IMF, World Bank and Polish central reserves. Polish authorities estimate that the deal should result in over \$US1 billion in additional foreign investment inflows. (POLAND: Review 1996, *Europe Review World of Information, Quest Economics: Janet Matthews Information Services*, March 1, 1996.)

<sup>73</sup> Poland: January 1996, *Bank of America WIS Country Outlooks, Janet Matthews, Information Services*.

<sup>74</sup> Poland: March 1996, Barclays Bank Country Report, 1996 Quest Economics: Janet Matthews Information Services, March 1, 1996.

<sup>75</sup> Sources: Poland: January 1996, *Bank of America WIS Country Outlooks, Janet Matthews, Information Services*, and *The Financial Times*, March 26, 1997.

with the adverse consequences of the reforms, which lead to the emergence of a DLA/PSL coalition government at the 1993 elections. The parties which emerged from Solidarity, after easily winning the parliamentary elections of 1989 and 1991, very soon lost widespread public support and in addition to losing control of parliament, surrendered to an ex-communist in late 1995 the presidency as well.

The next parliamentary elections are scheduled for September 1997 (although such timing is uncertain) and Polish political life in the nearest time will be marked by maneuvering on the part of the government and the opposition. Despite political uncertainties, it is believed that Polish economy is substantially insulated from political concerns, and that prospects for Poland joining NATO in 1999 and the EU in 2002 are unlikely to be affected by internal political competition<sup>76</sup>. The new constitution remains to be drafted. It is believed that its blueprint will not be approved by parliament before spring 1997, and very likely that the referendum approving it will not be held until the fall parliamentary elections<sup>77</sup>.

### **External Factors: The European Union and The IMF**

Poland applied for EU membership in April 1994. The biggest concern during the process of admission remains Poland's large (1/4 of the labor force) inefficient agricultural sector. Also, the size of population of the country (Poland would be the sixth most populous EU member state), whose large part lives in poverty<sup>78</sup> is a problem. With all probability Poland will be one of the first Eastern European post-communist countries to join EU, but its admission may be loaded with exemptions and special clauses<sup>79</sup>.

Today in Poland both economic policy and the new laws are to a large extent geared towards convergence with the EU norms, in order to smoothen the country's future admission. Although the EMU criteria will be difficult to satisfy for such young free-market economy as Polish, in 1996 the ratio of debt to GDP dropped below 60 % and the budget deficit was below 3 % of GDP, what gives Poland a comparable standing with some of the EU member states. The other key economic problems on the path to admission are to reduce inflation and to lower long-term interest rates (most resistance to these goals comes from the PSL)<sup>80</sup>.

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<sup>76</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>77</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>78</sup> Even if estimates of Polish finance minister, Kolodko, that GDP in the year 2000 will rise to \$US200bn, are met, the per capita GDP would be below \$US5,000. More than Portugal's \$US2,984 per capita GDP when it joined EU in 1986.

<sup>79</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

<sup>80</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

Although in 1995 paid off its debts to the IMF, the latter still continues to monitor the economy at regular intervals, in order to reassure foreign businesses and investors that the government follows responsible policies. IMF also plays an advisory role to the government as well as gives its endorsement regarding certain monetary issues. When the NBP decided, in the third quarter of 1995, to move ahead with the full zloty convertibility, it petitioned the IMF for approval<sup>81</sup>. Although recently, the IMF predicted Poland's high growth of 5-6 % annually with inflation going down to a single digit figure by 2000, it advised the government of a more flexible exchange rate policy and some structural changes in order to help lowering inflation<sup>82</sup>.

### **Macroeconomic Trends in Turkey**

The results of economic austerity in Turkey have been mixed. As discussed above, the main reason behind this mixed picture has been the inability of the governments to carry out the reforms to their fullest extent. This, in turn, was due to the weakness of the coalition governments. With the nature of the recent national election results, it is doubtful that the newest coalition government will be able to implement meaningful reforms in privatization, civil service, social security, and government subsidies. Table 8 presents data on macroeconomic indicators.

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<sup>81</sup> *FFO* - Updater, August 1995, p.1.

<sup>82</sup> Hilfe Country Report: POLAND, OCTOBER 1996, *Quest Economics, Janet Matthews Information Services*, October 1, 1996.

**Table 8: Macroeconomic Indicators for Turkey**

<u>Indicator</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
Real GNP Growth @ 1987 prices (%)	- 6.1	8.1	7.1
Consumer price inflation (%.)	106.3	88.1	80.4
Export fob (\$ billion)	18.4	21.9	23.1
Import fob (\$ billion)	22.6	35.2	42.6
Current Account (\$ billion)	2.6	- 2.2	- 6.6
Reserves excluding gold (\$ billion-Dec)	7.2	12.4	16.5
Total external debt (\$ billion-Dec)	66.3	73.9	78.7
Public sector borrowing req. (% of GNP)	8.1	6.9	9.5
Budget balance (% of GNP)	- 3.7	- 4.1	
Exchange rate against \$ US (end of year)	38,726	59,650	101,575

Source: EIU, *Country Report, 1997 1st Quarter*

The data in Table 8 indicate that the GNP recovered nicely from the serious decline in 1994. The PSBR, on the other hand, shows a disturbing trend. While it declined and foreign reserves increased by \$5.3 billion in 1995, the borrowing requirement jumped to 9.5 % of GDP in 1996 due to the WP's irresponsible monetary policy (e.g., like the doubling of public sector salaries without dramatic increase in public revenues). On the negative side, trade deficit widened, current account balance registered a deficit, the lira continued to fall against major currencies, and inflation remained at very high level. Also, Turkey's foreign debt increased substantially to reach 78 billion dollars (see Table 9). The financial aspects of austerity on the other hand, show a more promising results.

Despite a major reorientation of the Turkish economy, reforms are needed in numerous areas. Failure to properly address these issues will most certainly affect the future relations of the economy with external capital. One such area is the social security system. The government plans to raise the retirement thresholds to reduce public expenditures because the current system does not specify a minimum age for receiving government pension. Under the proposed new system, which required major bargaining between the two coalition parties, the required minimum age will be 55 for women and 60 for men. However, as Poortman pointed out, "the new arrangements will now cover all the present defects in the system because many workers are not registered and, thus, do not pay premiums."<sup>83</sup> Moreover, the government faces political obstacles from some members

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<sup>83</sup>Interview with Yesilada.



of the Republican People's Party (RPP) and trade unions. With regard to the civil service workers, the current arrangement of an oversized civil service with low salaries is a sure formula for disaster. The exact opposite is necessary to reform this sector. However, no politician in Turkey is powerful enough to take on this task! Welfare Party's response has been to increase salaries without touching the oversized bureaucracy.

Privatization is another sore point in the government's efforts to achieve long-term structural reform. Law 3291, passed in 1986, authorized the Public Participation Administration (PPA) to privatize the designated SEEs. The program began in 1987 at an experimental level but never reached a full scale effort. The Özal government let it slide down to a lower priority in late 1980s as the Motherland Party lost public support. The subsequent Demirel government did little to advance the topic either as powerful members of his coalition partner (RPP) objected to the idea. Tansu Çiller, on the other hand, feels strongly about this topic but has to cope with the objections of members her same coalition partner. Traditionally, the RPP has had strong ties to trade unions which are widely represented at the SEEs.

Feeling confident about her ability to achieve a break through in privatization, the previous Çiller government proposed to privatize the postal, telephone, and telegram (PTT), estimated at \$10bn-\$15bn. This attempt came to a sudden halt when it was challenged in the Constitutional Court in 1993. Following this failure, the government went back to the drawing board in 1994 and passed a law in November, after much parliamentary objections and bargaining, to speed up privatization. Once again, the law was challenged at the Constitutional Court. Finally in January 1995, the Constitutional Court upheld the law (EIU, 1995: 21). Finally in January 1997, the Constitutional Court allowed the privatization of Turk Telekom, thus signaling the go ahead of privatization in Turkey. The current government now targets privatization revenue at an initial figure of \$5 billion by selling 20 SEEs, which employ 105,000 workers and accounting for 38 % of the SEE sales.<sup>84</sup>

Other important issues include fiscal reform, investment incentives, continued realignment of the Turkish lira, reform of the banking sector, and civil service reform. Success or failure will continue to depend on the internal dynamics of the Turkish political

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<sup>84</sup>In February 1995, the state's 99.9 % holding of the Petlas tire factory was sold to Nadir Impex (owned by Muhtar Azeri) for \$60 million; by mid-February, eight bids were made for 30 % share of the Ereğli iron and steel works out of the state's holding of 51.1 %; privatization of HAVAS (the airport ground handling company) run into major problems when workers went on strike and the Prime Minister and her Transport Minister publicly accused each other of mishandling the sale, resulting in the resignation of the latter; the government also cancelled the sale of hte Meat and Fish Co. (Et ve Balık Kurumu) following mishandling of the bids; finally, there are talks in Ankara that the government is planning to draft a major privatization scheme for the PTT with the hope that this sale might bring in more than \$10 billion.

system and the relative pressures exerted on Turkish officials by foreign economic agents and institutions.

The decision to give the Central Bank more autonomy under the April 5 austerity package was very important because according to central bank law of November 1993, the government, through the treasury, was permitted to go to the bank for up to 15 % of budgetary outlays. In 1994, this would mean a 50 % increase in broad money M2 which, in turn, would add to inflation sending it into hyperinflation range. The new proposal of Çiller, reduced the treasury's demand to 7.5 %. This was a welcomed move by the government given the fact that Çiller's lax monetary policy since July 1993, and her use of central bank funds to finance the budget deficit contributed to rise inflation by increasing the money supply and, moreover, caused the resignation of two central bank governors (in seven months)! Unfortunately, the new coalition of Erbakan-Çiller has not paid attention to fiscal and monetary discipline. Under their irresponsible policy decision, like the doubling of civil servant salaries, the Central Bank's autonomy might become a mute point.

Finally, one other issue needs to be addressed. This is the problem of a very large "Black Economy" or "Unregistered Economy" in Turkey which still presents a serious challenge to the Turkish government. According to Osman Altug of Marmara University, the unregistered economy grew to 41% of GDP in 1994 from 34 % in 1992. Unregistered workers now numbered at about 200,000. The textile industry probably has unregistered exports of about \$3.3 billion per year. The Turkish bankers suspect that while the official figures show the economy shrinking by 6 % in 1994, following Çiller's austerity program, if one takes into account the black economy, the actual figure is more likely to be 2-3 %.<sup>85</sup> This factor explains the hidden resilience of Turkey's economy. The black economy is also a source of perverse national pride in that it allows the Turks to be more wealthy than the official figures indicate. However, the reality is that it helps the richer classes and hurts the underclass. Tax evasion is extremely rampant resulting in higher budget deficits, increased interest rates, and higher inflation. Under these conditions, the IMF insisted on a new letter of intent for which the present government is by no means ready

### **.Financial services**

Banking in Turkey continues to undergo reforms since 1980. Recently, efforts were underway to bring Turkey into line with European standards on capital adequacy and other prudential ratios in accordance with the customs union agreement. There are 71 banks, 21 of which are foreign owned. State owner banks are the major source of finance but this is declining. About fifty % of total bank assets are concentrated in four banks: Ziraat Bankasi (Agriculture Bank), Emlak Bankasi (Housing Bank), Isbank, and Akbank. The first two are

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<sup>85</sup>Financial Times, "Bulkward Against Recession" by John Barham in Survey of Turkey June 12, 1995, p. 3.

state owned. Most of the private banks in Turkey are linked to major industrial groups and represent a merger of industrial and financial interests of the Turkish business elites. Çukurova group controls Yapi Kredi bank, Pamukkale bank and Interbank. The Sabanci Holding owns the most profitable private bank Akbank. Koç holding includes the Koçbank. And Yasar holding owns 90 % of total shares in Tütünbank. In addition to Turkish banks, there are Western commercial banks and some Middle Eastern finance houses. In this environment, most Turkish firms generate funds internally from their banking subsidiaries rather than from equity floatations.<sup>86</sup> Trading in government bonds and Treasury bills remain as dominant instruments of investors.

Five major institutions provide services as development banks. These are the Industrial Development Bank of Turkey (TSKB), the Turkish Development Bank, the Industrial Investment and Credit Bank (SYKB), the Iller Bank (Provinces Bank), and the Turkish Export Credit Bank. The TSKB is the largest provider of long-term foreign exchange loans and local funding for industrial venture. It distributes medium and long-term credits from the International Finance Corporation as well as other international agencies. Credit from the TSKB is typically for 2-10 year period.

In contrast, private domestic investment bank are relatively new on the Turkish financial scene. They are products of banking and other financial market reforms initiated by Özal. Prior to 1980, they were, for most practical purposes, unheard of. Their rise coincides first with liberalization of foreign exchange markets in the mid-1980s. Since then, these banks have been feeding on capital markets. There are five major private merchant banks in the country: the EuroTürk Bank (subsidiary of Général Bank, Banque Indosuez, Amsterdam Rotterdam Bank, and Société Générale de Belgique), the Turk Merchant Bank (owned by Bankers Trust), the United Investment Bank (Kavala group and Jordanian interests), Tekfen Yatirim ve Finansman Bankasi (Tekfen Investment and Finance Bank), and the Yatirim Bank (Investment Bank which is owned by the Trans-Arabian Investment Bank and other Saudi Arabian Interests). It is widely believed that as the Istanbul Stock Exchange (ISE) expands and Turkey's economic and business ventures in the region (including Central Asian republics) increase, other Western investment banks will enter the Turkish market. As discussed above, this was an issue during the recent approval of a major credit package for Turkey by a consortium of Western banks. However, before continuing with the ISE, where much activity has been witnessed, it is important to explain how and why Islamic banking entered the Turkish market at a time when all reforms pointed in the direction of western economic interests.

The last type of banking in Turkey is Islamic finance houses which practice Islamic banking. At the end of 1994, there were five major Islamic banks and four Islamic finance houses operating in Turkey. The banks are the Arab-Turk Bank, Bank Mellat (Iranian),

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<sup>86</sup>EIU, *Country Report: Turkey, 1995-96*, p.23.

Bank of Bahrain, Bank of Kuwait, and Habib Bank (Pakistan). The main finance houses are the Al Baraka and Faisal Finance (both Saudi interests).

In Turkey, the entry of the Islamic capital into the economy coincided with the transition from military to civilian rule following the Motherland Party victory in the 1983 national elections and continued until the 1991 national elections when the True Path Party of Süleyman Demirel won the national elections. Turgut Özal's key role in accomplishing the necessary policy changes concerning foreign investment is obvious. First, as soon as Özal became the Prime Minister in November 1983, he revised the regulations on private financial institutions through a series of governmental decrees. Other related decisions soon followed.

First, Özal allowed the establishment of the Faisal Finance and Al Baraka Turkish Finance houses and provided them with special exemptions from Turkish bankruptcy laws. Interestingly, this happened shortly after the elections, on December 16, 1983, before the new government of Özal received a vote of confidence in the National Assembly. Second, the government extended tax exemptions to the Islamic Development Bank in order to allow capital flows in accordance with the ISEDAK agreements.<sup>87</sup>

### **Capital Flows and the Istanbul Stock Exchange**

Following the signing of the new letter of intent and the Fund's approval in 1995, Turkey returned to international loan markets in April 1995, and secured a \$500 million three-year loan package put together by U.S. and Japanese banks. This was achieved after a year's absence from such efforts by Turkey. The agreement signaled Turkey's return to credit worthiness and paved the way for additional \$2.0bn - \$2.5bn in loans later in 1995.<sup>88</sup> The consortium of banks included the Citibank (which plans to expand its operations in Turkey), the Chemical Bank (which is looking at privately financed infrastructure projects in Turkey), investment banks such as Goldman Sachs and J. P. Morgan (which are hoping for privatization mandates), and Japanese banks (Bank of Tokyo, Nomura, and Yamaichi). It is interesting to note that, the Turkish government sent international banks a letter in January 1995, warning that their future business operations with Turkey and/or in Turkey depended on their support for the government's effort to secure this loan.

The new loan consisted of \$252 million floating rate notes that appealed to investment banks and \$248 million in conventional syndicated loans. The Çiller government intended to use the loan for covering budget deficit and financing of foreign

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<sup>87</sup>This was a conference of Islamic countries where the participants decided to increase financial and other economic ties among the states. Turkey was a participant. For extended analysis see Birol Yesilada, "Turkey's Foreign Policy Toward the Middle East," in Atila Eralp, Muharrem Tünay, and Birol Yesilada, eds., *The Political and Socioeconomic Transformation*, pp. 169-192.

<sup>88</sup> *Financial Times*, April 27, 1995, p. 3

debt payments (the government faced a \$2.1 billion debt payments in July-August 1995). The cost of the deal was 3.5 % over London Interbank Loan Rate (LIBOR) which was rather expensive by today's standards. However, it was cheap when one considers that it was proposed in late 1994 at the time when the Turkish government was rolling over its \$12.5 billion domestic debt every quarter at extremely high interest rates. These developments provided positive signals for the investors in Turkish market. Despite such difficulties like the downgrading of Turkey's credit rating in 1994 and again in December 1996 - first half of January, 1997, Turkey has continued to actively borrow on the international capital markets, and it has not had major difficulties in keeping up its debt repayments. In addition, Turkey's reserves have steadily increased.

FDI in Turkey has been very little. This is more obvious if one considers the size and growth of the Turkish economy. For example, the net FDI in 1995 was only \$772 million. The Gulf Crisis and its effects, many government crisis during the Ciller-led coalitions, the coming to power of the Islamist Welfare Party made the investors very uneasy and cautious. In that regard, most of the investment in Turkey since 1992, has been directed to maintain the existing projects instead of creating new projects. While the portfolio inflows and outflows remained very insignificant up until the late 1980s, net portfolio investment increased steadily in the 1990s. In 1993 it rose to \$3.9 billion. However, in 1995 it fell sharply to \$1.72 billion.

The performance of the ISE, on the other hand, defies economic risk assessment. Despite continuing political problems (volatile coalitions, the Kurdish problem, and regional instability), and economic difficulties (e.g., high inflation, fiscal imbalances, etc.) the ISE continues to be one of the stars of the emerging markets. Flow of capital into Turkey's buoyant stock market is also an indicator of the vitality of its private sector. It should be noted that portfolio investments and outflows were insignificant in Turkey until the late 1980s, when the government removed all foreign exchange controls. The increase was remarkable. The Istanbul Stock Exchange (see Figure 2), which suffered a major setback after the downgrading of Turkey's long-term debt in early 1995, showed remarkable recovery in the second quarter of 1995, following the signing of the Customs Union (CU) agreement between Turkey and the European Union.

[Figure 2 here]

Following the signing of the CU agreement, the index continued to grow until the government began to experience problems with the unions and challenges to its efforts to amend the constitution. In Figure 2, (A) represents the time of the signing of the CU agreement, (B) the National Assembly's approval of constitutional amendments, (B)-(C) the period of political instability as the government faced organized labor's opposition and the collapse of the coalition, (C) the ratification of the CU by the European parliament, (D)

national elections of December 1995, (E) the CU goes into effect, (F) WP-TPP coalition, and (G) the privatization decision of the Constitutional Court.

The graph indicates that despite political instability, the market performed well since the signing of the CU agreement. Furthermore, the trend seem to continue since the beginning of 1996. Observations since that time show continued increase in the ISE composite index. Much of this increase is due to domestic trading though international investors are gradually increasing the funds available for the ISE investments. According to Landen Thomas, portfolio manager at Morgan Stanley's Turkey Fund, investors are attracted to Turkey for two reasons. First is improvements on the political scene despite the shifts in coalition governments. And the second is improvements in the interest rates.<sup>89</sup> Furthermore, returns on investments in Treasury bill show remarkable opportunity. Such yields, which surged to 250.9 % in December 1995 due to political instability, dropped to a low of 120 % in early 1996. As of mid-March, 1996, T-bill yields stood at 137 % which is far above the consumer price inflation of 69.6 %. These are promising developments since the ISE composite index dropped 4.4 % in dollar terms in 1995, even though it was up 46.8 % in lira terms. Since the beginning of 1996, the ISE composite increased in dollar terms to reach an all time high of 791 (1986=100) in January 1997. It is, however, unrealistic to expect this remarkable rise to continue as the government will face huge debt payments in early Summer and mid-Autumn.

An additional attraction of the Turkish market for foreign investors is this country's growing economic prominence in the region (Black Sea, the Middle East, and Central Asia). Potential of these new markets is known to international players who plan to increase their presence in Turkey (see above). Expecting this increase in foreign capital, the Turkish capital markets board announced plans to establish two regional exchanges.<sup>90</sup> The two locations considered are Denizli in the Aegean region and Gaziantep in the Southeastern region. The goal is to integrate regional development projects with international financial capital. The Aegean region is a highly diverse area in economic terms. Gaziantep, on the other hand, represents a far lesser developed region but one where the gigantic Southeast Anatolian Project is located. Following the completion of this project, an area larger than the size of Belgium will be converted to irrigated farming. Finally, there are plans to develop an international stock market with the status of a free-trade zone. Under this plan, trading will take place in dollars with no taxation of transactions.

In contrast to portfolio flows, FDI has been relatively small in Turkey not exceeding 0.4 % of GNP per year since 1985. One can find most Western brand names in the Turkish market but these are manufactured under license or partnership with Turkish businesses. Continued government regulations, red-tape, foreign exchange-rate instability, and regional

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<sup>89</sup>Reuter, report on Turkey by Daren Butler, March 29, 1996.

<sup>90</sup>EIU, *Country Report: Turkey, 1st Quarter*, p.31.

uncertainties contribute to this trend. The CU agreement, however, is expected to increase direct investment by EU companies since Turkey's unit labor cost is considerably below the EU levels. Perhaps with this agreement the government will be able to implement its build-operate-transfer scheme more successfully. Such investments are designed to attract investment in infrastructure without direct financing from the public sector.

### **Foreign debt**

As explained above, Turkey returned to return to the foreign loans market in February 1995. According to the Treasury department, the country's foreign debt stock fell to \$65.6 billion in September 1994 from a high of \$67.3 billion in January of the same year (see Table 9).<sup>91</sup> The country still faced a major challenge in this area as it paid \$10-12 billion in debt service in 1995. However, there were no major concerns in Turkey's ability to meet its debt service requirement, particularly following the securing of the letter of intent agreement and the return to international loan markets. According to figures obtained from the Treasury and the Central Bank, 80 % of the country's \$74bn foreign debt in 1995 was long-term debt. The debt service ratio was around 29.0-31.9 % with total external debt/GNP ratio standing at 35.1 %. Under these circumstances, the immediate debt crisis was not expected. However, these figures took a turn to the worse as the new Welfare-True Path government returned to the bond markets and private lending institutions (for short-term credits) rather aggressively and increased the debt burden once again.

[Table 9 here]

**Table 9: Outstanding External Debt of Turkey (Million US\$)**

	1991	1992	1993	1994	1995	1996 Q3 (*)
<b><u>BY MATURITY</u></b>						
Total Outstanding External Debt (DOD)	50,489	55,592	67,356	65,601	73,278	78,042
Medium - Long Term DOD	41,372	42,932	48,823	54,291	57,577	58,808
(Public Sector)	39,120	39,748	42,855	48,147	49,958	49,762
(Private Sector)	2,252	3,184	5,968	6,144	7,619	9,046
Short Term	9,117	12,660	18,533	11,310	15,701	19,234

<sup>91</sup> EIU, *Country Report*, p. 28.

**BY LENDER**

MEDIUM - LONG TERM	41,372	42,932	48,823	54,291	57,577	58,808
Multilateral Agencies	10,069	9,160	8,674	9,183	9,081	8,293
IMF	0	0	0	344	573	663
IBRD, IDA, IFC	6,540	5,761	5,440	5,380	5,191	4,695
European Investment Bank	602	463	250	264	86	70
European Resettlement Fund	2,859	2,889	2,952	3,065	3,114	2,739
Islamic Development Bank	54	40	15	117	108	118
OPEC Fund	5	3	2	0	0	0
Int. Fund for Agr. Development	9	13	15	13	9	8
Bilateral Lenders	14,587	15,035	18,153	20,678	21,558	22,564
OECD Countries	13,169	13,542	16,607	19,001	19,552	20,108
OPEC Countries	438	363	317	236	247	216
Other Countries	980	1,130	1,229	1,441	1,759	2,240
Commercial Banks	4,309	3,640	3,083	2,325	2,346	2,016
Bond Issues	6,683	9,316	12,623	13,788	14,186	15,118
Private Lenders	5,724	5,781	6,290	8,317	10,406	10,817
SHORT TERM	9,117	12,660	18,533	11,310	15,701	19,234
Commercial Bank Credits	4,144	6,490	9,526	2,901	4,263	4,599
Private Lender Credits	4,973	6,170	9,007	8,409	11,438	14,635

(\*) Provisional

Source: Turkish Treasury (1997)

**Political Outcomes**

The above analysis show that since 1980, Turkey has experienced important liberalization of its economy. There is no doubt that in today's economy Turkish citizens enjoy more freedoms than ever before. However, has economic freedom spilled over into political freedoms—specially since transition to civilian rule took place in 1983?

In order to answer this question, it is crucial to briefly review how economic and political policies interacted during the last two decades. During the 1970s, political instability and violence increased as economic conditions worsened in Turkey.<sup>92</sup> The result was the coup of September 12, 1980. Once in power, the coup coalition announced its adherence to the January austerity package and then severely restricted individual civil and

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<sup>92</sup>For detailed discussion see Henri J. Barkey, *The State and Industrialization Crisis in Turkey* (Boulder: Westview, 1990); C. H. Dodd, *The Crisis of Turkish Democracy* (North Humberstone: Eothen Press, 1983); Frank Tachau, *Authority, Democracy, and Development* (New York: Praeger, 1984).



political rights by replacing the 1961 Constitution with an authoritarian document. Moreover, it closed down all political parties. In an earlier study, Yesilada argued that the new Turkish political system resembled a heterogeneous form of interest representation which is a cross between state corporatist and pluralist forms of interest representation.<sup>93</sup> The 1982 Constitution placed state control over the activities of citizens, interest groups, and political parties much like the practices observed in other exclusionary state corporatist systems. Yet, despite these restrictions, politics have moved in the direction of pluralism, though it has been a gradual progress, since transition to civilian rule in November 1983. Today, all of the pre-1980 political parties are re-established, all restrictions on party officials have been lifted, and above all, in June 1993, Turkey became one of the few Western democracies to have a women head of government.

Can one attribute this transition from the coup imposed authoritarian state corporatism to a more pluralistic system to Turkey's integration with global financial markets? As explained earlier, there is no clear cut empirical evidence that such causality exists. In the Turkish case, we see a mixed record. Initially, foreign capital benefited from the authoritarian order of the 1980 coup. Since the application to join the European Union, however, there are signs of external economic pressures to reform the political system.

During the 1980s, the resurfacing of the pre-1980 political forces can be attributed to the following political factors: (1) continuity of political leadership in the Turkish political parties; (2) general opposition to the military imposed political parties; (3) some pressure from the European Union, than the European Community, and the United States to return to multiparty democracy; and (4) internal tensions and contradictions of the political order established by the generals.<sup>94</sup> Basically, it was primarily the domestic political pressures and not international capital that led to the unraveling of the authoritarian order. In fact, during the initial economic reform period, the national and international capital enjoyed the presence of an authoritarian regime since this neutralized organized labor's and opposition parties from preventing the implementation of the economic program.<sup>95</sup>

However, when we consider the recent experiences of Turkey with external capital the above observations are no longer applicable. This is particularly the case when we observe the interplay between Turkey's desire to be part of the European Union, the signing of the Customs Union (CU) agreement, and the reaction of the Istanbul Stock Exchange to this relationship. That is, the relationship involves Turkish response(s) to EU pressures for reform, EU's response to Turkish action(s), and the investors reaction to the policy outcome. In the next section, I will provide a brief overview of this relationship.

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<sup>93</sup>Birol Yesilada, "Problems of Political Development in the Third Turkish Republic, " *Polity*, Vol. 21, no. 2 (Winter, 1988), pp. 345-347.

<sup>94</sup>Ibid., and also see

### **A Crucial External Factor: The European Union**

Turkey applied for membership in the EU in 1987. Without going into the details of membership requirements and how Turkey fares vis-à-vis these criteria, it is sufficient for the purposes of this paper that the two sides agreed to create a customs union to further integrate their markets.<sup>96</sup> Yet, this was not to be an easy task. When the EU and Turkish officials met to discuss the CU, Greece vetoed the idea at the EU Council of Ministers meeting on December 19, 1994. The Greek government explained that it opposed the CU as long as Turkey did not improve its human rights record and ended its occupation of northern Cyprus. The supporters of the CU argued that Turkey was in the process of reforming its authoritarian constitution and that the Turkish military presence in northern Cyprus was result of complex problem which, in part, was caused by the Greek Junta in 1974. However, it quickly became clear that Greece was not about to drop its objection to the customs union until it obtained some concessions from the other EU countries. The deadlock ended as a result of intense negotiations between the EU and Greece, under the leadership of the then French foreign minister Alain Juppe. In exchange for lifting its veto, the Greek government received some economic and political concessions from the EU<sup>97</sup>

Yet, the agreement still required ratification by the European Parliament (EP) where Turkey opposition. The socialist bloc and the Greens opposed the CU because of Turkey's poor human rights record, especially in relations to the Kurdish problem, and the presence of authoritarian elements in the Turkish constitution.

The supporters of the CU, mostly the member countries with vested economic interests in Turkey, argued that since transition to a civilian rule in 1983, Turkey's political system has been gradually becoming more democratic in the Western pluralist fashion. The Kurdish problem, on the other hand, was more than a domestic concern for the Turks since the militant Kurdish Workers Party (PKK) operated out of Iraq and Syria. Nevertheless, the Turkish government of Tansu Çiller moved to reform the constitution of the country in order to secure the ratification of the CU.

In July 1995, the National Assembly passed amendments to 15 articles of the constitution easing the restrictions on individual civil and political rights. Among these, the important changes included:

1. The right of trade unions to engage in political activity (Arts. 33 & 52).

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<sup>95</sup>Yesilada and Fisunoglu, "Assessing the January," p. 207.

<sup>96</sup>For detailed discussion of EU-Turkey relations see Atila Eralp, "Turkey and the European Community: Prospects for a New Relationship," in Atila Eralp, Muharrem Tünay, and Birol Yesilada, eds., pp. 193-214 and John Redmond, (Aldershot: Dartmouth, 1993).

<sup>97</sup>Athens News Agency Bulletin, February 20, 1995, as cited in Wood and Yesilada, *The Emerging European Union*, p. 209.

2. The right of civil servants to join trade unions (Art. 53).
3. The lowering of the voting age to 18 (Arts. 67 & 68).
4. Permitting professional organizations to engage in politics (Art. 135), and
5. Permitting university staff and students to engage in politics (Arts. 67 & 68).

However, six other amendments were defeated which would have made it more difficult for the government to ban strikes, allowed strikes by civil servants, and withdrawn the present immunity from persecution of former members of the military government of 1980-83.<sup>98</sup> More alarming was that the government failed to amend Article 8 of the Law for the Suppression of Terrorism. This article makes even a verbal support of Kurdish nationalism a crime against the state. It was this law that the State used as basis for punishing the six ex-DEP (pro-Kurdish Democracy Party--closed down in 1994) members of the National Assembly. These parliamentarians received long prison sentences.

Against this background, the Turks and their European allies intensified their diplomatic efforts, aided by the U.S., to secure the ratification of the CU agreement. They argued that beside providing important economic benefits to European businesses, the CU held the promise of assisting Turkey with greater economic liberalization and structural reforms and eventually further democratization. Furthermore, they argued that the CU would give a leverage to the coalition government of Çiller as it faced growing Islamic fundamentalist opposition from the Welfare (*Refah*) Party of Necmettin Erbakan. This Islamic party opposed the CU and favored withdrawal of Turkey from NATO. With the national elections scheduled for December 24, 1995, the pro-CU forces intensified their efforts and succeeded in obtaining the ratification of the agreement by the EP on December 13, 1995. Unfortunately, the CU victory did not translate into an electoral victory for Mrs. Çiller. Her party, the True Path, received 19.2 % of the votes, while her other center-rightist opponent, the Motherland Party, obtained 19.7 % support, and *Refah* took 21.3 %.<sup>99</sup> With these results the Turkish political scene entered a period of uncertainty. Mrs. Çiller resigned as Prime Minister and negotiations began between the parties to formulate a new coalition government. After three months of intense bargaining between the parties the Motherland and True Path formed an uneasy coalition government that only lasted three months. Since then Çiller formed another coalition, this time with *Refah*, and agreed to Erbakan's serving as Prime Minister for the first two years of the coalition government.

The CU which entered into effect on January 1, 1996, gives the Turkey closer economic relations with the EU than any other nonmember countries except Iceland and Norway. It opens Turkey's huge market of 65 million consumers to EU products and encourages investments in Turkey by third parties (e.g., American and Japanese companies

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<sup>98</sup> Economist Intelligence Unit (1995). *Country report, Turkey. 3rd Quarter*, (London: EIU), pp. 10-11.

<sup>99</sup> *Financial Times* (December 27, 1995), p. 2.

which can manufacture goods in Turkey for sales in the EU). Moreover, the CU provides an access to Central Asian markets for the European companies because of Turkey's growing economic and political influence in this region. Turkey, in return, will receive large economic assistance from the EU and the Turkish companies would benefit from increased competition from their European counterparts. It was this immense economic potential and the desire of the secular Turkish elite to convince the citizens that Turkey is part of Europe that resulted in the constitutional reforms of 1995. It is highly doubtful that such reforms toward democratization would have occurred so quickly had the CU not been on the agenda.

### **CONCLUSIONS AND PROSPECTS**

Due to lack of more refined data (weekly observations of the WIG index in dollar terms) we were unable to carry out a meaningful empirical analysis of the two time series tables. Our future research plan includes tabulation of such comparable data for both the ISE and WIG and to carry out an integrated time series analysis (ARIMA) to assess the impact of key policies and external and internal shocks on these markets. It is important to note that the two indexes show a similar volatile fluctuations during their initial phases - 1986-92 for ISE and 1992-94 for WIG. However, the fluctuations seem to be tapering off during the later years. Having said this, we can nonetheless make some general observations about economic reforms in Poland and Turkey.

Market reforms and political reforms proceeded very fast in Poland in the 1990s. Liberalization of the economy began as a result of economic and political crises created by the communist governments of the 1980s. The communist governments continued to increase the country's foreign debt and followed inflationary policies. During the 1990s, the successive governments pushed ahead with comprehensive liberalization of the economy. As a result, the Polish economy was very rapidly transformed into a market oriented economy, abandoned its COMECON bonds and increasingly became linked to the West. The new linkage also provided a fresh supply of capital for the economy. The success of the WSE is an example of this new ties.

On the domestic side, one observes the importance of the progressive policies of the first Solidarity-led governments which enjoyed a period of unchallenged public support. However, these governments paid heavily in future elections for not giving in to public demands. Reforms were put into effect "too rapidly." In addition, President Walesa's unclear political leadership during the early 1990s led to the ousting of the Balcerowicz team without providing for an immediate alternative. Fortunately, leftist-oriented governments that followed did not change substantially the pro-market oriented economic policies. The independent role of the National Bank of Poland in providing the stabilizing force cannot be underestimated at the time when governments preferred inflationary policies.

Poland's economic standing and rating on the international arena was helped by a substantial reduction of its foreign debt in 1994. Subsequently, the influence of the IMF and the World Bank declined. Currently, Polish laws and policies are more often than not geared toward the EU standards in anticipation of the country's future membership in the Union. It is widely expected that after the 1997 parliamentary election the government will be formed by some form of Solidarity-PSL coalition. Although the pro-market policies are expected to continue, both parties are likely to be more cautious on two important issues of public concern: privatization and the penetration of the national economy by foreign capital.

While one can argue that economic reform seem to have taken place during the period of political transformation in Poland, it is not clear to what extent one development led to the other. That is, we observe both political and economic pressures coming from inside-out and outside-in simultaneously. External pressures include the role of the IMF with economic transformation and the EU with both economic and political transformation. Internal pressures include the market opportunities created by the reforms, particularly in the financial services, and democratic awakening of the masses.

The Turkish case is also important for our purposes. Market reforms and political reforms have proceeded at different paces in contemporary Turkey. Liberalization of the economy began as a result of crisis created by the bottleneck problems of the import substitution growth model. During the 1980s, the successive governments pushed ahead with liberalization of the foreign trade, investment, and foreign exchange regimes. As a result, the Turkish economy was successfully transformed into a market oriented economy with important links to international capital. The ISE grew rapidly and soon became one of the star markets of emerging markets. During the 1990s, these developments continued and Turkey became a major site for international economic activity. Several internal and external factors, which can be referred to as the inside-out and outside-in pressures, account for these developments.

On the domestic front one sees the importance of the governments which carried out these reform measures. In addition, Turgut Özal, who had his own technocratic team, had a vision for Turkey's economic future. Without the presence of Özal it would have taken much longer for the traditional political elite to undertake the necessary reform measures. Finally, international institutions (e.g., the IMF and the World Bank, the EU, and private banks and investors) pushed for the liberalization of the economy. It was the combination of these factors that explain Turkish economic miracle. The post-Özal governments failed to implement a comprehensive reform program or they failed to complete Özal's unfinished program.

Yet, can we conclude that recent political reforms in Turkey and the previous return to pluralism in the late 1980s are attributable to economic liberalization. Is there a link between the two? The analysis of political developments in Turkey suggests that there is no

clear causal link between the two. During the late 1980s, domestic political pressures resulted in transition to pluralism. However, strict restrictions on individual civil and political rights remained in place just when foreign capital began pouring into the Turkish economy. Within the last few years, different coalition governments promised to reform the Constitution but did not act on it. It was not until an external factor, in this case the European Parliament, threatened to block the passage of a very important economic agreement that the Turks moved to amend the constitution. Ironically, even with these reforms much is needed to bring Turkish democracy to the same level as Western democracies.