

THE ROLE OF THE IMF IN THE TURKISH FINANCIAL CRISIS OF 2000-2001:

A COMPARISON WITH THE MEXICAN CRISIS OF 1994

AND THE THAI CRISIS OF 1997

by

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ABSTRACT

The Role of the IMF in the Turkish Financial Crisis of 2000-2001:
A Comparison with the Mexican Crisis of 1994 and the Thai Crisis of 1997

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The purpose of this study is to present the argument that the financial crises, since the 1990s in the emerging market countries, are an outcome of their commitment to integration with the global financial markets through financial liberalization which lacks an effective and sufficient regulatory and supervisory system. Within the scope of this study, the Mexican crisis of 1994, the Thailand crisis of 1997, and Turkish crisis of 2000-2001 are shown as examples of the IMF's failure in dealing with crisis management and crisis prevention.

Based on the idea that understanding the underlying causes of each crisis may serve to prevent similar crises in the future, the first part of the study provides a literature view on the first-generation models, the second generation models and the third generation models which conceptualize different points of views regarding the causes at the root of crises.

The second part of the study provides different perspectives on the role of the IMF in crisis management and in providing stability, aiming to provide the argument that the IMF's approach to the crises in emerging markets is always the same in the context of the liberalization argument and the Fund's bureaucratic structure.

The reminder of the study is on the Mexico crisis of 1994, the Thailand Crisis of 1997, and the Turkish Crisis of 2000-2001. The aim of the county analysis is to provide a perspective on to what extent the previous crisis are relevant in understanding the role of the IMF in the Turkish Financial Crisis of 2000-2001. They are analyzed in detail in the context of pre-crisis conditions leading up to the crises and the role of the IMF in dealing with them.

This analysis reveals that the crises were neither solely the consequences of contradictory macroeconomic and fiscal polices by national governments, nor deterioration in macroeconomic fundamentals; the capital account liberalization which had been accompanied with a rapid deregulation process and undermined by the IMF, were at the root of the crises. In this respect, it is argued that the IMF has an important role in triggering Turkish financial crisis of 2000-2001 by underestimating both domestic political and economic difficulties culminated through premature financial liberalization and neglecting the experiences in Mexico and Thailand.

The study concludes that the IMF plays a triggering role in the recurrence of emerging market crises since it applies the same prescriptions, because of its strong commitment to the basic principles of the Washington Consensus.

Keywords:

Financial Crisis, Mexican Crisis, Thai Crisis, Turkish Financial Crisis, the IMF,

ÖZET

2000-2001 Türkiye Finansal Krizinde IMF'nin Rolü :
1994 Meksika Krizi ve 1997 Tayland Krizi ile Bir Karşılaştırma

Hazırlayan

Fazilet ÇAVDAR

Bu çalışmanın amacı 1990'lı yıllardan beri gelişmekte olan ülkelerde ortaya çıkan finansal krizlerin, efektif ve etkin bir denetim ve gözetim sistem kurmadan dünya finansal piyasalarına entegre olmaya yönelik benimsedikleri finansal serbestleşme sürecinin sonucu olduğunu tartışmaktır. Çalışma kapsamında yer alan 1994 Meksika krizi, 1997 Tayland krizi ve 2000-2001 Türkiye krizleri, IMF'nin kriz yönetiminde ve kriz önlemedeki başarısızlığının örnekleri olarak gösterilmiştir.

Her üç krizde de etkili olan faktörlerin anlaşılmasının benzeri krizleri önlemede önemli olduğu düşünülebilir. Çalışmanın birinci bölümünde, krizlerin temelinde yer alan sebepleri ortaya koymaya çalışan birinci nesil, ikinci nesil ve üçüncü nesil modeller üzerine literatür incelemesi yapılmıştır.

Çalışmanın ikinci bölümü; IMF'nin kriz yönetimi ve istikrar sağlamadaki rolü üzerine farklı görüşleri, IMF'nin gelişmekte olan ülkelerdeki krizlere yaklaşımının aynı olduğunu argümanını finansal serbestleşme tartışması ve IMF'nin bürokratik mekanizması çerçevesinde sunmaktadır.

Çalışmanın takip eden bölümleri, 1994 Meksika krizi, 1997 Tayland krizi ve 2000-2001 Türkiye krizleri üzerinedir. Bu bölümün amacı, önceki krizlerin, IMF'nin

Türkiye krizinin tetiklemedeki rolünü anlamak açısından ne kadar anlamlı oldu u ortaya koymaktır. Krizler, kriz öncesi ko ullar ve IMF'nin bunlara yakla ımı çerçevesinde incelenmi tir.

Bu analiz, krizlerin ne tek ba ına birbiriyle çeli en makroekonomik ve mali politikaların, ne de ekonomik göstergelerdeki kötüye gidi in sonucu olmadı ını, IMF tarafından göz ardı edilen hızlı bir deregülasyon süreciyle birlikte sermaye hareketlerinin serbestle tirilmesinin sonucu oldu unu ortaya koymaktadır. IMF, bu anlamda, gerek Türkiye'nin erken liberalizasyon sürecine ba lı olarak birikmi içsel ekonomik ve politik problemleri, gerekse Meksika ve Tayland deneyimlerini göz ardı etti i için 2000-2001 Türkiye krizini tetiklemi tir.

Çalı ma, IMF'nin, Washington Konsensüsüne olan güçlü ba lılı ı nedeniyle, aynı reçeteleri önerdi i için yükselmekte olan ülkelerdeki krizlerin tekrarlanmasında tetikleyici bir rol oynadı ı sonucuna varmaktadır.

Anahtar Sözcükler:

Finansal Kriz, Meksika Krizi, Tayland Krizi, Türkiye Finansal Krizi, IMF.

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CHAPTER 1

INTRODUCTION

As the numbers of financial crises have increased and their effects have become deeper especially since the 1990s, the role of the International Monetary Fund (IMF) which was founded by an international treaty in 1945 to help promote the health of the world economy has been questioned more frequently and in detail. The term financial crisis in the scope of this study refers to a banking crisis, a currency crisis, or their combination. According to Eichengreen and Bordo, the number of financial crises in industrial countries increased from 21 during the 1945-71 period to 44 during the 1971-1997 period while these numbers are 17 and 95 for emerging market countries for the same periods respectively. The possibility of experiencing a financial crisis during 1945-1971 was 7 percent while it was 10-12 percent between 1971-1997 (Eichengreen and Bordo, 2002:40-41). Since the current international system is more prone to crisis and the current international financial crises are more widespread than the previous crises, the effectiveness of the IMF in terms of both the appropriateness of its adjustment programs and its role in crises prevention and management has become more important.

On the one hand, the changing character of the crises, on the other hand, the fact that recent crises since the 1990s were perverse mostly to developing countries rather than to industrial countries led many researchers to reevaluate the causes at the root of financial crises and the role of the IMF in responding to them.

Challenging the mission of the IMF has been parallel to challenging the “Washington Consensus”¹ because the IMF is an institution charged with the implementation of the main principles of the Washington Consensus, i.e. a smaller role for the state, privatization, deregulation, liberalization of trade and capital account, and so on, which have been considered as inevitable for economic growth and development. However, the adaptation of these principles by developing countries did not bear the expected results but mostly resulted in severe financial crises such as Mexico (1994), East Asia (1997), Brazil (1998), the Russian Federation (1998), Turkey (2000), and Argentina (2002).

The World Bank’s recent report, “Learning from a Decade of Reform (2005)”, is really an important work in terms of its emphasis on the fact that the unexpectedness of crises is associated with the misperception and uniqueness of the Washington principles. The vice president of the World Bank, Gobindi Nnakani points at the foreword of the report that “ ...there is no unique universal set of ruleswe need to get away from formulae and the search for elusive best practices.” The report also points to the necessity for relying on country specificities and the inappropriateness of rigid formulas for sustainable economic growth. Removing restrictions on current accounts, which has become part of the International Monetary Fund’s (IMF) advice to developing countries, and the openness of capital accounts were described as the key sources of vulnerability combined with unsound policies in the financial sector such as maturity and currency mismatches which were common to almost all crisis-hit countries in emerging markets. In this sense, China and India are given as examples of successful liberalization stories, setting opening capital account as a medium term target in the process of economic growth.

Financial liberalization as a component of the Washington Consensus has been pushed by the IMF which has been heavily dominated by the U.S. The explanation of

Lawrence Summers, deputy secretary of the U.S. Treasury, on why the U.S needs the IMF and its inevitability for the U.S supports the idea that the IMF serves the interests of the U.S. Treasury and the Wall Street:

A well-funded IMF is critical to promoting American workers' interest in strong export markets, American savers' interest in stable financial markets, and all Americans' interest in the spread of market-based democracy, which is central to our national security. IMF and sister World Bank programs, not just in East Asia but in India, Latin America, Central Europe, and Africa, have led to more systematic trade liberalization than our bilateral or multilateral negotiations have ever achieved (Summers,1998).

The necessity of liberalization and the removal of trade barriers as prerequisites for IMF financial support have been determined as vital for the U.S's interests. With 17 percent of the capital, the US has a dominating say in the IMF's overall policies and direction. Therefore, it would not be wrong to regard the IMF as an institution that applies the principles of the Washington Consensus which are the interest of its major donors.

Peter Gowan claims that the IMF is an innovation of the U.S to create an unregulated international financial system by pulling all the barriers down which enables the Wall Street to extend its influence over the international financial system without putting its interest at risk and supporting it by bailing them out by the population of the borrowing countries without significant costs to the U.S economy.² Presenting liberalization as if it is an inevitable process that every country has to follow to become a member of the global financial market regardless of country specific features and pushing developing countries to raise their interest rates in the name of restoring confidence in markets when they fail to fulfill their "task" have been witnessed as the unchanged sequence of the recent financial crises in emerging markets.

The recurrence of financial crises in emerging market countries, even several times in the same country has challenged the role of the IMF. Although, the domestic

economic and political conditions prior to the crises are crucial in assessing the causes of the crises, what the recent crises confirm is that there is a trade-off between rapidly liberalized financial systems attracting large portions of portfolio investment and the cost of financial vulnerability. The failure of the IMF arises from its inability to recognize this trade-off in developing countries and its negligence of the fact that if financial liberalization is accompanied with insufficient supervision and regulation, the result will be excessive risk taking by financial intermediaries and eventually crises.

The discussion about crises in emerging markets, beginning with the crisis of Mexico in 1994, concentrates on two issues: (1) Whether these crises can be explained only by economic fundamentals, or they are characterized by pure creditor panic which is similar to a bank run which is in fact an impact of premature liberalization movements pushed on developing countries by industrialized international community led by G-7 and the IMF. (2) Whether the support packages contributed by international financial institutions, particularly the IMF, are effective in responding to the crises or whether they make things worse through their tight monetary and fiscal policies pushing emerging market countries to liberalize capital account restrictions.

Although the financial assistance packages of the IMF can allow crises-hit countries to meet the challenge of paying-off maturing short-term dollar-denominated liabilities and contribute to the countries' access to international capital markets, as experienced since the 1994 Mexican crisis, there must be something more effective to revert the recurrence of crises which the IMF consciously or unconsciously underemphasizes, namely avoiding rapid capital account liberalization.

The purpose of this study is to evaluate the role of the IMF in financial crises as both a crisis prevention institution and a crisis manager in the context of the premature financial liberalization imposed on developing countries. In that respect, it

will be argued that Turkish financial crisis 2000-2001 was linked to the IMF-directed disinflation program and will be compared with the Mexican Crisis of 1994 and the Thai Crisis of 1997.

Although I admit the effects of domestic political and economic policies of national governments for each case, this study focuses on the role of the IMF in terms of its effectiveness in dealing with the crises as well as its contribution to their occurrence time after time.

While evaluating the IMF-led stabilization program of Turkey which was put into effect at the beginning of 2000 and abolished at the end of the same year, my claim is that it was not hard to predict that there would be a crisis in Turkey as a result of the stabilization program adopted in December 1999 just looking at the experiences of Mexico and Thailand in 1994 and 1997 which had followed similar liberalization paths as suggested to them by international financial institutions.

The key question is why the IMF designed a fixed exchange rate-based inflation reduction program for Turkey, despite the failure of such a policy as experienced in Mexico and Thailand. The issue is not whether the IMF was faulty or not. The question is why the IMF keeps making the same mistakes and what the reason behind its traditional formula “ONE SIZE FITS ALL” is. In this respect, these three countries are good examples of the IMF’s systematic failure in responding to financial crises in the developing world. As long as crisis management concentrates on providing sufficient liquidity to enable immediately outstanding debts to be rolled-over and on reassuring international creditors that all debts will be repaid in full, stabilization efforts cannot give the expected results such as sustainable economic growth.

This paper will focus on three cases: The Mexican Crisis (1994-95), the Thai Crisis (1997-98) and the Turkish Crisis (2000-2001), which represent somewhat

different country typologies. For each case, the study will investigate (1) the content and effectiveness of IMF surveillance during the period leading up to the crisis and (2) the design and effectiveness of the IMF-supported program in the resolution of the crisis. I base my argument regarding the success of the Mexican stabilization program and the Thai economic reforms on the IMF's own assessments about those countries rather than on analyzing whether they implemented their economic reforms or not. . Regarding the Turkish disinflation program, I evaluate the main pillars of the program in detail arguing the failure of the IMF in diagnosing the structural weaknesses of the Turkish financial and political system prior to the stabilization program.

These three cases have remarkable similarities as well as differences. However, the most common feature of these countries is the premature financial liberalization process imposed on them that eventually resulted in severe crises.

I will on the one hand discuss the dangers of premature capital account liberalization in an environment where volatile short-term capital flows create a major threat to the sustainable growth prospects of countries whose financial systems are weakly regulated, identifying key similarities and differences among three cases; on the efforts of the IMF to help global money managers to increase their gains from speculative invests which has a destabilizing effect on the national economies of developing countries. The organizational structure of the Fund has been created to implicitly serve this mandate.

Through this thesis, I will try to investigate the reason(s) behind the IMF's failure in preventing and managing crises in the context of the Mexican, Thai and Turkish financial crises and to give an understanding of to what extent the previous two crises are relevant in evaluating the role of the IMF supported stabilization program in the Turkish financial crisis of 2000-2001.

The Turkish financial crisis is a striking case for evaluating the role of the IMF because the IMF was already in Turkey when the crisis erupted; most importantly since the crisis was preceded by the disinflation program, it has been thought that the stabilization program contributed to the occurrence of the crisis given the fragilities in the financial and political system. e economic and political problems. My claim is that it would not have been difficult to predict that a financial crisis would occur in Turkey if the IMF directed fixed exchange rate based stabilization program was analyzed in detail. However, I do not claim that everything before the stabilization was good and there would not be any crises if that program was not accepted. Sooner or later Turkey would face a crisis. I acknowledge that it was not possible to reduce the probability of a crisis to zero but what I would like to emphasize is that the problems with the design of the program exacerbated the severity of a possible crisis, triggering the underlying causes which rendered Turkey vulnerable to crises. It caused the abolition of the program before inflation was brought under control. In this respect, the Turkish case can be considered as a good example of the idea that the IMF is a part of the problem rather than a part of the solution in emerging market financial crises.

I have chosen the Mexico Peso crisis of 1994 due to three reasons. Firstly, the Mexican crisis in 1994 has been regarded as the first crisis of the twentieth-first century which signaled recurrence of similar types of crises if they could not be understood and managed well. Since the IMF had not been familiar with the Mexican type crisis in 1994, it could be tolerated up to a point for its failure in predicting the crisis and handling it as a traditional balance of payment crisis. Therefore, the relevance of the Mexican case for this study is whether the IMF learned something from that crisis for dealing with the same type of crises or whether it ignored whatever it had experienced and assessed each crisis by its own dynamics.

Secondly, Mexico, like Turkey, had struggled with high and persistent inflation for years and initiated to implement an exchange rate based stabilization program in 1989 under the guidance of the IMF a prior to the crisis of 1994.

Thirdly, it is a good example to demonstrate the influence of the U.S on the IMF's crisis management policies. For example, the Clinton administration, on the one hand, urged the Congress to provide Mexico with high loan guarantees pointing to that the crisis could expand to a severe economic downturn in Mexico that would put the U.S interest at risk including trade, employment, and immigration; on the other hand the IMF was encouraged by the United States in order to organize a financial assistance package, which was the largest one the IMF had ever extended to a country at that time, in order to prevent the crisis from undermining market-oriented reforms that the U.S and the IMF have forced the emerging market countries to adopt.

The Thai crisis has been regarded as a turning point in evaluating the mission of the IMF by both those in and outside of the Fund³. In other words, it was expected that the IMF would be more careful in dealing with the Asian crisis of 1997-1998 after having experienced a similar one in Mexico. The Thai crisis -generally Asian crisis- has been regarded as a very important in financial crisis literature because yesterday's growth miracle countries suddenly found themselves in the middle of a severe crisis whose effects could not be removed easily. It is a good example to understand the fact that if reasons at the root of any crisis cannot be well-diagnosed, the policies to deal with the crisis will not be sufficient and efficient to bring the crisis afflicted country back to equilibrium as expected. Thailand's crisis of 1997 differs from both the Mexican and the Turkish crises because it run into crisis despite its strong fundamentals prior to the crisis.

The comparison of these two crises with the crisis of Turkey in 2000-2001 shows us that notwithstanding differences in terms of conditions and time, the

common feature in all these cases is capital account liberalization processes which was imposed on them without setting regulatory framework by international financial institutions, mostly by the IMF, as an inevitable component of economic growth. In this sense, the IMF had much more responsibility in the occurrence of these crises which also supports the assumption that the IMF is an institution merely under the mandate of developed countries and serves the interest of foreign investors. The increasing number of crises since the 1980s in emerging market countries is a reflection of this concern.

Prior to the crisis, in all three countries fixed or semi-fixed exchange rate regimes were chosen as an instrumental element of the stabilization effort and all experienced sizable inflows of capital, current account deficits, and a real exchange rate appreciation. When conditions changed for one reason or another, a massive reversal of capital flows placed intense downward pressure on the exchange rate, precipitating a rapid decline in foreign exchange reserves. All countries eventually applied to the IMF for financial aid. IMF-supported programs were agreed with Mexico in February 1995 for the amount of about \$17,8 billion, with Thailand in December 1997 for the amount of about \$17,2 billion, and a 7,5-billion and a-19 billion standby agreements with Turkey in December and in May 2001⁴.

The sequence of the crises is similar in the three cases: The crises were preceded by financial liberalization and a deregulation process which was supported especially by the G-7 countries and the IMF on behalf of promoting economic growth. A central feature of liberalization is that when all controls are removed, it is very difficult to prevent the inflow of funds which come in the form of loans to the banking system or to private companies directly, or as portfolio investment through purchase of shares in the stock markets. Having opened up their financial doors to the outside world, these three countries were first buffeted by large inflows of foreign funds and

then by large outflows when everything changed overnight. Furthermore, these were not the first crises they had. Mexico in 1982, Thailand in 1983, and Turkey in 1994 had experienced economic crises which had long-lasting effects.

In all three countries, the IMF-supported programs consisted of two principal components: conventional concretionary macroeconomic policies (consisting of tighter monetary and fiscal policies, at least initially) designed to reduce exchange rate pressure, and structural reform measures to bolster the credibility of macroeconomic stabilization and address the structural weaknesses contributing to the crisis. Both the Mexican crisis in 1994 and the Thai Crisis in 1997 were considered as unexpected because there were no serious concerns regarding the fundamentals of each country prior to the crises. The suddenness of the crises has been attributed mostly to the shifts in the expectation of investors. However, putting the surge in investors' expectation at the core of the crises is nothing but to mask the essential factor(s) leading up to the crises and to offer the same crises management policies.

It has been argued that if the fundamentals of countries are strong enough, the surge in expectation should not have a detrimental effect. It is fair that the domestic factors which include an imperfect understanding of the liberalization process, accompanied with a lack of adequate safeguards, the assumption that the local currency will remain stable, an over-reliance on foreign loans and funds without due consideration of their volatility, channeling of too much fund into real estate and share purchases; and inefficient or wrong use of financial and corporate resources were crucial in the process leading up to the crises in Mexico, Thailand, and Turkey. However, it is important to realize that they were impacts of a broader set of policy which had its origins in the basic principles of neo-liberal thought, i.e. financial and capital account liberalization accompanied with a rapid deregulation process as a requirement of being members of global financial markets.

Imposing liberalization and attempting to amend its Article of Agreement by setting liberalization as one of its purposes is a very well-known story of the IMF since the 1970s. As Peter Gowan clearly points, removing barriers to the free flow of funds both ways between Wall Street and private operators within the target state, giving full rights to Wall Street operators to do business within the financial systems and economies of the target states, and redesigning the financial systems of target states to fit in with the business strategies of Wall Street operators and of their American clients form the policies of the IMF for developing countries. Therefore, it is not surprising that the bureaucratic structure and decision making process of the IMF has been designed in accordance with this context which makes the IMF programs look like each other.

The evaluation of the financial crises in Mexico, Thailand and Turkey will be within this general framework. The outline of country evaluations includes pre-crisis build-up of vulnerabilities, the response of the IMF to crises, and the outcome of the IMF's crisis management and prevention policies.

The rest of the study is organized as follows: The next two chapters present the literature review on the causes of financial crises and the debates on the role of the IMF in financial crisis in the context of financial liberalization and of the bureaucratic structure of the IMF.

In the light of this review, the chapters 4 and 5 evaluate the Mexico peso crisis of 1994-95 and the Thai crisis of 1997-98. I have chosen these two cases in order to show that even though the macroeconomic and political structures of these developing countries were not very similar to each other; the crisis they experienced had a common feature, i.e., premature financial liberalization which had been imposed on them to accelerate economic growth.

Chapter 6 is on the Turkish Financial crisis of 2000-01. The purpose of this chapter is to see whether the crisis in Turkey in 2000 and 2001 which resulted in the demise of the IMF directed program was due to the errors in the implementation of the program as the IMF claims almost after every program failure or whether it was the result of internal inconsistencies and mistakes in the design of the IMF-directed program itself. Similarities and differences among the cases of Mexico, Thailand, and Turkey will provide a significant perspective on the role of the IMF in financial crises. The last chapter is the conclusion.

CHAPTER 2

THE DEBATES ON THE CAUSES OF FINANCIAL CRISES

The reasons behind financial crises differ both from country to country and through time. However, the crises since the 1990s especially in developing countries have lead economists to rethink the causes of crises in detail. Are financial crises the result of the faulty economic policies of national governments? Do external factors play a more crucial role in crises? Is it possible to anticipate future crises and to prevent them by setting early warning systems? Mainly three lines of arguments have emerged in dealing with these questions which will be explained briefly as follows.

The First -Generation Models

The earlier models, initially improved by Paul Krugman, concentrate on the balance of payment crises, emphasizing the importance of inconsistent macroeconomic policies. According to this view, called the first-generation model, currency crises are the result of a fundamental inconsistency between domestic policy and the attempt to maintain a fixed exchange rate⁵. For example, government policy aiming to finance large budget deficits through monetizing is inconsistent in the longer term with the fix exchange rate policy because excessive money growth leads to reduced international reserves and eventually triggers an attack by speculators who believe in the unsustainability of that policy⁶. This inconsistency which makes

economy vulnerable to speculative attacks and currency crises has been regarded as sufficient to understand the causes of the balance of payment crises.

The Second Generation Models (Self-fulfilling Models)

The inadequacy of the first-generation model in explaining the forces at work in the crises in Europe in 1992 and in Mexico in 1994 led economists to rethink the causes of financial crises and to devise a new model called the second-generation model. The expectations of investors are at the core of this model which was first represented by Maurice Obstfeld (Obstfeld, 1996: 1037-1047). In his study, “a currency attack has a self-fulfilling element because the exchange rate collapses if attacked, but survives otherwise”. In this sense, if investors believe in government commitment to defend a fixed exchange rate system there will not be a speculative attack, but if there is a lack of confidence in the maintenance of the fixed exchange rate, a speculative attack is possible. He argues that the 1992 the European Monetary crisis (ERM) could not be understood in terms of Krugman’s earlier model which sees crises as a result of the exhaustion of foreign exchange reserves, because a number of other factors such as interest rates or the unemployment rate determine a government’s decision to defend or abandon the fixed exchange rate system⁷. In this sense, when speculative attack occurred against the French franc, the Belgian franc and Danish crone in 1992, none of the three exchange rates were unsustainable as the first generation model postulated.⁸

The study of Andres Velasco and Ricardo Hausmann also points to the effect of financial panic which had a crucial role in ERM crises, emphasizing the fact that there were no radical differences between pre-crisis policies and post-crisis policies so

that it was unrelated to economic fundamentals as opposed to Krugman's seminal paper in 1979 (Velasco and Hausmann, 2004: 5). The ERM crises, the Mexico peso crisis and the Asian crisis were all the result of self-fulfilling pessimism. Velasco, on the other hand, in his earlier study, claims that not all economies are vulnerable to self-fulfilling crises and vulnerability does not require economic fundamentals bad enough, although he does not mention the exact way to define a vulnerability threshold (Tornell and Velasco, 1996). Krugman, as opposed to his earlier emphasis on the incompatibility of monetary and fiscal policies, acknowledges that the crises in the 1990s are best described by second-generation models emphasizing the importance of herding by investors in triggering the crises (Krugman, 1997).

In both first- and second-generation models, the crises are ultimately the result of flawed government policies, with the speculators merely determining the government choice. However, the sequence of the speculative attack differs in the two models. In the former model, the international reserves are depleted as a result of unsustainable monetary and fiscal policies before a speculative attack occurs, whilst in the second generation models the speculative attack comes first, then the international reserve depletion as a result of the attack on currency.

The Third Generation Models: A Mixed Model

These models in some way reflect an emergence of consensus between the first and the second generation models. The recent episodes in emerging countries make this consensus necessary-although there are still some differences of opinion- because neither financial panic nor weak economic fundamentals on their own can be accountable for the crises.

Robert Flood and Nancy Marion's "modified first-generation model" points that a sudden shift in speculative opinion to trigger an attack is bounded by the position of fundamentals. In their new model, a self-fulfilling shift in expectations can cause a crisis if the state of the economy is in a possible attack zone. Therefore, they argue that fundamentals must change enough to put the economy into the fragile zone, but the collapse is initiated by a change in the risk expectation of agents and does not require a change in government stabilization policies. They clarify the situation as following:

If the private investors suddenly come to believe there is an increased risk, that alone can lead to a self-fulfilling speculative attack if the fundamentals have deteriorated to the point of putting the economy in a fragile state (Flood and Nancy, 1996: 22).

The complexity of recent crises may be because of the difficulty of determining which economic fundamentals are accountable for the crises, or if they are result of financial panic, what factors are behind the financial panic in the era of international capital mobility. This confusion can be explained partly by the dual character of the recent crises. In other words, both the typical balance of payment problems caused by overspending of the public and private sector and the appreciation of the real exchange rate caused mainly by capital inflows makes it difficult to differentiate the real causes from the signals of crises.

Graciela Kaminsky, in her study on currency and banking crises, describes a list of variables to construct an early warning system that enables policy makers to take the necessary steps identifying the weaknesses and imbalances before crises (Kaminsky, 1998). In her analysis, crises are not new phenomena and could be prevented. In another study of Graciela Kaminsky and Carmen M.Reinhart, the twin character of the crises" has been emphasized, surveying 102 crises (76 currency crises and 26 banking crises) in 20 countries for the period of 1975-1995 (Kaminsky and Reinhart, 1999: 473-500).⁹ The study reveals that 18 crises of the 50 balance of

payment crises for the period of 1980-1995 are defined twin crises. One of the important common points between the Mexican 1994 peso crisis and the Asian crisis in 1997 is determined as the vulnerability of the financial sector that is a result of the premature financial liberalization movement. Their study shows that crises are typically preceded by a multitude of weak and deteriorating economic fundamentals. While speculative attacks can occur as market sentiment shifts and herding behavior takes over, the incidence of crises where the economic fundamentals are sound are rare. Since the banking sector has a crucial role, especially in emerging markets, for both developing the financial sector by collecting information about business and industries and that of real sector financing investments, any bank panic can cause a sharp decline in financing investments and deterioration in the balance sheets of banks due to unpaid loans which aggravate the contraction in economic activity in a vulnerable financial environment. The increasing interaction between banking crises and currency crises is another indication of premature financial liberalization and a rapid deregulation process that increase the distress of the economy. Therefore, it would be difficult to characterize the crises as merely self-fulfilling factors.

Guillermo Ortiz also points to the dual character of the recent crises, putting more emphasis on the role of financial panic and arguing for the complexity of recent crises. He characterizes the recent crises as “capital account crises” in which the magnitude, maturity, and currency composition of debt- public or private- has a crucial role in cases when that financial panic erupts (Ortiz, 2002). Therefore, the fiscal stance of government, private sector indebtedness and the stance of financial sector should be carefully watched in order to understand the sentiment of investors.

Frederic Mishkin mentions that the crises in emerging market countries is mostly the result of “mismanagement of financial liberalization”, which refers to lifting restrictions, providing government safety net and opening up to foreign capital

with inadequate prudential regulation and supervision (Mishkin, 2005: 16-19). While supporting the idea that globalization is good for a country's economic growth, he emphasizes the political aspect of the crises, namely moral hazard, or in his terms, political agent problem. The policies of governments in the name of globalization to protect the interests of such domestic groups as tax-payers as a source of votes and foreign investors as a source to finance budget deficits prevent them from taking the necessary steps to regulate and supervise the system effectively. In this regard, governments pervert financial globalization.

Stephan Haggard, analyzing the political economy of the Asian Crisis, points to the effect of such domestic factors as business-government relations on the policy environment in the period before the crisis (Haggard, 2000: 45). In his view, business-government relationships through the concentration of the private sector, government involvement in banking and industrial policy and weakly regulated liberalization movements increase the vulnerability to external shocks in the era of free capital movements. Especially moral hazard and political uncertainty generated by government involvement in financial sector together with premature financial liberalization can create the inclination for financial crises or compound their cost once they strike.

In the 1990s, as clearly determined in the recent report of the World Bank (2005), since bank supervision and regulation lagged behind liberalization, the fragility of financial systems and the vulnerability to crises increased. Many empirical studies conclude that financial liberalization is a significant factor in financial crisis since it allows free movement of capital and excessive risk taking in the absence of an effective regulatory system. Encouragement of liberalization especially by the IMF for developing countries is based on the idea that liberalization is good for economic growth. Even after the Mexican crisis, the IMF suggested to amend its Article of

Agreement, adding capital account liberalization explicitly into its purposes. But the crisis in the 1990s demonstrated that capital account liberalization can cause instability rather than economic growth. Therefore, there is something wrong with pushing liberalization as a way of economic growth. In its later reports, the IMF admits its failure and offers a rectified liberalization notion as “orderly liberalization”.

The recurrences of crises have revealed that the crises seem sudden events which no one can anticipate until they erupt. However once they occur, they are regarded as a known movie, as argued in the literature. The prevention and management of the crises requires the diagnosis of the vulnerabilities of each country based on past experiences, and the creation of learning of mechanisms. At this point, the international institutions such as the IMF and the World Bank have a crucial role, but recent crises have lead many researchers to rethink the effectiveness of these institutions, especially the IMF.

The inability of the IMF to prevent recurring of the crises in emerging markets as well as to manage them led many economists to rethink the role of the IMF as a “stabilization provider of the global economy”.

CHAPTER 3

THE DEBATES ON THE ROLE OF THE IMF

What was very important when the IMF was established in 1945 was to promote economic integration among its members and to allow a coordinated response to economic problems. Its foundation was a result of the most disastrous economic crisis in history, namely the Great Depression.

The Articles of Agreement of the IMF states its purpose as to seek to increase international monetary cooperation, facilitate the expansion of international trade, promote exchange-rate stability, and avoid competitive depreciation. The agreement established a multilateral system for international payments for goods and services that assisted member states to correct balance-of-payments problems, while avoiding measures destructive of national and international prosperity¹⁰. The Fund sets its purpose at the very beginning of its official web page:

The IMF is an organization of 184 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty.¹¹

IMF justifies its existence relying on this general purpose which eventually aims to provide or restore confidence to the markets. However, as the recent crises episodes since the 1990s have shown what the IMF does within this general framework is far from providing financial stability for developing countries.

Global stability through promotion of liberalization, privatization, reduction of public spending, the freeing of interest rates and exchange rates, and the lifting of exchange controls have been regarded as the main pillars of the IMF adjustment and

stabilization programs. Lending, monitoring and technical assistance have been determined as tools to serve the stated purposes.

The IMF has expanded its role, redefining its mission according to the changing circumstances, focusing on development finance and policy and poverty alleviation in poor countries, and on the management and resolution of capital account crises in emerging markets. Although its original mission has been considered to end with the collapse of the Bretton Woods system in 1970 and the Fund has no longer been performing the functions it was originally designed for; namely, securing multilateral discipline in exchange rate policies and providing liquidity for current account financing, the Fund increased its lending procedures such as Extended Fund Facility (EFF) in 1974, Structural Adjustment Facility (SAF) in 1986, Enhanced Structural Adjustment Facility (ESAF) in 1987, The Supplemental Reserve Facility (SRF) in 1997, Poverty Reduction and Growth Facility (PRGF) and the Contingency Credit Line (CCL) in 1999. In short, the IMF has recognized the changes and expanded its role by introducing some reforms on the way it operates.

The IMF's effort to find a *raison d'être* for its existence and to overcome a more effective institution by increasing its lending and surveillance activities to cope with the economic problems of the 20th century could not prevent it from being exposed to severe criticism in many respects. As mentioned in the work of Ziya Oni and Fikret Onen, the IMF has always been subject to criticism from intellectuals and policy-makers in the Third World and partly from radical intellectuals in the north; but with the Asian crisis, the IMF has begun to be criticized seriously by the intellectuals from the center, some of whom are within the Bretton Woods Institutions (Oni and Onen, 2000). Joseph E. Stiglitz, who was the former chief economist of the World Bank and the winner of the Nobel Prize, is the most well-known one. With his famous book called "Globalization and Its Discontents", he gives a clear picture of reevaluation

of the role of the IMF within the context of the Post Washington Consensus. Together with Stiglitz, Jeffrey Sachs, Martin Feldstein, James Tobin, Robert Wade, Frank Veneroso, Dani Rodrik, and Paul Krugman have made important intellectual contributions to the reevaluation process of the IMF.

The failure of the IMF to learn from its past mistakes, its inability to diagnose the real or triggering causes behind the crises, the inappropriateness of its programs, the lack of effectiveness of the IMF programs in dealing with financial crises in emerging markets and in preventing the frequency of recurrent crises, and the moral hazard effect of the IMF programs are all important dimensions of the criticisms. The assessment of the role of the IMF is a crucial issue because the IMF is not merely a lending institution but also an advisory body whose policy recommendations have a global effect.

Those who believe that the IMF was founded to finance current account deficits of countries suffering from balance of payment problems in the era of exchange controls and limited capital movements argue that there is need for the IMF to provide loans to emerging market countries and economies in transition to finance current account deficits or to assist adjustment in the case of financial crisis since in the era of capital account liberalization, capital markets can serve the financial needs of those countries. According to this view, the IMF is expected to concentrate on its surveillance activities and to operate as a research institution¹².

One of the most controversial subjects in the context of the role of the IMF in crisis management is the moral hazard effect of its policies. Although the moral hazard effect of IMF's lending activities has been regarded as a source of financial crisis, it is an impact rather than a real cause. To the proponents of this line of argument, the availability of IMF financing can encourage both borrowers and lenders to take some risk that they would not otherwise take, i.e. when countries know they

can turn to the IMF in the event of a crisis, this leads them to take excessive risk to either maximize their gains at the lender side or finance their budget or financial deficits at the borrower side. If there is expectation of implicit insurance from the IMF, foreign investors will not exercise sufficient care in determining whether a country's debt is sound before investing. Ay e Evrensel's temporal inter-program analysis, on the other hand, shows that both the increasing number of IMF backed stabilization programs and the fact that as a country goes in and out of IMF programs, on average, the country enters a new IMF program with worse economic conditions than when it had entered the earlier program may be interpreted as a signal of moral hazard¹³. For instance, the effect of bail out package of the IMF for the Mexico Peso crisis in 1994 has been seen as an important source of the meltdown in Asia crises within this framework.

On the other hand, since IMF lending is associated with some economic and structural conditions, the moral hazard argument cannot totally explain the risky activities of borrowing countries. Michel Camdessus points that IMF's lending activities may create some degree of moral hazard at the investor side,- even its programs are hardly bailouts- but at the borrower side, since the political and economic costs of the reckless policies would be too great, no country dares to pursue risky policies with the thought that the IMF will bail them out in the event of a crisis¹⁴. Similarly, Anne Kruger argues that the IMF bail out is not a bail out in any simplistic sense because IMF support comes as a loan to be repaid with interest the recipient country eventually repays what it received from the IMF adding interest rate.

That the IMF is imposing a fundamentally flawed development model forcing developing countries to eliminate tariffs and to liberalize their financial system without giving attention to individual country specific conditions, and its typical demands when countries get into economic difficulties such as privatizing operations,

cutting public expenses, (with education and health care the usual victims), eliminating subsidies, opening and deregulating all markets are the most repeated criticisms received by the IMF. But the less emphasized dimension of this debate is the question of why the IMF repeats the same mistakes systematically? Are the failures of the stabilization programs supported by the IMF really a result of the implementation failures of the crisis-hit countries or the natural consequence of stabilization programs which aim to serve the interest of international bond holders to wage their speculative assaults rather than to increase the welfare of developing countries?

The crises of the last two decades have revealed that loss of confidence is the most viable factor preceding a crisis as well as in dealing with it. The success of the IMF prescriptions in managing a crisis is related to what extent it restores confidence in crisis afflicted countries. In some cases, the IMF's involvement in a crisis resolution process or in an adjustment program on its own contributes to the recovery of crises. However, in some cases the IMF's overemphasis on structural difficulties in recipient countries which had already been under pressure and on the necessity to implement tight monetary and fiscal policies, like in Thailand, exacerbates the loss of confidence that produces unexpected outcomes.

Imposing a reform agenda which is full of quantitative targets regarding monetary and fiscal policies as well as reformation of the financial and corporate sector in the general framework of further liberalization and privatization for the sake of restoring confidence and stabilization and offering a similar agenda to all emerging countries without questioning the pre-crisis conditions or whether the crisis environment is appropriate to meet the program requirements have been perceived as an ideological effort to impose the principles of market fundamentalism on developing countries. The inadequacy of the programs regarding misdiagnosis of the crises in

terms of giving the expected outcomes and the inability of the IMF to prevent the recurrence of the crises in emerging countries since the 1990s have intensified the concerns about the role of the IMF.

Liberalization, the U.S and Wall Street

Most of the criticisms against the IMF focus on the similarity of its programs in the context of capital account liberalization. Focusing on inflation, financial liberalization, tightening monetary policies and putting these policies at the center of each adjustment program to deal with financial crises recurring in emerging market countries not only have little effect of recovery but also have contributed to the vulnerability and fragility of emerging markets. Therefore, the IMF has been accused of promoting premature capital account liberalization and of failing to alert countries against unsustainable surges in capital inflows, currency appreciations and current account imbalances.¹⁵

It has been argued that the international community's standards and codes to prevent crises as well as to respond to them are not convenient to deal with the problems of emerging markets. Applying the same approach to all emerging markets regardless of their level of development risks the success of any stabilization program. The main ingredients of a stable economic environment are generally characterized by low inflation rate, sustained economic growth, and openness to capital movements which are emphasized in almost every IMF program. In a speech of the ex-managing director of the IMF, Michel Camdessus, the main pillars of macroeconomic stability are clarified as "fiscal consolidation, anti-inflationary policy and liberalization of the financial sector, opening up the economy to international trade and foreign capital,

price liberalization, the reform of public enterprises.”¹⁶ These conditions, although desirable for economic stability, correspond generally to the economic and political preferences of the liberal, western states. The IMF’s attempt to apply this approach to all emerging market countries regardless of their political and economic level of development renders countries vulnerable to financial crises. Among them, liberalization is the most dangerous one that increases the fragility of countries.

Barry Eichengreen argues that pressuring countries where the relevant preconditions are not met to adopt the standards and codes of the international community risks the development strategy and economic growth (Eichengreen, 2002: 136). He recommends capital controls as a measure for crisis prevention in the light of the fact that the capital account crises of the 1990s demonstrated the dangers of removing all controls on capital accounts where financial systems are underdeveloped and efficient supervision is weak.

The Independent Evolution Office (IEO) in its Evolution Report (IEO, 2005), clearly acknowledges that although the IMF explicitly did not push capital account liberalization on developing countries, it generally supported rapid capital account liberalization in the early 1990s and offered little practical advice on the pace and sequencing of liberalization.¹⁷ The report mentions that despite some specific country instances, the IMF encouraged countries to adopt capital account liberalization without giving sufficient weight to the detrimental effect of short-term capital outflows until the aftermath of the Asian Crisis. Stanley Fischer, similarly, admits that capital account liberalization should be carried out in an orderly, non-disruptive way that minimizes the risks that premature liberalization could pose for an economy and its policymakers.¹⁸

In the analysis of the Trade and Development Report (1998), it is argued that the crisis process in developing countries in the post-Bretton Woods system starts with

policies designed to maintain macroeconomic stability and to integrate the economy into the global system targeting to take advantage of global market opportunities. However, in the absence of effective controls, the impact of capital flows distorts the effects of policies, making it very difficult for them to attain their original objectives¹⁹. To the report, the crisis is not mostly a matter of unsustainable domestic policies.

Joseph E. Stiglitz strictly blames the IMF for its insistence on liberalization as an inevitable policy vehicle which eventually leads most developing countries to financial crises, some of which have detrimental effects on the global economy (Stiglitz, 2002). He points to the flaws of the Washington Consensus and highlights the dangers of launching fiscal conservation, liberalization and privatization as a panacea for economic underdevelopment. His main argument on the failure of the IMF in emerging market crises is that the IMF serves the interests of the financial community in the United States rather than the economic growth and welfare of the developing countries. He is very clear while pointing to the real aim of the IMF:

The IMF never officially changed its mandate, nor did it ever formally set out to put the interest of the financial community over the stability of the global economy or the welfare of poor countries (Stiglitz, 2002: 207).

He does mention explicitly that the main concern of the IMF in pushing capital liberalization as a universal principle is not the interests of the American people, but the gains of Wall Street, which eventually risks global economic stability²⁰. In his view, the IMF's focus is the repayment of loans more than the maintenance of the affected country's GDP and employment.²¹ He emphasizes the incoherent aspect of IMF policies, pointing out that the IMF justifies its intervention in an ongoing crisis in one country relying on the concept of contagion argument which is a natural consequence of market fundamentalism promoted by the IMF. Stiglitz highlights that it is an irony for the IMF as a governmental body to claim that markets work better than governments to justify its existence and its interventions in markets.²² A CATO

paper claims that the Fund's short-term balance of payment assistance does not only create an addiction and dependence on aid but also is contrary to the temporary nature of the Fund's loan.²³

Michel Chossudovsky, in his study called "The Globalization of Poverty" clearly argues that the IMF offers the same menu of budgetary austerity, devaluation, trade liberalization and privatization for more than 150 indebted countries which by through increasing the debt stock, exacerbating the balance of payment crises, and destabilizing the national currencies (Chossudovsky, 2003: 19). The reason behind the same prescriptions being applied worldwide is the natural outcome of the fact that IMF as other international financial institutions acts on behalf of powerful economic and financial interests, because the Wall Street bankers and the heads of the world's largest business conglomerates are behind global institutions. In his view, the structural adjustment programs including strong economic medicine under the IMF bailout agreements are shaped in close consultation with Wall Street commercial banks such as Chase, Bank America, Citigroup, J.P. Morgan and merchant banks such as Goldman Sachs, Morgan Stanley, Salomon Smith, Lehman Brothers (Chossudovsky, 2003: 325). David Moberg argues that the United States, often through the IMF and the World Bank, is setting policies that are designed to protect the interests of Wall Street, turning governments into handmaidens of global corporations and financiers.²⁴

Along a similar line of argument, Martin Feldstein claims that the IMF has done wrong things in the name of finding a new *raison d'être* for its existence after the collapse of the fixed exchange rate system in 1971. While refocusing on the IMF, he believes that the failure of the IMF in East Asia was due to its inability to differentiate the problems of the Asian countries from the Soviet Union countries and to its insistence on structural and institutional reforms as a condition for

receiving IMF funds to deal with the Asian crises, particularly the Korean crisis, as it did in the former Soviet Union to help their transformation and integration to the international system (Feldstein, 1998: 48-50). For example, Korea as the 11th largest economy in the world was in crisis not because of overvalued exchange rate, high inflation and excessive current account deficit but because of excessive short-term foreign debts. Therefore, it was in need of coordination of creditors to restructure its short-term foreign liabilities to prevent the depletion of its foreign reserves and to meet its liabilities rather than on reduced government spending, higher taxes, and higher interest rates that could meet their foreign currency obligations to the U.S, Japanese and European banks. He further emphasizes that the IMF would be more effective in its actions if it pursued less ambitious goals of maintaining countries access to global capital markets and if it avoided using currency crises as an opportunity to force fundamental structural and institutional reforms on countries. Pushing institutional reforms in finance, corporate governance and labor markets lead lenders to think that these economies are fundamentally unsound, instead of restoring confidence immediately. While evaluating the role of the IMF in the Asian crisis, Jeffrey Frankel emphasizes the viability of the IMF for U.S interests.

The international financial institutions allow us (the U.S.) to internationalize the financial burden, which the United States and other major countries would otherwise have to bear individually....The IMF is the right institution for the job....and it allows us to exercise our influence in a highly leveraged way (Frankel, 2000:332).

In this perspective, he mentions that approval of additional funds for the IMF resources by the Congress should be regarded as an investment rather than as a cost.

Anne Kruger, evaluating the role of the IMF programs, rationalizes the IMF's tight monetary and fiscal policies based on the fact that countries approach to the IMF when they are in the midst of crisis and there is already a loss of confidence in the markets²⁵. Kruger does not agree with those who think that the IMF programs

resemble a “one size fits all” model because what makes the IMF programs look like each other is that member countries approach the IMF when it is too late. At this point, there is no alternative of recommending member country to give a letter of intent that includes its commitment to implement the key macroeconomic policies which are flexible to internal and external changes.

Michael Mussa and Miguel Savastano also note that a Fund supported program is a process that contains a great deal of flexibility to respond both to differences in circumstances and to changes in individual cases pointing to the six phases of IMF programs that evolve along a multiplicity of potential pathways²⁶. Along similar lines, Stanley Fischer mentions that countries approach the Fund only in a crisis situation which requires implementation of some unpleasant measures that make the Fund an unpopular institution. He believes that since the crisis hit countries’ governments are usually reluctant to take the responsibility to implement some strict measures because of populist aims, they prefer to call the program “Fund supported program” and find it convenient to blame the Fund when it fails²⁷. He adds that although the IMF is aware of the vulnerabilities of countries and does everything to convince them, sharing its views on the vulnerabilities with the public might cause a crisis that may otherwise never occur.

The theoretical rationale for capital account liberalization is based primarily on the argument that free capital mobility promotes an efficient global allocation of savings and a better diversification of risk, hence greater economic growth and welfare²⁸. Aaron Tornell, Lorenza Martinez, and Frank Westermann argue that even though financial liberalization which follows trade liberalization leads to occasional crises, the gain in the long-run is above its costs (Tornell, Martinez, and Westermann, 2003: 50). They emphasize that occasional crises are costs that have to be paid to attain faster growth in the presence of severe contract enforceability problems.

However, they cannot give an explanation on why countries are not forced to implement structural reforms as much as they are forced to adopt liberalization. In Stiglitz view, free capital movement does not necessarily lead to economic growth and welfare unless the pace and the sequencing of the reforms have been well defined.²⁹ Ziya Öni and Fikretenses argue that although the principles of neo-liberal thought are presented as growth accelerating, global growth in the neo-liberal era has been lower than earlier times and the gap between developed and developing countries has increased through the neo-liberal era (Öni and enses, 2003:7). They point that the frequency of financial crisis is a feature of premature financial liberalization associated with under-regulated financial systems and open capital account regimes which lead countries to rely on short-term and highly volatile speculative capital flows. In a prematurely liberalized economy, most countries have found themselves in fragile growth.

The empirical work of Aslı Demirgüç-Kunt and Enrica Detragiache covering 53 countries for the period 1980-95 shows that banking crises are more likely to occur in liberalized financial systems where effective prudential regulation and supervision are not fully developed, even if macroeconomic stabilization has been achieved (Demirgüç and Detragiache, 1998). They emphasize that financial liberalization has a larger impact on the probability of a banking crisis in countries where institutional development is weak.

Despite the IMF's emphasis that there is no alternative to liberalization for developing countries, China and India as well as Malaysia are regarded as good examples of deviations from the Washington Consensus³⁰. China and India's growth strategy based on high levels of trade protection, lack of privatization, and lax fiscal and financial policies within the framework of gradual liberalization, as well as Malaysia's selective capital controls accompanied by an exchange rate pegged to the

U.S dollar as opposed to the further opening of its economy, have challenged the inevitability of liberalization for stabilization.

Premature capital account liberalization for emerging market countries could not bring the promised benefits such as greater efficiency, higher investment, and faster growth as expected; rather, these reforms caused the flow of speculative money into the emerging markets in the expectation of obtaining arbitrage profits which are very sensitive to any bad news in the country to which they have flowed. The so called hot money which is mostly in short-term leads developing countries to finance their long term investment and to increase the borrowing requirements from abroad, which they cannot have control over it.

Barry Eichengreen also states that the IMF should act as an advisor to promote prudent regulation of capital accounts and as a guardian against avoidable financial crises instead of promoting capital account liberalization as a way of economic growth (Eichengreen, 1999). Robert Wade and Frank Veneroso point to the IMF's underestimation of country specific conditions while arguing for the inappropriateness of IMF- typical- prescriptions including austerity policies and financial liberalization for Asian financial structures (Wade and Venerosa, 1998). They argue that the IMF should concentrate on organizing a determined refinancing effort and then on helping to erect the structure of financial regulation that will help minimize the risks of recurring crises.

An official report prepared by the US Congressional International Financial Institution Advisory Commission, better known as the "The Meltzer Report", is a striking document in terms of the criticisms of Washington based institutions by center, while the report says nothing more than what many critics have been saying for years and advises the restructuring of the IMF considering its failures in the past.³¹ The report confirms that the Fund's duty of ensuring a stable global financial order is

derailed by its prescription of indiscriminate capital account liberalization for developing countries, its habit of assembling financial rescue packages that simply encourage speculative investment, and its prescribing tight fiscal and monetary policies that merely worsen the situation in the crisis countries instead of reversing it.

In the Report's view:

The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive (Meltzer Report, 2000: 7).

The report states that although the IMF reinterpreted its purpose in search of new roles, its recommendations attached to lending activities were undermining national sovereignty and hindering the development of strong democratic institutions which correct their own mistakes and respond to the changes in external conditions (Meltzer Report, 2000: 28) The IMF's enlarged role in the name of crisis management has made it a part of the problem rather than of the solution as it was seen in the Mexican crisis of 1994-95, in the Asian Crisis of 1997-98, and Turkish crisis of 2000-01. The report concludes that the IMF should be restructured as a smaller institution providing short-term liquidity assistance without protecting foreign lenders and financial institutions from their losses and providing advice related to economic policy without imposing conditions and authorizing the negotiations of policy reforms.

The IMF's view that the trend toward open capital movements is irreversible and benefits from free access to capital markets are undeniable has been reinterpreted, putting the notions of "orderly and properly sequenced" at the beginning of the notion of liberalization and charging itself as the most appropriate international institution to promote this goal. However, admitting the adverse effects of capital account liberalization on emerging market countries in the absence of preconditions and offering institutional development in order to prevent these negative effects on the

stability of the banking sector and the whole economy is not an easy task for developing countries which have already liberalized their financial markets. In other words, although the diagnosis of the IMF regarding the crisis of the 1990s is true, its cure is not as coherent given the irreversibility of financial liberalization.

As Dani Rodrik argues, the necessity of producing different models regarding what causes financial crises is due to the inability to recognize the fact that financial liberalization exposes the danger of debilitating the crises (Rodrik, 1998: 1-16). According to the outcome of his study covering 100 countries for the period of 1975-1989, there is no evidence that countries with free capital flows grow faster and experience lower inflation (Rodrik, 1998: 8). Therefore, Rodrik stresses that focusing on macroeconomic fundamentals, lack of information on government policies, strengthening regulatory and supervision systems in a prematurely liberalized system mask a broader issue: namely financial liberalization.

Although there is no fair evidence that the IMF pushes liberalization on developing countries, the IMF's commitment to promoting liberalization as a development strategy and its attempts to determine liberalization as its purpose by amending the Fund's articles of agreement is a sign of the IMF's unwillingness to make concessions from liberalization under any circumstances. That is what makes the IMF packages look identical.

The IMF's decision making procedure has been structured in such a way as to make any deviation from liberalization impossible. Although the IMF is composed of 184 member countries, it seems to serve the problems of emerging countries that have little say because of the weighted voting system in the Fund. That is the second factor that makes the IMF reform packages look like uniform sets of rules.

The Bureaucratic Structure of the IMF

The success of a program depends on, first of all, how well it is designed and then on how well it is implemented. When a stabilization program supported by the IMF fails, the IMF generally accuses the crisis afflicted countries of not committing to the requirements of the program and of lack of a political will for the implementation. However, even if the IMF's claim regarding countries' lack of political will is right, it has to be aware of domestic and external factors that may influence the implementation of the program. Otherwise, Article IV Consultations with member countries which take place generally once a year become meaningless. Although the letter of intents are written by governments requesting help and are addressed to the IMF, they are in fact carefully negotiated with the Fund dictating the liberalization of markets, opening up of capital markets, privatization of financial and non-financial state enterprises, all of which are requirements of the Washington Consensus. In that respect, the formulation of programs and the process by which they are set are very crucial in understanding the role of the IMF in both crisis prevention and management.

Although the implementation of a stabilization program depends on a combination of various factors such as domestic political conditions and external factors, the design of the program has an important effect on its implementation. In this sense, instead of questioning whether a country is committed or not to implementing a stabilization program, questioning how well the program is designed and how well the costs and the benefits of the implementation of that program have been negotiated is vital for the success of a stabilization program. In other words, the design of the program has priority over its implementation.

Graham Birds argues that the cost of implementing a program which does not take into consideration the severity of the initial economic situation in the country concerned will be relatively high and the probability of full implementation will be relatively low (Bird, 2003: 4). In this sense, IMF conditionality which generally sets similar targets regardless of country specific conditions inherently may involve the probability of failure independent of its implementation. Bird emphasizes that a well designed program should take initial conditions fully into account and be adjusted to changes during its course in order to eliminate the cost of probability of implementation failures (Bird, 2003: 34-37).

The IMF rescue packages cover wide areas of reforms entailing bank restructuring, strengthening regulatory framework, market opening policies, transparency, monitoring, information disclosure, and privatization. There is no doubt these are all desirable to achieve stabilization; but the question is whether the crisis affected countries will be able to implement all of them together in the middle of the crisis. Since the most important aspect of recent crises is loss of confidence and the urgent need is to restore confidence, what is needed at first is to provide liquidity through lending or restructuring outstanding debts and then to focus on weaknesses in afflicted countries to identify the root causes behind the crisis.

The IMF programs are characterized as an agreement known as “The Letter of Intent” between the IMF staff and the government officials of recipient countries. Therefore, the failure of the program cannot be attributed to the IMF. However, the fact that recipient countries are generally developing countries, at least since 1994, which are in a desperate position and need IMF loans to cope with the crisis and have power over the decision making processes according to their vote which is associated with their quotas, makes the IMF and its major donors the dominant power of the programs. In this sense, the IMF is not an institution that solely provides financial

assistance conditioning some economic measures and structural reforms; rather it is a political and bureaucratic institution which should be taken into consideration in evaluating its role in financial crises. Therefore, the similarity of the IMF programs for developing countries is also associated with its bureaucratic structure.

Decision making procedures in the IMF are based on a weighted voting system. According to the Fund's Articles of Agreement, each member has a quota expressed in special drawing rights³². Quotas which reflect member countries' financial contribution to the IMF's resources also determine their voting weight and representation in the Fund. According to the weighted voting system, each member has 250 votes plus one additional vote for each 100,000 special drawing rights³³. In other words, the larger a country's quota in the IMF, the more votes it has. In this respect, the voting structure of the Fund reflects the economic weight of each member that enables major shareholders, especially the U.S, to have a strong influence on the IMF's decision making process.

Many important decisions require 85 percent majority which enables the U.S alone and the United Kingdom, Germany, and France together to have veto power. Although it is argued by Dennis Leech (2002) that the 85 percent majority rule limits the effectiveness of the U.S., enabling other countries to bloc the veto power of the U.S, whether a member country is favored by the U.S for its political and economic interest is a determining factor at the phase of approval of IMF programs.

In their analysis, Robert J. Barro and Jong-Wha Lee argue that IMF programs which consist of loan agreements and policy conditions attached to them are affected both by member countries' quotas and by their economic and political connections with the U.S. and the major Western European countries (Barro and Lee. 2003: 3). Thomas Oatley and Jason Yackee emphasize that IMF decisions are likely to reflect American interests because they allow the United States to exert political pressures

through the voting system (Oatley and Yackee, 2000:8). They observe that both the magnitude of the loans and the conditionality attached to the loans are determined according to the amount of American bank exposure in developing countries. They conclude that the decision making procedures of the IMF allow American policy makers to shape IMF lending decisions in response to the demands of American financial institutions. The Clinton administration's extraordinary pressure to activate a bail-out package to which it directly contributed \$US20 billion for Mexico immediately after the 1994 crisis can be given as one of the best examples of this view.

Despite presence of different views among U.S's top level officials on whether the U.S should keep on supporting the IMF or not, the dominant view is positive since the IMF has been assumed as an important institution to exert the U.S influence on international system as an economic and military power. John J. LaFalce, a former congressman from Democratic Party of the U.S House of Representatives, highlights that although the IMF is not a perfect toll, it is regarded as the only toll for the U.S to use both its voice and its vote to make the IMF a more effective international institution in terms of exerting the U.S influence and leadership among the 182 countries of the IMF³⁴. Therefore, conditioning lending to economic reforms that open economies to both internal and external competition for countries in seeking for IMF support has been determined as one of the core elements in shaping the role of the IMF in accordance with that stated purpose.

In such an excessively politicized system, it should come as no surprise that IMF policies are found to be too responsive to its principal stockholders who are high income, international creditor countries whose interests require the free movement of capital.

In the following chapters, three financial crises which have their roots in premature financial liberalization will be analyzed: namely the Peso crisis of Mexico in 1994, the Thailand crisis in 1997, and the Turkish financial crisis of 2000-2001. The striking feature of these three cases is the fact that what had been introduced by international financial institutions as examples of successful liberalization stories at the very beginning, entailing decreasing state involvement in the economy through trade liberalization, privatization, and reduced public spending, freeing interest rates, and lifting exchange controls found themselves in crisis.

The importance of these cases for this study is that they are good examples of the failure of the IMF in managing financial crises as well as in preventing them which is a natural consequence of imposing a uniform set of conditions on them in accordance with the Washington or the Post-Washington Consensus irrespective of the institutional and political capacities of these individual countries³⁵. The comparison of Mexico and the Thai crisis with Turkey demonstrates that the IMF had a contributing effect to the Turkish financial crisis by approving the disinflation program launched in December 1999 which undermined the drawbacks of pegged exchange rate based stabilization programs in a prematurely liberalized financial system like in Mexico and Thailand.

CHAPTER 4

THE MEXICAN CRISIS OF 1994

The purposes of this chapter are twofold: 1) to show how a country becomes vulnerable to financial crises if it follows the prescriptions of gradually liberalized industrial countries without adopting an effective regulatory system, 2) to show whether the partners of the crisis diagnosed the causes properly and how they managed it in the context of the relations between the U.S and the IMF. Understanding the factors leading to the Mexican crisis is important to evaluate the role of the IMF in promoting the disinflation program of Turkey which led to the crises in November 2000 and February 2001 and which eventually resulted in abolishment of the program. Both Turkey and Mexico had many common points in the sense of conditions in the period of the crises and their way of dealing with persistent inflation.

Banco de Mexico in its Annual report (1996) states that the Mexican economy suffered its most severe crisis since the 1930's in 1995³⁶. The Mexican crisis in 1994 has been declared to be the first financial crisis of the 21st century by Michel Camdessus, meaning the first major financial crisis that hit an emerging market economy in the new world of globalized financial markets³⁷. In showing the response of the international community to prevent the recurrence of this type of crises and the management of the crises once they occur, the Mexico Peso crisis is also relevant. It is a good example of the fact that the implementation of a pegged exchange rate based stabilization program in an environment where capital moves freely eventually results in abandoning the program and might cause currency crises if the country's foreign

reserves are depleted and not sufficient to get rid of speculative attack on currency, due to devaluation.

In addition to the above mentioned aspects, the crisis revealed the fact that financial liberalization is a kind of policy instrument of developed countries to expand their influence all over the world rather than one that contributes to the economic growth of developing countries.

Conditions Prior to the Crisis

What is striking about the Mexican crisis is that there was no alarming ring before the crisis. Contrary to this, the IMF, World Bank, specialists in the financial sector, and rating institutions were praising Mexico due to its successful reform program adopted in the late 1980s. There was an over-optimism regarding the economic policies of Mexico and political considerations masked the forthcoming disaster and prevented taking necessary measures to avoid the crisis³⁸.

In the analysis of Jeffrey D. Sachs, Aaron Tornell, and Andres Velasco, although the Mexico crisis was identified as unexpected, self-fulfilling speculative attack on the peso, they argued that the combination of large appreciation of real exchange rate, a weak banking system, and low levels of foreign reserves determines the vulnerability of a country to financial crisis which provides an explanation for why some emerging market countries are more vulnerable to crisis than others (Sachs, Tornell, and Velasco, 1996: 148-149). Regarding the overvaluation of the exchange rate and a weak banking system, they mention the destabilizing effect of capital flows on financial systems emphasizing the necessity of regulating the volatile environment

of emerging market countries to prevent the recurrence of the crises as in the experiences of Malaysia and China.

Although the 1994 crisis was presented as an unexpected event, the studies on crises have shown that it was the final outcome of a long term process. Mexico had experienced two severe crises in 1976 and 1982 which had been thought of as a consequence of highly interventionist state policies.³⁹ Two crises had resulted in the devaluation of the peso almost by 100 percent and necessitated IMF-sponsored adjustment programs. In this respect, the previous crisis experiences led Mexico to find ways of achieving economic stability focusing on liberalization, privatization, and deregulation. The 1994 Mexican crisis was preceded by a combination of policy choices in such a domestic, political and international environment which was dominated by debates on the ratification of the North American Free Trade Agreement (NAFTA) and presidential elections.

Mexico adopted a stabilization program in 1989 which the IMF supported with an arrangement under the Enhanced Fund Facility, aiming to reduce inflation centered on a predetermined exchange rate as anchor and supported by fiscal and monetary policies; comprehensive structural reforms including privatization and trade and exchange liberalization, the opening of the economy to international competition; a broad social and economic agreement between the government, the private sector and the labor unions aiming at stabilizing price, exchange rate and wage increases.⁴⁰ Within this framework, Mexico initiated the liberalization of its trade by eliminating import licenses for capital and intermediate goods in 1985 and for consumer goods in 1987; reduced the tariffs for some categories joining the General Agreements on Tariffs and Trade (GATT); started financial liberalization with the elimination of credit quotas and the obligatory reserve requirements in 1988; the eradication of all interest-rate ceilings, the reform of regulation of direct foreign investment, the

opening of the stock market to foreign investors in 1989; the opening of money market to foreign investors with the eradication of restrictions to portfolio investments in government bonds in 1990, and the initiation of negotiations on NAFTA in the same year; announcement of the new Law on Foreign Investment, substituting the 1973 Act (which established as a general rule a maximum foreign ownership of 49 per cent of enterprise capital) in 1993 and the enactment of NAFTA in January 1994 (see Box 4.1).⁴¹ Between 1991 and 1992, all of its 18 commercial banks which were mostly owned by financial holding companies were privatized. It is argued that all these reforms led by PRI had the support of different interest groups within society that had suffered from the inflationary consequences of past interventionist policies that produced the 1976 and 1982 crises.⁴²

At the very beginning, the program seemed to be working well and Mexico joined the club of first-world countries by being member of NAFTA. Inflation was reduced from 51,7 percent in 1988 (160 percent in 1987) to 8 percent in 1993. The rate of economic growth was average 3,8 percent in 1989-93 whereas it was not above zero in 1985-1988 (Table 2). Fiscal deficit was reduced from 13 percent of GDP in 1988 to a surplus from 1992 onwards. In turn, public debt decreased from 68 percent of the GDP in 1988 to 22 percent in 1993. In 1982, the deficit was 16.1% of GDP and public debt was 51.2 percent of GDP.⁴³

Economic recovery, together with real appreciation of the local currency due to the use of the exchange rate as nominal anchor which resulted in an increase in real interest rates and attracted large capital flows which in turn exacerbated real exchange rate appreciation, resulted in gross capital inflows that jumped from \$3,5 billion in 1989 to \$33,3 billion in 1993 which reached 7,1 percent of GDP (Table 2, Table 3). What made capital flows bad for the Mexican economy was that they were mostly short-term maturity and in the form of portfolio investments which are more volatile

and more prone to reversals. Current account deficits were exceeded by even more rapidly rising net capital inflows leading to overall balance of payment surpluses that enabled Mexico to increase its foreign exchange reserves to almost \$25 billion by the end of 1993. Direct investment inflows reached about \$4-5 billion annually in 1991-93, while net portfolio investment inflows skyrocketed to \$28.9 billion by 1993, based on the perception that Mexico's economy was fundamentally strong, which was bolstered by the approval of the NAFTA agreement.

But these are merely one side of the coin. Mexico's access to the international markets was bounded with the provision of high yield spreads. Although Mexico was experiencing a very large current account deficit, this did not appear to present an immediate problem since Mexico's foreign currency reserves were plentiful, its exports were growing rapidly, and there did not seem to be a significant risk that Mexico would soon have trouble attracting and retaining foreign investment. On the other hand, the current account deficit was accompanied by a fiscal balance which in fact signaled that real exchange rate appreciation which originated in capital inflows was at the source of current account deficits. Although factors that cause a crisis in terms of first-generation models did not exist in Mexico prior to the crisis of 1994, the reliance of the Mexican economy on short-term and volatile capital flows was at the heart of the crisis.

In fact Mexico's reform package had been formulated to enable it to become a member of the first-world countries and to improve economically. However, according to Brett M. Humphrey, the rapid liberalization of capital account, financial liberalization adopted as a way of dealing with trauma of the debt crisis of 1982, and the encouragement of capital flows to finance current account deficits prepared the end of Mexico (Humphrey, 2000:3-4). In other words, the dependency of Mexico on short term-capital flows as an impact of the removal of all barriers on the foreign

purchases of Mexican government bills as well as other restrictions on foreign investments which were not accompanied by sufficient efforts at improvements of supervision and regulation exposed the country to the vicious cycle of boom-bust.

The 1994 crisis has revealed the other side of the coin. Until shortly before the crisis, the country had been widely praised for its achievements in stabilization, economic growth and market-oriented reforms under IMF supported programs.

The inflation reduction program based on the pegged exchange rate system eventually led to the appreciation of real currency due to the slow reduction in inflation rate which eventually caused current account deficits. As the sustainability of the pegged exchange rate system was based on the existence of sufficient foreign reserves, Mexico began to open its financial sector and privatize its banks in the early 1990s⁴⁴. Capital account liberalization which was at first considered as a way of eliminating appreciation of the exchange rate contributed to the financial vulnerability of Mexico by increasing the amount of capital flows in Mexico. Capital inflows were mostly short-term maturity and mostly in speculative form aiming to obtain high returns and very sensitive to interest rates changes. Averaging 7 percent of the GDP in 1992-1994, capital inflows helped to finance the current account deficits in Mexico, but the issue is the sustainability of this way of financing.

Until 1994, since foreign investors gave more importance to the first side of the coin, it was logical to invest in Mexico. Once some political uncertainties were revealed, the vulnerability of Mexico became obvious. The Chiapas Rebellion in January 1994, then the assassination of Luis Donaldo Colosio who was presidential candidate of the ruling party in March 1994 caused declines in investor confidence and reversal of capital flows which were very important for the sustainability of Mexico's economic growth. The increase in the U.S. interest rates exacerbated the capital flight.

Evolution of the Crisis

The Mexican financial crisis started on 20 December 1994 with the announcement of the fluctuation of the peso by 15,26 percent which resulted in the abandonment of the pegged exchange rate based inflation reduction program. The economics of the crisis have been explained by a combination of factors such as real exchange rate overvaluation, excessive current account deficits, excessive reliance on short term capital inflows, higher levels of investment risk deriving from political events, in different degrees depending on different points of view.⁴⁵

According to the U.S. General Accounting Office Report (1995), Mexico's financial crisis originated in the growing inconsistency in 1994 between Mexico's monetary and fiscal policies and its exchange rate system. The stabilization program based on a predetermined exchange rate system together with the opening of the economy to international competition and privatization without prudent regulation added to exchange rate overvaluation, current account deficit, elections, the rise in U.S. interest rates, loss of investor confidence due to politically linked assassinations, and loose monetary policy in response to the reduction in foreign capital flows led to the Mexican Peso Crisis in 1994.

However, the core issue which was neglected through the stabilization program was Mexico's excessive reliance on short-term foreign borrowing which contributed to financial fragility. Cheap borrowing led firms, banks, and households to borrow for both investment and consumption. G. Calvo argues that high capital account deficits due to capital flows and overvaluation of the peso, on the one hand, low saving rates on the other, lied at the heart of Mexico's difficulties in 1994 (Calvo,1998: 1-23). He argues that sudden shifts referring to high negative swings in capital flows is

dangerous especially for those whose financial system liberalized very rapidly and whose capital account deficits and consumption are financed by capital inflows.

The amount of capital flight was \$US3,4 billion in the aftermath of the assassination of Colosio in March 1994 which caused foreign currency reserves to drop from \$29.3 billion at the end of February to \$25.9 billion at the end of March and to \$17.7 billion by the end of April. The sudden capital outflow in Mexico was attributed to political uncertainties surrounding the elections and was expected to be temporary. Therefore, increasing interest rates and substituting the peso dominated bond (CETES) with dollar dominated bonds (TESEBONOS) were considered to be the best option to restore investor confidence and prevent further outflow. The stock of Tesobonos was \$29 billion in December and all of them were due in 1995, whereas the amount of foreign reserves decreased from \$17 billion in April to \$10 billion in December 20 and to \$6 billion at the end of the year (Table 3).

Increasing interest rates as a way as of keeping foreign capital in the country not only caused the increase of the ratio of non-performing loans and deteriorated the balance sheets of banks suffering from maturity and currency mismatches but also could not prevent capital outflow. Therefore, Mexico had to devalue the peso by 15 percent which resulted in further deterioration of foreign reserves and ultimately allowed the exchange rate to float.

Dornbusch and Werner, in their analysis of Mexico's stabilization program, clearly state that there was an overvaluation problem resulting from real exchange rate appreciation in the process of trade liberalization, domestic fiscal tightening and the access to external capital as often occurs with such a policy. To them, had attention been given to the Chile's experiences in the 1970s, Mexico would have realized that the rapid decline in inflation rate at the very beginning of program would result in the overvaluation of the exchange rate that stopped growth and ended a speculative attack

on the exchange rate and currency realignment (Dornbusch and Werner, 1994). In this respect, the Mexican crisis was not a surprise.

However, the problem was not mainly the appreciation of exchange rate. The sequencing of liberalization and privatization in the financial sector and liberalization of the capital account were more important than that. Previous experiences in Latin America suggest that it is potentially dangerous to attempt a trade liberalization or export-promotion strategy at a time when macro policies are promoting large capital inflows and the currency is appreciating in real terms. The elimination of the detrimental effects of the implementation of such policy can be possible by setting an efficient regulatory and supervisory system. Privatization of banks within one year without effective monitoring and a regulatory system not only contributed to the expansion of commercial bank credit by over 100 percent, credit for housing by 1000 percent, and credit for consumption by 450 percent, but also to the increase in the ratio of non-performing loans from 3,6 percent in 1991 to 4,7 percent in 1992, and to 6,1 percent in 1994.⁴⁶

While all these were happening, international financial institutions, the U.S, and some analysts in the financial sector were praising the economic growth in Mexico just before the crisis. For example, the IMF in its last Staff Report for Mexico's Article IV Consultation before the crisis praised Mexico's considerable success in its comprehensive program and did not argue for any change in the exchange rate policy⁴⁷.

Sebastian Edwards argues that despite the contrast between Mexico's achievements in reform policies and economic results, financial experts and international institutions like the World Bank and the IMF created a Mexican miracle by praising the success of its reform program (Edwards, 1997: 7). The positive climate was partly due to the approval of NAFTA. The U.S had to praise Mexico in order to

obtain support for NAFTA which would allow America to expand its power all over the continent. Clinton's claim was that the NAFTA would generate 200,000 American jobs in the first two years of its effect by fostering an export boom to Mexico and export-related jobs paid much better than jobs that had no connection to exports.⁴⁸ The emphasis was on the importance of the approval of the NAFTA agreement for the sustainability of so-called Mexican economic growth. The World Bank's Country Report which was published in May 1994 appreciated the outcome of the economic reform program which had made Mexico one of the most open economies in Latin America and emphasized the further contribution of the NAFTA to this process.⁴⁹ Edwards in his work emphasizes that statements of both the World Bank and of the IMF about the recovery of the economy after the elections masked the subsequent crisis which had been thought of as unexpected⁵⁰.

Along similar lines, Thae M.Lee argues that although there were numerous warning signals that the Mexican economy was in trouble in 1994 (interest rates were high; the current account deficit was growing and financed in large part by short-term capital; government reserves were dwindling), the U.S Treasury Undersecretary Lawrence Summers was still emphasizing the "underlying soundness of Mexican economic policies" in late December 1994(Lee, 1995: 8). Robert A. Blecker claims that the Mexican Miracle was a game of multinational corporations who profit from lower wages and that of financial speculators pursuing high returns investing in Mexican stock markets freely (Blecker, 1997: 5).

The following statement by Stanley Fischer made just a few weeks before the approval of the stand-by agreement of Mexico is another indication of fact that the main concern of the IMF is free movement of capital.

The Mexican authorities have announced a comprehensive economic program aimed at stabilizing the economy.... The authorities also have announced the expansion of their already wide-ranging privatization.....Mexican financial markets will be opened to greater foreign participation (Fischer, 1995).

According to the GAO Report (1996), although the U.S officials had some concerns about Mexico's macroeconomic policies as growing current account deficits, appreciated peso, and the adverse effect of political developments such as Chiapas uprising and coming election in August 1994 on foreign investor's confidence, they did not perceive a high risk of financial problems and believed that Mexico would manage a possible crisis. The report mentions that the IMF's 1994 Article IV consultations with Mexico overweighed their concerns because of the positive statements regarding Mexico's ability to manage economic and political difficulties. Therefore, no one could blame Mexico for not implementing sound policies. In fact both U.S officials and the Mexican government were aware that any political instability would expose Mexico to financial panic causing capital flight. However, focusing on political uncertainty and monetary and fiscal policies rather than diagnosing the real cause(s) at the root of Mexico's vulnerable financial system, considering investors' panic as a temporary reaction to political uncertainties and as easily manageable with the support of U.S financial assistance, exacerbated the severity of peso crisis of 1994. In the GAO Report, a U.S Treasury official states that U.S interest rates had a greater effect on Mexican markets than political uncertainties. This clearly shows that in an environment of capital account liberalization, any factor can trigger financial crisis, but the issue was to take the necessary measures to prevent a possible crisis which was somehow underestimated.

Studies analyzing the causes of the Mexican crisis point to lessons drawn from the crisis in order to create an early warning system that will help to prevent recurrence of similar crises and at least minimize the severity of which once occur.⁵¹ If the economic and political factors which make a country vulnerable to crisis are diagnosed well, the severity of a possible crisis can be minimized.

What made the Mexican crisis inevitable was the premature liberalization movement which had rendered its financial system very sensitive to political turmoil within the country and to interest rate changes in the U.S. Given the fact that foreign investors were in search of obtaining high yields, the increase in the U.S.'s interest rates six times throughout 1994 which narrowed the differentials between the U.S.'s and Mexican Treasury bills and expectations regarding further decrease in profits led investors to leave the Mexican markets.⁵² With increasing political instability, there was no reason for foreign investors to invest in Mexico anymore. It was time to leave Mexico, whose fragilities in the economy were revealed. As a liberalized economy, Mexico could not prevent outflows. Mexico government's commitment to maintain the pegged exchange rate system replacing all domestic peso denominated debts with domestic dollar denominated bonds converted the given vulnerabilities into a crisis which ended in the devaluation of the peso.

Mexico as a prominent liberalizer not only failed to obtain benefits from liberalization in terms of GDP growth which declined steadily from 5,1 in 1990 to 2 in 1993, but also experienced a severe crisis which resulted in 6,5 percent decline in GDP and increase in unemployment in 1995. Tornell, Martinez, and Westermann attribute this failure to lack of judicial and structural reforms which led to financial fragility and occasional crises through undertaking credit risk rather than liberalization itself (Tornell, Martinez, and Westermann, 2003: 29-40).

According to the IMF's Independent Evaluation Office(IEO) Report, although the initiatives for capital account liberalization came from the Mexican authorities themselves within the context of NAFTA, Mexico's efforts to liberalize the foreign investment regime received strong endorsement from the IMF Executive Board without adequate attention given to weak prudential regulation or how to manage the surge in inflows received between 1989 and 1993 as well as a large current account

deficit financed by short-term capital flows and a rapid increase in external borrowing⁵³. In neglecting the destabilizing effect of capital inflows on the economy, the IMF failed to perform its surveillance function- which is described as very important for its general purpose of providing stability- well and thereby contributed to the crisis.

The Management of the Crisis: The U.S and the IMF

Whether the IMF managed the crises successfully or merely guaranteed repayment of debt can be evaluated comparing the program targets and the real outcomes of the program. After the crisis, the IMF, in one sense under the pressure of the U.S, approved a \$17,8 billion stand-by credit for Mexico on February 1995.⁵⁴ The United States also approved a \$20 billion financial aid for its NAFTA partner. Initially, the Clinton administration had proposed \$40 billion, but because of strong opposition from the Congress and the possibility of the rejection of rescue packages, Bill Clinton announced a \$20 billion short-term loan package using his own authority and claiming that further delay risked both the U.S. economy, the U.S. workers, and global economy.⁵⁵ Some argue that the urgency of the Clinton administration was due to the pressures of Wall Street who risked their investment in Mexico. Especially the U.S. Treasury Secretary Robert Rubin's close relation with Wall Street (he was a former chairman of Goldman Sachs which is a global investment bank, securities and investment management firm) raised concerns about the legitimacy of the bail-out. John P.Sweeney mentions that the main concern of the U.S was to bail-out the Mexican government and U.S mutual Funds such as Fidelity of Boston, Goldman Sachs, Merrill Lynch, Dalomon Brothers, and Citigroup which invested billions of

dollars in Mexico as in other emerging markets all over the world (Sweeney, 1995: 1). He argues that handling the Mexican crisis merely as a liquidity shortage problem regardless of structural and systemic problems within Mexico would have made the crisis worse. On the other hand, there was an actual obligation to help Mexico under the NAFTA agreement. If Clinton had underestimated this obligation, NAFTA and its credibility would have been lost.

The IMF kept on praising the stabilization program even while announcing a \$17.8 billion standby credit agreement, emphasizing Mexico's remarkable success in economic transformation since the late 1980s on the basis of prudent macroeconomic policies and structural reforms resulting reduced inflation and greater integration into global economy. In fact, such an assessment which implies that the crisis was not a matter of the Mexican government's contradictory monetary and fiscal policies admits that Mexico was a victim of capital account and financial liberalization accompanied by a rapid deregulation process. However, the program concentrated on solving the liquidity problem and restoring confidence to Mexican markets as soon as possible without mentioning that the vulnerabilities of the Mexican financial system had its origins in rapid liberalization reforms. They did not want anyone have a negative idea on liberalization while emphasizing the benefits of further liberalization even in the midst of the crisis⁵⁶. Therefore, the program concentrated on a traditional balance of payment crisis solution which requires tight monetary and fiscal policies to finance current account deficits.

The IMF program basically involved 1) the reduction in the external current account deficit from 8 percent of the GDP in 1994 to 4 percent of the GDP in 1995, and to 3-3,5 percent of the GDP in 1996, 2) lowering of the annualized rate of inflation to around 9 percent in the fourth quarter of 1995, 3) around 1.5 percent GDP growth for 1995 as a whole. Wage, price, and credit restraints together with structural

reforms which aimed at expanding the scope of privatization efforts to rail, ports, airports, electricity generation, and radio and telecommunications would help to reach these goals. The expected \$6 billion revenue from privatization would be used for public external debt⁵⁷.

At first, the program can be regarded as a success in terms of solving the liquidity problems of Mexico, promoting confidence and enabling the reentry of Mexico into international markets. Through the provision of financial assistance, Mexico's debts were to be rolled over in full, and the loans were in the process of being paid in full. Mexico quickly regained access to private capital markets. However, it could not be assessed as success in terms of the outcomes of the program targets. For example, the IMF forecasted a Mexican growth rate of 1.5 percent in 1995 in setting up the program, but the actual outcome was a 6.2 percent decline. The inflation rate never reached the 9 percent targeted level, which was higher than its pre-liberalization level (Table 2). The unemployment rate jumped to 6,3 percent in 1995 and to 5,5 percent in 1996 from 3,7 percent in 1994. Inflation rate returned to double digit levels and did not reach its pre-crisis level again during the following four years. In that respect, the IMF's crisis management appears to save speculators rather than to stabilize the economy.

The Mexican Crisis of 1994 brings several important questions into one's mind:

Firstly, does the IMF, as an institution established for promoting global monetary stability and one that justifies with this purpose, have the right to say that the Mexican Crisis was a surprise? The IMF, in line with its purpose mentioned in the Article of Agreement, holds a consultation every year with each of its members known as "Article IV Consultations" to obtain information on the country's overall economic position and on whether the member country follows sound economic policies that do

not harm global exchange rate stability in the context of its Article IV of Articles of Agreement. As a part of this process, the IMF has the privilege of reaching information, of monitoring developments and of assessing them better. Just several months before the crisis, the IMF had completed its Article IV Consultations with Mexico in February 1994. According to the GAO Report, the IMF did not mention any serious concerns related to Mexico's monetary and fiscal policies in its Article IV Consultation.⁵⁸ Notwithstanding its concerns on further appreciation of the peso, the IMF officials noted that Mexico was successful in lowering and controlling inflation, liberalizing and privatizing its industries, increasing its export competitiveness, and emphasized the continuation of capital inflows to Mexico as an indicator of investors' confidence in the Mexican economy (GAO, 1996: 104-105). In this sense, the IMF, as I mentioned at the very beginning my study, was a part of the problem rather than the solution due to its inability to foresee the crisis.

Secondly and related to the first question, did the IMF manage the crisis well and contribute to the recovery of Mexico? Management of a crisis requires diagnosing the causes at the root of the crisis very well. However, the IMF approved in February 1995 an 18-month stand-by credit of \$17.8 billion in support of Mexico's program for 1995-96, of which \$7.8 billion was made available immediately directed by the U.S Treasury to restore investor confidence and to prevent the contagion of the crisis to other emerging markets without conditioning structural reforms. In terms of solving the liquidity problem, the IMF together with the U.S managed the crisis successfully, which was, in fact, the price for premature capital account liberalization.

The basic mistake made by the IMF was to promote liberalization without measuring its cost and benefits for Mexico like for other developing countries. As mentioned by Joshua Aizenman in the reassessment of the financial liberalization process in Latin America in the 1990s, financial liberalization has a danger of leading

to a financial crisis if a country has not reached a certain degree of economic development which requires determining the sequencing for capital account liberalization very well (Aizenman, 1999). Carlos Arteta and Charles Wyplosz also point to the importance of sequencing of liberalization, arguing that liberalization is not a matter of openness but that of absence of macroeconomic imbalances before opening the capital account (Arteta and Wyplosz, 2003:94). Therefore, encouraging developing countries to adopt capital account liberalization without considering their domestic economic and political dynamics hurts more than helping in the long-run, as witnessed in recent emerging market financial crises.

After each crisis, the IMF gives different explanations in assessing the causes of the crises since the former ones remain insufficient to understand the subsequent crises. For instance, the Mexican crisis was explained by weakening macroeconomic fundamentals which in turn were consequences of the inappropriate monetary and exchange rate policies of the government and lack of information on government policies. The IMF stressed the importance of sustainable monetary and exchange rate policies as well as the necessity of strengthening the financial system to foster an environment in which the benefits of integration of capital markets could be realized.⁵⁹ However, the Thai crisis brought to light that macroeconomic fundamentals were not at the heart of the problem.

The Asian crisis which began in Thailand with the devaluation of the baht and spread to the entire region demonstrated the fallacy of the assumption regarding deterioration in macroeconomic fundamentals since Thailand had been growing rapidly and had high private saving rates in the period leading up to the crisis, but strong fundamentals did not prevent the sudden reversal of capital flows which had become vital for Thailand's economy prior to the crisis.

In fact, the Thai crisis of 1997 which later became a global financial crisis known as the Asian Crisis was due to the shortcomings of the IMF in dealing with the Mexican crisis in 1994. In other words, since the IMF's crisis management policy concentrated on recovering the impacts of the crisis rather than defining the causes at the root of the crisis, such as restoring foreign investor's confidence to solve the liquidity problem in Mexican financial markets and imposing an increase in interest rates and privatization as liquidity generating mechanisms, its recovery prescriptions provided temporary solutions which could not prevent the boom-bust financial cycles.

CHAPTER 5

THE THAI CRISIS OF 1997

In this chapter I will analyze the Thai crisis and the role of the IMF in managing the crisis. I choose Thailand as the case because the Asian Crisis originated in Thailand and spread to the rest of the region in a very short period.

The purpose of this chapter is :1) to mention the failure of the IMF in diagnosing the causes at the root of the crisis and in dealing with the crisis 2) to present the Thai crisis as an example of the crisis prone systems that premature financial liberalization creates regardless of sound monetary and fiscal policies.

What makes the East Asian crisis in general and the Thai Crisis in particular very crucial is that the growth miracles of the previous decade found themselves in a full-fledged crisis. The uniqueness of the Asian crisis stems from the fact that the crisis originated in the private sector rather than in public sector borrowing and lending which the IMF underestimated while managing the crisis.

The Asian crisis has revealed the fact that a crisis can erupt as a result of neither pure deterioration of macroeconomic fundamentals nor self-fulfilling attacks on currency since they are all impacts of a more crucial phenomenon, i.e., premature financial liberalization, which has been imposed on developing countries as an inevitable step of being a part of global economy. The issue is not whether the country is vulnerable to the crisis or not. The crisis is a clear evidence of the existing vulnerability. The point is why they were not recognized and handled to prevent the crisis from occurring. In this respect, the role of the Thai government as well as that of the IMF will be questioned.

The end part of the crisis story appeared to be very similar to the Mexican financial crisis of 1994-95: When Thailand could no longer finance its current account deficits by additional short-term borrowing or by selling its foreign reserves it had to abandon the peg and devalue the baht. Over-borrowing, mismatching maturities and currencies, reliance on short-term borrowing to finance current account deficits were the similar components of the crisis.

The crisis in 1997 was not the first one for Thailand as in Mexico. Although Thailand experienced a serious financial crisis in 1983-85 with a 25 percent devaluation of the baht, the importance of the Thai crisis of 1997 are many folds: First of all, the crisis led many to question the realities of the Asian economic miracle. The crisis disclosed that what was very good for economic growth at first may cause the collapse of the growth if it could not be managed well. It is argued that in the world of open economies, the health of the economy basically depends upon how well the economy manages itself to be in a healthy balance of trade and capital flow (Laplamvanit, 1999: 8). The Thai crisis should be questioned within this framework. What kind of policies were at the root of the imbalances? Could not the imbalances be handled properly without making the existing situation worse? Was it a matter of the influence of the state on the economy and inefficient economic and political institutions or that of financial panic focusing on external factors which were out of the control of the government? Or was the crisis a natural consequence of a boom-bust cycle originating in rapid capital account and financial liberalization process accompanied by a rapid deregulation process? The handling of the crisis varies depending on from which perspective the crisis is looked at.

As in the Mexican crisis, the Thai crisis disclosed the shortcomings of rapid financial liberalization and the effect of sudden reversals of capital flow in countries where there is no effective system that can manage them. In fact, the crisis cannot be

attributed to a single factor because it seems that a combination of several factors in one way or another associated with each other that make the countries in the region exposed to financial crisis. But it will not be wrong to say that premature financial liberalization resulted in unsustainable capital flows, a well known common point in both Mexico and Thailand and other emerging markets as in Turkey.

Studies comparing the crisis in 1983-84 in Thailand with that in 1997 claim that the common factor was the lack of the states capacity to supervise the financial sector, acknowledging the effects of both the domestic political structure and that of external factors during each period prior to the crises and they state that if the state had had the capacity to better regulate the financial sector, both crises could have been prevented⁶⁰. In this sense, neither inappropriate macroeconomic policies nor unfavorable external factors were the essential factors in the Thai case.

Imposing austerity, closing down financial institutions, and pushing liberalization unquestionably within the context of rescue packages are the basic indicators of the IMF approach to crises which are the result of the mistaken policies of crisis afflicted countries. On the other hand, answering the question of to what extent the crisis came out of a process of capital account liberalization without an appropriate framework of regulation or as a matter of mistaken government policies, requires looking back to the events leading up to the crisis.

Conditions Prior To the Crisis

Once the Thai crisis erupted in 2 July 1997, it was again assessed as an unanticipated crisis because Thailand, as many countries in the region, had achieved very rapid economic growth which had led many to call it the Asian Miracle. It was a

miracle in the sense of growth rates of 8-9 percent between 1991 and 1995, and 5,5 percent in 1996 led by investment and export. The inflation rate was relatively low, between 3,4 percent and 5,9 percent, unemployment was not a problem, the government ran a budget surplus and the saving rate was above 30 percent of the GDP (Tables 4,5,7). The macroeconomic indicators of Thailand did not signal a crisis in terms of first generation models. A stable macroeconomic environment, high levels of domestic saving and of private domestic investment, growing human capital, increasing export, successful industrialization, and the integration of the banking sector have been regarded as the factors behind the Asian Miracle (Ito, 2001: 56-59, World Bank, 1993). According to the IMF's country report (2000), Thailand's average export growth during the 1985-95 period was 23 percent which was the highest among the countries in the region. It was not under 10 percent of the GDP by 1991 and stayed at 8 percent of the GDP until 1996. However, what was neglected in the process of growth was the effect of the increase in non-tradable and speculative capital inflows. GDP growth, high saving rates, government fiscal balance surpluses, and the high volume of exports masked how seriously the country had become indebted and how recklessly the capital had been transferred and used in the economy. The 1997 crisis revealed that the miracle was an appearance and had prevented many from seeing the real deterioration through other indicators such as the increase in current account deficits, in short-term borrowing rates, in the borrowing of banks and private institutions, and in non-performing loan rates.

Although the domestic saving rates were high for Thailand as for other Asian countries, the rise in private sector investment was not matched by a rise in private savings leading to a private sector savings-investment gap. This caused the current account deficit to widen from about 3 percent of the GDP in 1988 to 8 percent of the GDP in 1996 which was financed with private capital inflows. That was in fact the

consequence of a comprehensive reform plan initiated by the Thai government with the collaboration of international financial institutions in 1990, aiming to enhance the competitiveness, efficiency, flexibility, and stability of the financial sector⁶¹.

The main component of the reform program was to dismantle interest controls on both deposits and lending rates. Between 1986 and 1992, all ceilings on commercial bank and finance companies deposit rates as well as lending rates were removed. Furthermore, the scope of activities and the portfolio of financial institutions such as insurance, underwriting, and the distribution of debt securities were expanded which lead commercial banks and financial institution to invest in areas about which they had no knowledge nor experience. With the encouragement of the IMF and the World Bank, in 1990, the country relaxed capital controls on foreign exchange regulations in accordance with the Article VIII of the Fund's Articles of Agreement. The establishment of the Bangkok International Banking Facilities (BIBF) in 1992 was the millstone for Thailand's capital account liberalization process which enabled commercial banks and financial institutions to access cheaper finance resources and to increase the level of foreign debt (See Box: 5.1). With the goal of developing Thailand into a regional finance center, various tax incentives were granted to BIBF banks such as lower corporate income tax rate. Because political competition undermined independent monitoring and regulation by the central bank, the number of financial institutions increased. The financial liberalization processes went on expanding the amount of baht and foreign currencies that could be transferred in and out of the country, increasing the amount of bidding of short-term maturity bonds, reducing restrictions on the branching of banks such as lifting the government bond requirement for foreign banks to open banking branches in Thailand⁶².

The liberalization of both capital accounts and the financial system accompanied by an inadequate institutional and regulatory framework resulted in rapid

build-up of vulnerability since it increased reliance on short-term foreign capital flows which rendered Thailand vulnerable to reversals in capital flows and to downturns in economic activity. Removing barriers on the volume of credit regardless of their maturity and of investment fields caused both careless lending such as in real estate and maturity mismatches which made the financial system fragile. Another important component of the program was the pegged exchange rate system which facilitated the vulnerability preceded by the deregulation process. Philippe Delhaise claims that despite the fact that financial liberalization was necessary for the sustainable economic growth of Thailand, this target was incompatible with fixed exchange rate policy. (Delhaise,1998: 85). Medhi Krongkaew also points to the difficulty for the Bank of Thailand to use its monetary policy to promote the stability of the macroeconomic system in a free capital movement system in a fixed exchange regime (Krongkaew, 1999: 405). According to Wade's diagnosis, unsupervised liberalization of a financial system and opening capital accounts are very dangerous when inexperienced banks and non-banks borrow abroad in an environment of fixed exchange rate system (Wade, 2002: 6).

Along similar lines, Joseph Stiglitz emphasizes that the pressure applied for liberalization by international financial institutions and the U.S Treasury before putting regulatory processes into place, caused the growth strategy of the 1990s to be set aside and made the disaster of 1997 inevitable (Stiglitz, 2002: 515).

As a result of the financial deregulation process, Thailand received almost 355 billions bahts worth of capital flow during the 1992-1996 period. But the issue was the pattern of capital inflows rather than the amount. Although other countries such as Malaysia and China received foreign direct investments which were long-term and not sensitive to surges in expectations, capital inflows to Thailand were mostly in short-term maturity and originated from commercial banks and off-shore banking facilities.

6,5 percent bank-sourced capital inflows of total inflows in the period of 1987-1991 rose up to 50,4 percent in the period of 1992-1996 as a result of capital account opening. Differences in interest rates between Thailand and the foreign money market and the pace of economic growth, together with financial liberalization as well as the stable exchange rate of the baht attracted a growing stream of net capital inflows to Thailand⁶³.

The combination of greater availability of credit and lower lending cost caused flows of capital into Thailand which were more than the need to finance saving-investment gap (Table 8). The fixed exchange rate based policy which tied the Baht to the USD was another important component of the above mentioned combination since it eliminated the exchange rate risk for capital flows. As a result of external financial liberalization, Thai commercial banks no longer needed to depend entirely on local bank deposits as the major source of funds for lending, since they could easily and cheaply acquire money overseas through BIBF. Jansen emphasizes that the financial liberalization package of Thailand made the financial system fragile by shifting the composition of capital flows from non-bank originated- foreign direct investments to bank originated- short-term debts as well as by increasing the amount of private debts⁶⁴.

About 20 percent of the loans of commercial banks at the end of 1996 were used to finance real estate, construction, and financial service sectors which are prone to boom-bust cycles. The share of financial institutions in financing the real estate sector was twice as much as for banks.⁶⁵ The natural consequence of this process was the misallocation of loan and the deterioration of loan quality. On the other hand, the borrowing of both commercial banks and financial institutions was short-term maturity whereas lending was for longer terms. Although Thai authorities highlighted that their foreign reserves were sufficient to cover over 6 months import as an

indicator of the strength of the Thai economy, the origin of the increase in foreign reserves was rapid increases in short-term debt. The ratio of short-term debt to foreign reserves increased from 0,6 in 1990 to 1 in 1995 and 1996. This means that any loss of confidence in the Thai economy would cause the disappearance of much foreign reserves as a result of debt recall or of loan cut which put Thailand at great risk.

According to the IMF Country Report (2000), the persistent and widening current account deficits, over-investments, declining rates of return due to interest rate increase in industrialized countries, as well as the sharp decrease in export growth from 24,7 percent in 1995 to -1,9 percent in 1996 as a consequence of the deprecation of the US dollar and Japanese yen appreciation put Thailand's dependency on capital flows under threat. When the perception of a potential crisis started around the end of 1996, speculative attack on the Thai baht took place in February 1997, which was eliminated by the announcement of the Bank of Thailand regarding its intention not to devaluate the baht. Restrictions on purchasing the baht by non-residents and forbidding Thai banks from lending baht in the offshore market imposed large losses on foreign speculators in short position in May could not prevent the speculative attack on the baht from eventually causing its foreign exchange reserves to decline from USD 40 billion in the third quarter of 1996 to USD 26,6 billion by the end of February 1997, which eventually resulted in devaluation on 2 July 1997.⁶⁶ The efforts of the Thai authorities to prevent the crisis did not work because the financial liberalization processes intensified since the 1990s reduced the monitoring supervision of banking operations and transactions as well as the management of financial flows.⁶⁷

The effect of the political system in Thailand at the onset of the crisis cannot be ignored since the policies of the Thai government had a corrosive effect on investor confidence. The Thai political system was characterized by coalition governments and chronic cabinet instability. The prime minister, as a leader of the governing coalition,

was vulnerable to policy blackmail by coalition partners threatening to defect in pursuit of a better dealing in another alliance configuration (Haggard, 2000: 52). It is difficult to take actions decisively within a weak and fragmented political system which is under the effect of the direct or indirect interests of government members in the financial sector. When the Chavalit government of a six-party coalition took office in November 1996, given the country's macroeconomic problems such as widening current account deficits, declining GDP and export growth, Thailand's last financial institution, Finance One, announced that it was in search of a merger with a bank to stave off collapse which was preceded by bankruptcy of the first Thai company, Somprasong Land. However, the government could not take the necessary action to restructure the financial institutions in time because of the interests of Chart Pattana, the second largest party of the coalition, in the suspension of unviable financial institutions. Rather than risking the collapse of his new government by alienating Chart Pattana, Chavalit preferred to compromise and delay measure dealing with the problems in both macroeconomics and the financial sector which resulted in the crisis.

Although political failings and the uncertainties about the capacity of the government to act had contributed to the outbreak of investor's loss of confidence, it was not the heart of the 1997 crisis since the indecisiveness of the government was a common characteristic of all elected governments in Thailand which was underestimated by the IMF at the phase of the crisis management.

Liberalization of both financial markets and capital accounts which was not accompanied by a strengthening of the institutional and regulatory framework led to a rapid fragility in both the financial and corporate sectors through building up of currency and maturity mismatches that rendered Thailand vulnerable to reversal in capital flows and resulted in the crisis of 1997. The IMF had a major role in this process through its approval of Thailand's liberalization process. For instance, the IEO

Report mentions that at the phase of establishment of BIBF, the IMF staff did not make any comments on its implications for capital inflows in documents prepared around this time and paid little attention to the vulnerabilities being created by BIBF which urged banks and non-bank institutions to borrow in shorter-term maturities.⁶⁸

The Thai crisis confirmed the fact that the crises of the 1990s were consequences of premature capital account liberalization in process since the late 1980s increasing vulnerabilities to crisis. Other factors, either economic or political, had a mere triggering role. In this sense, the IMF in fact, contributed to the Thai crisis by neglecting the most important lesson of the Mexican crisis, namely, the risks of rapid liberalization, since it evaluated the Mexican crisis as one that had resulted from the country's own choice of inappropriate exchange rate regime and bad fundamentals.

Evolution of the Crisis

The unexpectedness of the crisis is mostly attributed to the fact that there was no kind of sign in the sense of arguments of both first generation crisis models and second-generation models. The Thai case is striking in the sense of how a highly praised economy had failed. Those who believe in the unexpectedness of the financial crisis emphasize the role of financial panic. According to the study of Steve Radelet and Jeffrey Sachs, foreign capital inflows into financial systems which are very vulnerable to financial panic are at the core of the problem in the Thai crisis (Radelet and Sachs, 1998: 2). Although they acknowledge that the crisis was a combination of several factors, their emphasis is on the role of financial panic among international investment communities which resulted in sudden reversals of capital flows.

However, Corsetti, Pesenti, and Roubini argue that concentrating on financial panic as a cause of financial crisis in emerging markets is a naïve argument because there must be some other factors that lead to change in the expectation of investors, pointing that the panic had its origins in fundamentals. According to them, regulatory inadequacies in the financial sector and close links between public and private institutions were responsible for the corruption and misallocation of resources (Corsetti, Pesenti, and Roubini, 1999a: 4, 1999b:4). Paul Krugman argues that Asia's extraordinary growth would eventually slow down according to the perspiration theory (Krugman, 1997). A faster rise in wages than in productivity and increase in import which led to further trade deficits were regarded as clear signs of the loss of momentum in the economic growth of Asian countries. In this sense, some knew what would happen at the end of the rapid economic growth process. Aaron Tornell argues that it was possible to predict the Asian crisis by looking at the Mexican crisis since the same kind of fundamentals such as banking fragility, real appreciation of currency, and international liquidity of the countries had effects on the severity of the crisis although the timing of the crisis depended on investors' expectations at the final stage (Tornell, 1999).

The combination of massive short-term capital movements and the weakness in the financial and corporate sector, and pegged exchange rates were the recipe for financial crisis as in the case of Mexican crisis of 1994-95. Although the level of domestic savings were high and the inflation rate was stable, capital poured into real estate speculation, the stock market and finance companies, supporting an unproductive boom which did not contribute to the country's growth. Takatoshi Ito states that relying on short-term portfolio investments and loans was the underlying factor of the vulnerability of the financial sector (Ito, 2002: 6). According to the Trade

and Development Report (1998), domestic policies that appear sustainable in conditions of rapid growth and high capital inflows appear less so as capital flows out.

Anne Kruger emphasizes policies and fundamental weaknesses such as current account deficits, domestic credit expansion, and overvaluation of the currency in assessing the East Asian crisis (Kruger, 1998: 20-21). She admits that a more gradual liberalization could have delayed the crisis; but the economic growth of East Asia was impossible in the absence of capital account liberalization. In her view, external factors such as Japan's slow growth and the reduction in demand for semiconductor products which were very important for Thai exports determined only the timing of the crisis in Thailand whose economic fundamentals had already deteriorated. She points out that China, Taipei, Singapore, and Hong Kong had not experienced currency crises although they were within the same external environment (Kruger, 1998: 8-19).

Those who question the effects of domestic factors in evaluating the causes of the crisis also emphasize the role of political factors such as relations among business, government, and financial system, and political uncertainties such as elections, and riots.. Stephan Haggard claims that close business-government relations which were beneficial for the economic growth of Asian countries as long as the partners of these relations were not beholden to particular interests became a source of instability in the long run and could result in crisis (Haggard, 2000: 21). According to Haggard, this shift was due to the increasing concentration of private economic power on the government's decision making process, the involvement of the government in banking and industrial policy, and weakly regulated liberalization of the financial sector. (Haggard, 2000: 33-34). Because many large corporations in Asia are controlled by big families who are also owners of banks, investment decisions and bank financing

could not be made independently which resulted in the misallocation of resources (Ito, 2002: 72).

The Thai financial system has been characterized by commercial banks and financial institutions most of which are banks' affiliates. Another important feature is the concentration of assets and ownership within the banking system that gives the bank owners bargaining power vis-à-vis government. Since most banks were established by business families to help finance their own trading operations, the banking system has been able to resist complying with regulations inconsistent with its economic interests because of its privileged place in Thai political economy. The effect of this power is remarkable especially if the government is in the need of funds to finance its deficits. Thai governments assumed that a more diversified and competitive financial system would better serve the needs of the country, promoting liberalization of the financial system. Giving permission for the licensing of new bank entries and the establishment of BIBF was a reflection of such assumptions which were not accompanied by adequate supervision, eventually leading to excessive risk taking and misallocation of credits.

While the indecisiveness of the government of Thailand was regarded as an important source for compounding economic problems by exacerbating loss of investor confidence, financial liberalization with a weak regulatory system has been admitted to be a precondition for the crisis since the weak and fragmented financial system was a historical feature of the Thai political system. Logarfo and Montinola point out that despite of its legal base to ensure the stability of the banking system and since the 1940s to increase the government's power over banks and financial institutions, the capacity of the Thai government to supervise the system remained limited because of the privileged place of the banks within the system. In addition, Andrew Macintyre argues that cabinet instability was a chronic problem in Thailand

as party leaders were always vulnerable to policy blackmail by coalition partners threatening to defect in pursuit of better deals in another alliance configuration which made it impossible for politicians to agree on economic reforms and to focus on the crisis once it erupted (Macintyre, 1999:1-38) In his view, local politics played a crucial role in the collapse of investor confidence prior to the crisis.

However, as Joseph Stiglitz and Yılmaz Akyüz mention, before the outbreak of the crisis, this political structure characterized by intensive state involvement in industrial policies and in capital markets was the most important element of the growth strategy accounting for the Asian Miracle (Stiglitz, 2001: 519; Akyüz, 2000:10).Therefore, they argue that the government-business-financial institution triangle had enabled the countries of the region to balance borrowing, consumption and over investment by controlling external borrowing and private investments. Stiglitz points that even in the most developed countries as in the U.S, loans to capital markets were either intermediated by government or by government sponsored enterprises, or had government guarantees. According to him, the problem with the East Asian countries was that they became very sensitive to the risks of international markets while liberalizing their economies without improving their risk management strategies (Stiglitz, 2001: 522). In this sense, rather than accusing the government of being indecisive in taking the necessary measures to avoid the crisis or to manage it once it occurred, one should question whether the IMF did take into consideration the features of the Thai political and electoral system while warning it of vulnerabilities and managing the crisis.

The Thai Crisis is once again a crisis of liberalization lacking necessary regulatory measures to manage the speculative attack on the baht. The sudden drop in export growth in 1996 led speculators to think that the Thai government could not sustain current account deficit of 8 percent of the GDP by committing to the fixed

exchange rate. Weakening fundamentals, especially declining export growth and increasing current account deficits raised concerns about the sustainability of Thailand's reliance on short-term capital inflows to finance its current account deficits.

In sum, accumulated weaknesses originated in premature financial liberalization which came to the surface as a result of the sharp decrease in labor intensive export due to wage rises and export in general due to the appreciation of the baht on the one hand, and the devaluation of the Chinese Yuan and the appreciation of the USD against the yen on the other hand. However, all these are impacts, not reasons. They are the impacts of financial liberalization process imposed prematurely on developing countries in favor of high-yield seeking investors.

The Management of the Crisis

There are a number of similarities between the crises that originated in Mexico in 1994 and the Thai crisis of 1997 as well as many differences. Capital inflows preceding the crisis were among the common features reaching 8,7 percent of Mexico's GDP during the period of 1991-1993 mostly coming from the United States. Thailand similarly received capital flows that reached 15,5 percent of its GDP during 1994-1996 which fueled⁰ as mentioned above, the expansion of bank lending in non-tradable sectors. The real exchange rate in Mexico and Thailand had appreciated as a consequence of the pegged exchange rate system and resulted in escalating current account deficits that were financed with short-term capital flows.

On the other hand, regarding macroeconomic fundamentals, Mexico's budget surpluses in 1991 and 1992 turned to a deficit in 1993, while Thailand had fiscal

surpluses in the years before the 1997 crisis. The inflation rate was moderate for years in Thailand while Mexico had struggled to lower it and had managed to reduce it to single digit prior to the crisis. The Mexican crisis began with the depreciation of the peso by the government and was deepened by the concerns of foreign investors about the government's ability to service public debt denominated in dollars which resulted in panic and withdrawal of capital from the country. The crisis was prevented from spreading to other countries in the region with the urgent response of the IMF with the commitment of USD 17,8 billion. The Thailand crisis, on the other hand, started with concerns regarding the fragility of the financial sector and deepened with the inappropriate measures imposed by the IMF to prevent the crisis which resulted in the expansion of the crisis to the entire region.

While defining the Mexican crisis as the first crisis of the twentieth century, Michel Camdessus was signaling the possible occurrence of similar crises. In that respect, the Fund failed not only to prevent the Thai crisis but also caused the crisis to spread to other countries in the region in a very short period, it came to be known as the Asian crisis because of the failure in crisis management.

When the crisis erupted in 1997 July, the managing director of the IMF Michel Camdessus pointed that the IMF was aware of the vulnerabilities of Thailand and pressed for urgent measures in a continuous dialog with the Thai authorities⁶⁹. IMF officials claimed that despite the timely and vigorous warnings of the IMF and others who had foreseen the crisis, Thai policymakers ignored many warnings and did not take action, accumulating large reserve losses and contributing to a deepening of the crisis and to its spreading to other economies in the region. Had the Thai government responded appropriately to the IMF's advice, the crisis could have been avoided or made much less severe. IMF officials mention that declaring their concerns to the public would have provoked the crisis that they were trying to avoid. Stanley Fischer

argues that the necessity to revise the program resulted from the Thai government's unwillingness to make the data regarding its international reserves position public and from its unwillingness to implement the requirements of the program (Fischer, 2001: 11).

Similarly, according to the Nukul Commission Report (1998), the Thai crisis was mainly the result of the insistence of the Thai government on pursuing a fixed exchange rate regime despite slowing economy, declining export growth, weak financial institutions and property market collapse which destroyed foreign investors' confidence in the Thai economy and put pressure on the baht. In addition, the report mentions that the Thai government did not take into consideration the warnings of the IMF officials at the beginning of 1997 and Article IV Consultations' report submitted in March 1997 which emphasized the necessity for changing the exchange rate regime. However, the same report also mentions that the Bank of Thailand had the option of not liberalizing its capital markets in 1990, which was not compatible with the pegged exchange rate system. In this sense, it will not be wrong to claim that the IMF's warning about the inappropriateness of pegged exchange rate system just prior to the crisis was very late.

On the other hand, Thailand had been pursuing the basic principles of the IMF such as liberalization of capital accounts and the financial system as a requirement of integration with the global economy since the 1990s, as well as high interest rates and a pegged exchange rate to attract capital flow to accelerate economic growth. In its annual report of 1997, while the current account deficits were widening, the IMF was praising Thailand's remarkable economic performance and authorities' sound macroeconomic policies which were characterized by high savings and investment, public sector surplus, growing export and manageable debt (IMF Annual Report 1997: 91) Therefore, accusing the Thai government of neglecting the warnings of the

IMF about the exchange rate regime and financial system rather than focusing on the underlying factors at the root of the rapid build-up of private short-term foreign debt liabilities, and a weak financial system which made the country vulnerable to crisis is an inadequate explanation.

Inappropriate prescriptions which caused the revision of the former programs and prevented the necessary precautions from being taken were the natural consequences of the inability of the IMF to understand the nature of the crisis at the very beginning. Evaluating the crisis as a typical balance of payment crisis resulted from the over-borrowing of government leading to current account deficits rather than as a liquidity crisis originated in the over-borrowing of the private sector is an indication of the inability of the IMF in dealing with the crisis. The IMF's own studies admit to its own mistakes in assessing the Asian crisis:

Understanding the nature of the crisis was less clear when the programs were being formulated than it is now with the benefit of hindsight, but some broad aspects of the situation were apparent from the start.(Timothy Lane,1999:18).

Robert Wade, in similar line, argues that misdiagnosing the crisis as a crisis of excess consumption rather than as excess investment and insisting on a domestic austerity package and fundamental structural reforms in return for bail-out funds had made things worse (Wade, 1998: 7).

Given that the crisis was typical current account crisis rooted in government fiscal indiscipline instead of a capital account crisis originating in over-borrowing by the private sector facilitated by capital account liberalization, monetary tightening and fiscal austerity can be seen as sufficient policies to bring the economy to equilibrium. However, the fact that the government ran a budget surplus, inflation was moderate, and central bank reserves seemed sufficient, there was no reason in the context of first generation models to suspect a subsequent crisis. Under these circumstances, increasing interest rates, promoting fiscal austerity, closing insolvent banks and

financial institutions caused falling output, rising unemployment, and further capital flight. Initial attempts of the IMF to respond to the crisis was to arrange a \$17.2 billion support package in August 1997 with \$4 billion from the IMF's own resources attached to tight monetary and fiscal policies⁷⁰.

Although the Fund admits the effect of a combination of inadequate financial sector supervision, poor assessment and management of financial risk, short-term, foreign currency dominated and un-hedged debts, private sector expenditures and financing decisions, it justifies its crisis management prescriptions based on the argument that the crisis was made worse by governance issues and government involvement in the private sector and lack of transparency in corporate and fiscal accounting together with external shocks such as devaluation of the yen and Yuan, and a sharp decline in export (IMF,1999).

The principal articles of the program mentioned in the first Letter of Intent were: 1) to achieve an orderly adjustment of the domestic economy to the sharp reduction in the current account deficit to about 5 percent of GDP in 1997 and 3 percent of GDP in 1998 and to correct the public sector deficit to a surplus of 1 percent of GDP in 1997/98; 2) to ensure positive growth of 2.5 percent in 1997 and 3.5 percent in 1998; 3) to limit rate of inflation to 9.5 percent in 1997 and 5 percent in 1998; 4) to isolate insolvent institutions and ensure the viability of the remaining through recapitalization and supervision. While lending was conditioned to realize these quantitative targets, the IMF determined the financial sector restructuring as the centerpiece of the program (IMF, Press Release 1998).

The first Letter of Intent signed in August 1997 highlights the causes of the crisis as problems in the financial sector and huge current account deficits while admitting the adverse effect of the combination of a fixed exchange rate, an increasingly open capital account, and high domestic interest rates to combat inflation

which left the economy vulnerable to sudden shifts in market sentiment and external shocks on the crisis (Letter of Intent, 1997).

Therefore, restoring confidence, stabilizing the currency, stemming capital outflows and strengthening the financial system which were presented as closely interlinked and inevitable in order to overcome the crisis were described centerpieces of the stabilization program. However, the IMF's emphasis on difficulties in the financial sector as root causes of the crises and the necessity of the return of capital flows for the recovery process did nothing but mask the reason at the heart of the crisis: namely, premature financial liberalization which ended in failure. However, the IMF failed to manage the crisis which resulted in its contagion to the entire region that is known as the Asian Crisis.

The first failure of the IMF in managing the crisis was to handle the Thai crisis as it did Mexican peso crisis of 1994 which originated in the public sector. However, the issue in Thailand was private sector originated over-borrowing. Thus, the policy measures designed to rein in government overspending made things worse.

The IMF also failed to stabilize currency and restore market confidence. The assumption of the program makers was to restore confidence in markets and attract private capital flows through official financing and current adjustments. The IMF seemed to believe that raising interest rates and promoting fiscal austerity would calm down investors and persuade them to keep their resources in the country, eliminate panic, stop further devaluation, increase the price of domestic financial assets, and compensate downward pressure on aggregate demand stimulating investments. In this respect, the program repeated the pattern of the Mexican bailout of 1994. Cleaning up the financial sector by closing unviable financial institutions and permitting foreign institutions to operate in the domestic market was another strategy for regaining

confidence in markets. However, the performance of the first initiation to respond to the crisis was a failure in terms of restoring confidence.

As the Mexican crisis had demonstrated, restoring confidence and preventing further capital outflows are very crucial to achieve stabilization. This goal was also clearly set at the very beginning of the first letter of Intent of Thailand signed in August 1997 and repeated in each letter of intent:

The package is focused on upfront measures that are expected to restore confidence early, stabilize the currency, stem capital outflows, and strengthen the financial system (Letter of Intent, August 1997).

Despite the importance of restructuring the financial sector for stabilization and sustainable economic growth, announcing that there were still unviable financial institutions while many financial institutions were struggling to remain solvent and overemphasizing the importance of restructuring and recapitalizing the financial sector at the very beginning of the economic recovery that had no other effect than worsening the situation is really striking in rethinking the role of the IMF in crisis management.

In the further articles of the second letter of intent, the restoration of confidence in the financial sector was mentioned as a major plank of the program; however, isolating unviable financial institutions in the name of restoring confidence, in Jeffery Sachs' words, was a kind of approach that was nothing but screaming fire in the theatre, together with proposing high interest rates, budget cuts, and immediate bank closures (Sachs, 1997).

The major task of the IMF as crisis manager is to restore confidence by providing liquidity both direct and through catalytic effect on markets. The success of the program depends on to what extent the qualitative and structural targets set within the program are consistent with this general purpose. The first quarter of the 34-

month program was a failure according to this perspective which was mentioned clearly in the second letter of intent:

....the slower return of confidence has further depreciated the exchange rate, put pressure on interest rates, and is resulting in a much sharper decline in private investment and consumption than originally anticipated. (Letter of Intent, November 1997)

Furthermore, targeting fiscal surplus for Thailand which had not suffered from budget deficits severely and even run fiscal surplus before the crisis is a reflection of a “one size fit all” approach. Larger slowdown in economic growth, a larger than expected depreciation of the baht, and further capital outflow were clear signs of the underestimation of country specific conditions. The IMF ignored the fact that Thailand had no high inflation or any expectation of inflation after the crisis while imposing tight monetary and fiscal prescriptions as it had offered Mexico which suffered from high inflation. Interestingly, a G-24 discussion paper (2001) acknowledged that the tightening of macroeconomic policies exacerbated rather than checked the crisis, emphasizing the inability of the IMF in terms of both estimating the severity of the crisis and in designing optimal policies in response to the crisis.⁷¹ The main argument of the paper is that making mistakes in understanding causes, raising interest rates, cutting government expenditures, and closing banks in response to the crisis served to turn what started of as currency crisis into a full-fledged financial crisis and economic recession in 1998 (K.S.Jomo, 2001: 23). Since the IMF approached the crisis as if it was due to weaknesses in macroeconomic and financial system despite sound fiscal balance before the crisis, its prescriptions undermined rather than restored the crisis. The best indicator of decreasing confidence was seen in the risk premium of Thai Eurobonds. According to the G-24 paper, following the devaluation in July 1997, the risk premium increased by 10 basis points, whereas they jumped four times as much with the acceptance of the IMF program in August 1997⁷².

The urgent need of Thailand seemed to be roll-over short-term liabilities of banks which were almost \$US30 billion as mentioned in the first letter of Intent. Given the fact that the total amount of short-term external debts were \$US 38 billion and almost all international reserves had been depleted, the IMF's 17,2 billion package which would be drawn over a period of 34 months and was highly conditional was far from generating confidence in markets. Furthermore, using interest rates in order to prevent further capital flow did not keep the investors staying in Thailand but also compounded the burden of outstanding debts which resulted in both the ratio of indebtedness and level of non-performing loans. According to Stiglitz, the IMF imposed a program on crisis-hit Asian countries that even a country with one of the best business environment, namely the U.S., could not accept. Stiglitz points to President Clinton's opposition to the demand of Federal Reserve Bank's a half point rise in interest rates due to the adverse effects of rising interest rates on unemployment and economic recovery during his term (Stiglitz, 2002: 109). That was the major mistake in Stiglitz's view. The second one which was as important as the first one was to insist on closing unviable banks and demand banks and financial institutions to meet capital adequacy ratio on behalf of restructuring the financial sector in the midst of the downturn (Stiglitz, 2002: 115-116). Stiglitz claims that the mistakes made by the IMF were not due to misdiagnosis of the causes; but due to the fact that the IMF approached the crisis in accordance with the interests and ideology of the Western financial community. That is why the IMF prescription for Thailand was not very different from that for Mexico.

On the Thai side, there was no another way but to follow the prescription of the IMF because she was in crisis and any dispute with the IMF was perceived as compounding the loss of investor confidence. In that sense, the country was bounded

with to IMF's program which further damaged creditor confidence and exacerbated the effects of financial ruin.

Although the IMF did not explicitly condition liberalization for financial assistance, its commitment to promoting liberalization was the dominant thought even in the midst of the crisis as understood from Thailand's several letters of intents. The Thai government committed to remove temporary controls on the exchange restrictions and purchases as well as on sales of bahts by non residents in the first Letter of Intent signed in August and repeated this commitment in the revised letters approved in February for the stabilization of the baht and to restore confidence.

Since the crisis was presented as having originated primarily because of the difficulties in the financial sector without questioning the root causes of these difficulties, the restructuring of the financial sector and return of the capital flows were emphasized as inevitable for the recovery process. Although the highlight of the rescue package for Mexico was similar to that of Thailand, since the priority was given to inject liquidity led by the U.S to the Mexican markets on behalf of regaining confidence, Mexico had accessed international financial markets in a very short period and achieved a V-shape recovery process as opposed to Thailand. However, in Thailand, lending had been conditioned on fulfilling the requirements of the financial restructuring process which in the short run could bring about neither confidence nor recovery in macroeconomic indicators. In view of G-24 Discussion paper by K.S Jomo (2001), IMF was more generous in helping Mexico because of the United States' interests in ensuring that the tequila crisis should not be seen as an adverse consequence of Mexico's joining the NAFTA⁷³. In the Asia crisis, however, the IMF gave the priority liabilities and other commitments to Western and Japanese banks rather than to crisis afflicted countries' people.

According to Fernando Carvalho, while the short term goal of the IMF was to stop panic during the crisis, its larger strategy was to redesign the economic system of the client country in the image of the U.S., adding liberalization of markets, privatization, commercial and financial opening within letters of intent in accordance with the Washington Consensus (Carvalho, 2001:6,12). That the IMF insisted on the Chuan administration to amend the Alien Business Law, as well as the other associated laws, aimed at liberalizing foreign investment limits in non-financial sector is a reflection of the fact that the IMF evaluated the crisis as a typical balance of payment problem⁷⁴.

Its insistence on further capital account openness and the privatization of key state enterprises such as telecommunication, transportation, energy, and communication have been considered as tailoring the dress of the public sector crisis to that of the private sector. However, the Thai crisis was different from the previous IMF- stand-by arrangements in that the Thai crisis was not a public profligacy since there was a balance between public expenditures and revenues.

According to the explanation of Robert Wade and Frank Veneroso, the Asia crisis was a by-product of consensus among Wall Street, the U.S Treasury, and the IMF. In their explanations, the interests of the owners and managers of international capital required the IMF to impose reforms in one way or another by further opening up Asian economies. Instead of rescheduling the outstanding debts of Thailand, organizing a financial assistance package attached to several structural reforms was clear evidence of the fact that the IMF's main concern was to save its donors' loss. Robert Wade questions the IMF's insistence on capital account opening in countries that had already been awash with domestic savings such as Thailand (Wade and Veneroso, 1998: 1547). Wade mentions that on the one hand, the U.S' needs to maintain high levels of consumption and investment without causing recession, on the

other hand, the needs of Wall Street's banks and brokerage firms to expand their sales by doing business in emerging markets, put capital account liberalization on the agenda of the U.S' foreign policy (Wade, 1998:4). Efforts to revise the IMF's articles of agreement, adding capital account liberalization as a condition of membership and IMF's emphasis on further capital opening as a condition of loans for Thailand as for other Asian countries were the clear evidences of this policy. A testimony by Alan Greenspan on the Asian Crisis reflects that concern:

... many of the leaders of these countries and their economic advisors are endeavoring to move their economies much more rapidly toward the type of economic system that we have in the United States. The IMF's current approach in Asia is fully supportive of the views of those in the West who understand the importance of greater reliance on market forces, reduced government controls....(Greenspan, 1998)

For the IMF, since capital account liberalization does not create a risk for developing countries and market-friendly policies discipline the operation of the financial system, the problem in Thailand has not been considered as related to rapid liberalization of the financial sector. As none of the fundamentals in terms of "first-generation" models seem to have been present in any of the afflicted Asian economies, IMF's traditional response to the Thai crisis could not provide the country with a well-managed recovery process. Stanley Fischer clearly admits the failure of the IMF in dealing with the crisis:

On the macroeconomic side, we would probably not have asked for as much fiscal tightening as we did initially—though that request was soon reversed in the Thai and other cases (Fischer, 2001:12).

The Fund's later assessments on crisis management acknowledge the fact that the fiscal policy was tighter than necessary.⁷⁵ In his testimony to the Institute for International Economics, John J. LaFalce also admits that even the U.S could not comply, economically, socially, or politically to cut the budget deficit by 1.5 percent

of GDP in five months, it was a mistake for the IMF to impose tax increases or budget cuts for the Asian countries during the crisis while arguing one size would not fit all.⁷⁶

While emphasizing that the IMF does not simply apply the same prescriptions for East Asia, referring to the structural aspects of the programs in response to critiques of the IMF, Jeffrey Frankel admits that the IMF was overoptimistic about program targets at the very beginning regarding economic growth and budget surplus which would be modified later. (Frankel, 2000:336). However, he argues that the IMF was right in pushing countries to implement fiscal and monetary austerity measures as well as structural reforms, emphasizing that the crisis was a historic opportunity to get them to undertake important structural reforms that they would not otherwise have done.

Although at the very beginning of the crisis, it was perceived as a typical financial panic disaster, it revealed the necessity of being careful in sequencing the capital account liberalization. Capital account liberalization without a framework of regulation was perhaps the single most irresponsible action of the whole crisis. Since the detrimental affects of rapid and premature liberalization on emerging market countries have been experienced many times and the Asian crisis was one the best examples of this fact, the IMF re-invented liberalization, emphasizing the notion of orderly liberalization. Stanley Fischer points to this issue just after the Thai crisis:

...that an amendment of the Fund's Articles of Agreement is the best way of ensuring that capital account liberalization is carried out in an orderly, non-disruptive way, that minimizes the risks that premature liberalization could pose for an economy and its policymakers (Fischer, 1997).

The international community appears to have reached a consensus on the fact that liberalization is not good for economic growth under certain circumstances. Stanley Fischer emphasizes that adopting market-friendly controls such as reserve requirements on foreign deposits, restrictions on the open positions, or controls on

capital outflow which should be removed gradually at a certain level of economic development can help to minimize the burden of rapid liberalization in developing countries, In Nicola Bullard's words, the crisis in Asia was a crisis of international institutions, particularly of the IMF, since it prescribed wrong medicine for recipient countries.⁷⁷ However, Fischer puts all the responsibility on the shoulders of national governments, arguing that it is ultimately the government that has the duty to evaluate the situation and make the right decisions. According to him, the responsibility of the IMF is to provide information, analyze the situation, and make suggestions.

The general argument of the IMF is to put the blame on national governments for implementing unsound macroeconomic policies prior to the crises and for not committing to its prescriptions properly. However, as Medhi Krongkaev points, Thai authorities took the necessary steps to reduce the adverse effects of excessive short-term capital inflows on the economy (Krongkaev, 1999: 405-408). When the Thai authorities realized that short-term capital inflows had become excessive, they introduced some measures to discourage such inflows. Issuing deposit requirements of 7 percent for nonresidents' baht deposits in commercial banks with maturity for less than one year in 1995 August, putting the same requirement for financial institutions in 1996 April, and expanding deposit requirements to short-term external borrowings on gross basis for commercial banks and the Bangkok International Banking Facility (BIBF) in June 1996 were official policy responses to reduce the vulnerabilities of the Thai economy which resulted from excessive short-term financing. As a result of these initiations, the percentage of short-term capital flows decreased sharply after 1995 (Table 8).

Responding to questions concerning with problems in Thailand, Michel Camdessus mentioned that the IMF was closely monitoring what the Thai authorities were doing and pressing them to take additional steps.⁷⁸ The IMF, despite its concern

regarding delays in financial sector reform, praised the Thai authorities for complying pretty well with all the macroeconomic elements of the program, budget measures, monetary measures, and exchange measures.⁷⁹

The Thai crisis demonstrated that whether the crisis affected countries are able to implement the reform packages is as important as whether these reforms are needed, which has a significant effect on investors' confidence to overcome the liquidity problem. Setting the sequence and timing of the reforms and the priorities of each stabilization program requires understanding the country's specificities very well. What makes the IMF-supported stabilization programs look alike as well as be ineffective in addressing the crisis is the lack of this perspective. The Thai crisis has once more revealed that the IMF failed to warn the countries adequately of vulnerabilities and its response was centered on regarding the crisis as one of government profligacy, as in the Mexican case.

One of the most important lessons drawn from both the Mexican and the Thai crises was that financial liberalization has catastrophic effect on the economic welfare of developing countries if it is urged without the structuring of an efficient regulatory system, especially in countries which have adopted fixed exchange rate system to control inflation. Since financial liberalization reduced national monitoring and the supervision of banking operations and transactions as well as management of financial flows, it was at the root of both crises. As the Asian crisis demonstrated, even sound macroeconomic fundamentals cannot guarantee freedom from crisis since financial markets are driven by investors' sentiments as much as by economic fundamentals in a financially integrated international system. Since financial liberalization was used as a way of cheaper financing for domestic borrowers, private or public, and for obtaining higher arbitrage profits for foreign investors, these eventually made two countries reliant on short-term borrowing to finance their current account deficits.

In fact, assessing the recovery process and the role of the IMF by looking at improvements in macroeconomic fundamentals does not seem to be very meaningful since macroeconomic fundamentals were not the causes at the root of the crisis and since approaching the issue in this vein requires a one size tailored model view. However, the IMF failed not only in diagnosing the crisis but also in forecasting its targets as a consequence of its inability to understand the crisis. The implementation of the standard prescriptions for the recovery process in Thailand clearly reflects the fact that the IMF regarded the crisis as a consequence of structural weaknesses and internal imbalances inherent to the way Asian economies were organized, rather than as a consequence of global financial fragility. The natural consequence of this assumption was to design a program stabilizing exchange rates, rebuilding reserves, and reversing capital inflows through tightening monetary and fiscal policies, supported by large scale external assistance from multilateral and bilateral sources to restore investor confidence

Although Thailand followed the IMF prescriptions, its GDP growth recorded its lowest level with about 10 percent decline and it could not reach its pre-crisis level by 2001. The unemployment rate was doubled after the crisis and remained above the pre-crisis rates. Hence, the program not only increased economic deterioration but also exacerbated external fragility through the promotion of liberalization and privatization.

The crisis in Thailand demonstrated that one size does not fit all, since, as the Meltzer Report clearly points out, the causes of the Asian crisis were very different. Cutting government expenditure, raising taxes, raising interest rates, and closing banks aggravated the crisis (Meltzer Report, 2000: 33). Offering tight monetary and fiscal policies which could be appropriate for countries suffering from persistent inflation as Mexico or Turkey-which was not even sufficient on its own as experienced- did not

bear the expected results in Thailand since higher interest rates do not necessarily serve higher returns but also lower spending which result in income reduction and the burden of borrowing.

In fact, the IMF diagnosed the distinguishing features of the Thai crisis as understood from the introduction of the first letter of intent of Thailand:

.....in recent years the combination of a fixed exchange rate, an increasingly open capital account, and high domestic interest rates to combat inflation, attracted short-term capital flows that left the economy vulnerable to sudden shifts in market sentiment and external shocks.”(Letter of Intent, August 1997).

Nevertheless, as Fernando Carvalho argues, the short-term adjustment policies which were recommended were identical to those proposed to conventional cases of excess demand imbalances (Carvalho, 2001: 7).

Wade argues that a sharp dose of austerity may make sense for Latin American style excessive consumption crises whereas increasing interest rates for reversing the currency falls in Asia worsens the existing problems of excessive capacity (Wade, 2002: 16). On the other hand, Thailand did not have much chance, as opposed to Mexico who obtained the direct assistance of the U.S in dealing with the crisis of 1994. Although Japan offered to establish the Asian Monetary Fund (AMF) to help the countries in the region, the U.S strictly opposed this for fear of being excluded from any creation that might threaten its power on the global economy (Wade, 2002: 17). While during the Mexican crisis the U.S was directly involved in the crisis resolution process to prevent the contagion of the crisis to other countries in the region, the U.S’s response to Thai crisis was to avoid direct participation in the requested and to reject the Japanese proposal which was perceived to be a threat to the monopoly of the IMF and the basic principles of the Washington consensus of rapid deregulation, reducing the role of the state, and liberalization of capital flows.

Eisuke Sakakibara, former Ministers of finance of Japan, mentions that the U.S strongly opposed to the creation of the AMF on the grounds that it would undermine the discipline imposed by the IMF and pose moral hazard problem.⁸⁰ On the other hand, Sakakibara believes that the American reaction was driven by its perception that Japan was posing a challenge to American hegemony in Asia through the AMF.⁸¹ It is understandable for the U.S, who is a defender of financial liberalization as a means to secure the financial interests of its own multinational and financial corporations to oppose a Japanese based creation which focuses on the regulation of financial systems through means such as capital control and better oversight on financial markets⁸².

The potential threat of an AMF creation had been clarified by Fred Bergsten, in a testimony to the Committee on Banking and Financial Services on the causes of the Asian as following⁸³:

That sequence of events in turn led directly to Japan's proposals for an Asia-only "Asian monetary fund," which would exclude us from the most crucial area of cooperation with (what are still) the world's most dynamic economies (as well as the largest potential source of security problems). The costs of any such outcome, to the broad national security as well as economic interests of the United States, would play out over many years and could be huge.

The U.S did not intervene directly in the crisis as it did in Mexico; however, it did not want any regional creation that could lessen the supervision of the IMF. Regarding alternative measures of crisis management, the Malaysian experience is remarkable. Although it has been argued, for example, by K.S. Jomo (2005), Ethan Kaplan and Dani Rodrik (2001) that Malaysia could have been better off in the immediate aftermath of the crisis following the IMF-prescribed path rather than following its own path based on controls on short-term capital outflows accompanied with pegged exchange rate regime and capital controls did not play a significant role in her recovery process, the Malaysian case has demonstrated that there are alternatives to capital account liberalization which do not have adverse effects on

investors' confidence. Furthermore, compared to the IMF-sponsored program in Thailand, Malaysia made far more progress in terms of both growth and employment and wages⁸⁴. It is a good example of the idea that investor confidence can be restored without rising interest rates or closing unviable banks.

Stiglitz argues that as Malaysia's capital controls allowed it to recover more quickly following an independent course rejecting the IMF strategy, China averted the crisis by taking a course directly opposite to that advocated by the IMF (Stiglitz, 2002:125-126). Nevertheless, the Fund did not link the recovery in Malaysia directly to capital control regime, stressing the contribution of the stabilization in the currencies of the region and the relative undervaluation of the ringgit resulting in a large balance of payments surplus which compensated for the potential negative effect of capital controls.⁸⁵ For instance, Stanley Fischer argues that capital controls served to reduce the willingness of foreign investors to invest in Malaysia and reduced the opportunities of Malaysian citizens to interact with the world economy which became unworkable in the long run.⁸⁶ Hence, since the IMF strongly believes in the basic argument of the Washington Consensus that liberalization promotes economic growth for all countries, it did not recognize that short-term capital account liberalization contributed to the Thai crisis and pushed reforms that diminished the role of the public sector in the economy and opposed any creation or policy contrary to its general idea.

The IMF, while pointing to the importance of the gradual liberalization of financial systems, strongly believes that freedom of capital movement would promote impressive growth performance in developing countries and at the final stage also benefits industrialized countries, and stresses the unacceptability of any phased approach that leads to undue delays in capital account liberalization.⁸⁷ However, the Fund does not give a clear explanation regarding how developing countries can

reconcile the requirements of capital account liberalization imposed on them with those requirements necessary to strengthen their financial systems.

The Turkish financial crisis of 2000-01 was another episode of the IMF's commitment to imposing capital account liberalization even though the costs of the rapid deregulation process in emerging market countries were acknowledged after of the Asian crisis. The IMF admitted the detrimental impacts of premature financial liberalization on Asian Countries and emphasized the importance of orderly liberalization to minimize the cost of liberalization and the possible recurrence of crises⁸⁸. On the other hand, the Fund keeps on committing to promotion of openness of capital movements on the ground that its benefits are undeniable and the liberalization trend is irreversible.

Despite the importance of domestic factors in both the Mexican and the Thai crises in making those countries vulnerable to the crises, short-term capital flows accelerated by rapid deregulation process which was urged by international financial community had a significant impact on the occurrence of the crises. In this sense, the Turkish financial crisis is a good example in showing the difference between the IMF's declarations and actions. While blaming the Mexican and Thai authorities for implementing contradictory monetary and exchange policies, the IMF on its own approved a program using the exchange rate as anchor to diminish inflation in a prematurely liberalized economy notwithstanding the clear evidence of the adverse effects of exchange rate based adjustment programs in deregulated and weak financial systems which eventually contributed to the crisis of 2000-2001.

The following chapter shows the fact that the IMF did not handle the difficulties in a different way, but rather suggested the same solutions as for with crisis-hit countries even though Turkey was not in crisis when it approached the IMF.

CHAPTER 6

THE TURKISH FINANCIAL CRISIS OF 2000-2001

The purpose of this chapter is to analyze the role of the IMF in triggering the crises of November 2000 and February 2001 in Turkey which were preceded by a disinflation program launched in December 1999. In this general framework my aim is to show that the crises were the inevitable consequences of the IMF-directed disinflation program which was totally in accordance with the basic principles of the Washington Consensus. I have evaluated the November 2000 and February 2001 crises as a single crisis since both had its origins the IMF-sponsored stabilization program. Although I admit the effects of economic and political weaknesses in Turkey which have a destabilizing role on its economy, the aim is to show to what extent the crises are linked to the IMF-led disinflation program of Turkey.

One of the biggest problems of the Turkish economy has been high and chronic inflation since the 1970s which has been on the agenda of all governments aiming at reducing it. After the elections in 1999, the new government of Turkey announced an extensive disinflation program in December 1999 backed by a Stand-by Agreement approved by the IMF, aiming at lowering the inflation rate to a single digit by the end of 2002. However, the program had to be abandoned 14 months after its introduction because it resulted in the most severe crisis Turkey had ever experienced.

In this chapter, I will mainly discuss that the crisis of 2000-2001 was a design - rather than an implementation- flaw within the framework of structural weaknesses inherent to the disinflation program, evaluating the domestic economic and political

conditions before the crisis and comparing the Turkish crisis with the Mexican and Thai crises.

The importance of the crisis of 2000-2001 is many folds: First of all, the crisis occurred at a time when an IMF program was being implemented. That makes it a matter of design flaw. Secondly, the IMF usually, as in the East Asia crisis, accuses crisis afflicted countries of being too late to ask for help to manage the crisis and it justifies the imposition of tight fiscal and monetary policies based on this argument. This claim does not make sense in the Turkish context as Turkey had applied to IMF assistance to stabilize its economy before the crisis erupted. However, the program involved the same prescription; cutting expenditures, increasing taxes, and imposing privatization. Furthermore, the Fund put the fixed exchange rate system at the center of the program although the demise of the exchange rate based stabilization program had been experienced before by Mexico and Thailand.

I do not claim that there would have been no such crisis in Turkey if such a program had not been initiated. However, given the fact that the program was introduced to stabilize the economy and to prevent a possible crisis, it served to exacerbate the severity and likelihood of a crisis rather than preventing it due to the neglect of vulnerabilities prior to the program. Understanding whether the corruption of the program resulted in crisis due to errors in implementation or as a the result of the internal inconsistencies and flaws in the design of the program is crucial in order to assess the role of the IMF in terms of crisis prevention as well as assessing its role in triggering the crisis of 2000 and 2001. Even though the crisis was a result of implementation errors, this does not necessarily mean that the program was designed perfectly, as a well designed program requires forecasting the ability of a country to ensure the implementation of the program given conditions prior to the crisis. Turkey's IMF-directed program was far from that perspective.

Conditions Prior To the Crisis

The year of 1999 was a very interesting year for Turkey. First of all, it was election year. After the general elections in April, a three-party coalition government- Democratic Social Party (DSP), Nationalist Action Party (MHP), and Monetary Party (ANAP) - took the office. Each of them has different ideologies and the first two represents low-level income groups of the society. Turkey experienced two major earthquakes that caused an important burden on its economy. It was also an important year in terms of Turkey's accession process to the European Union.

Turkey, as other developing countries in the scope of this study, began opening up its economy in the 1980s after the crisis in the late 1970s resulted in import-substitution development model. Reducing the weight of the state in economic affairs through the elimination of controls over imports and some key prices were thought to accelerate economic growth, with the encouragement of international financial institutions such as the IMF, and the World Bank⁸⁹.

The first attempt was to eliminate interest controls on deposit and loans in 1980, which ended with the failure of six banks in 1983 and 1984. Therefore, the Central Bank of Turkey took control again of interest rates. Throughout the financial liberalization process, the year 1989 was a turning point in which foreign exchange operations and international capital movements were made entirely liberal and Turkish lira became convertible (See Box:6.1). However, Turkey could not capture the benefits of financial liberalization policies in terms of attracting foreign direct investments which were very important for economic growth and for more employment opportunities⁹⁰. While the goal of capital account liberalization was put forward as further integration with the international market, the easing financial

constraints on public expenditures was stated to be the important factor underlying this decision. Contrary to expectations, the deregulation of capital movements exposed the economy to the effect of the short-term capital flows, since such flows have been very sensitive to the net differential between the domestic and foreign interest rate and caused the loss of the Central Bank's authority on monetary policy which made the rate of currency depreciation out of the control of the Central Bank of Turkey.

The study of the Central Bank (2002) clearly points that as the basics were not set properly before the economy opened up, Turkey's experience with financial liberalization was characterized by volatile economic growth, increasing uncertainties, high indebtedness, and deteriorating income distribution that made economic activities dependent on the availability of foreign financing mainly in the form of short-term capital⁹¹.

Ziya Öni argues that the crises in 1994 as well as in 2000-2001 have their origins in the premature capital account liberalization decision taken in 1989, which was an outcome of the electoral concerns of the ruling party (Öni , 2004). The initiation of financial liberalization, which aimed for further integration with international capital markets to accelerate economic growth and to decrease both inflation and interest rates, was premature since the liberalization process had been initiated without establishing a regulatory framework in line with political concerns and in an environment of weak and fragmented political system. As a result, the government had the opportunity to finance its deficits through an alternative way, which eventually led the economy back on short-term capital inflows -hot money- which were considered as sustainable forever. On the other hand, the sustainability of the demand for government securities in the absence of a program aiming at reducing public sector requirements led government to increase interest rates which in turn increased vulnerability of the banks.

As Ziya Öni argues, financial liberalization altered the way of financing of the public deficit by presenting the government with the opportunity to borrow domestically (Öni , 2003:7). The Turkish banking sector played a key role in this process, and detached from its traditional functions, started to act as arbitrage seekers. The public sector borrowing requirement affected the banking sector unfavorably, changing their assets and liabilities management.

Once again premature financial liberalization exposed the economy to crisis risk by accelerating to reliance on short-term speculative capital which is volatile and very sensitive to herd-psychology. The fragmented coalition governments of the 1990s could not take the necessary measures to regulate the banking system and provide fiscal stabilization. One of the reasons for the indecisiveness of governments can be attributed to the ideological differences among the members of the coalition government and to electoral concerns; but more important than this is the dependency of the government on bank financing.

Turkey, since the financial liberalization of its economy in 1989, has been subject to four main financial crises, three of which originated internationally. The crisis which took place in 1994 in Turkey, The Mexican Crisis in 1994, the Asian crisis in 1998 and the Russian Crisis in 1999, whose effects were costly to all emerging markets because the crises were preceded by sharp capital outflows, which were not trivial for the economic growth of those countries.

In sum, the disinflation program of Turkey was initiated in an environment in which both economic and political conditions were unfavorable. Whether taking into consideration these unfavorable conditions was a crucial aspect in terms of the success of the program, and to what extent the policies and program targets were consistent with each other will be evaluated within the framework of the stabilization program.

The Stabilization Program of 1999: A Design Flaw

Turkey signed a letter of Intent in December 1999 with the IMF which aimed to reduce inflation and provide sustainable economic growth through a three-year standby- agreement. This was the 17th stand-by agreement with the IMF. The centerpiece of the program was the fixed exchange rate, differing from previous exchange based stabilization in having a pre-announced exit strategy aiming at achieving a smooth transition to flexible exchange rate system. Pre-announcing exit strategy from the pegged exchange rate system was included into the program to limit the risks encountered in other countries with exchange rate based monetary policies.

The aim of the program was stated as freeing Turkey from inflation and enhancing the prospects for growth and for a better standard of living for all parts of the society.⁹² Within this general context, fiscal adjustment, structural reform, and exchange rate commitment were set as the main pillars of the program. Exchange rate commitment which was supported with appropriate income policies was regarded as the backbone of the program that would make disinflation and growth possible at the same time. Creating primary surplus which was set as 3,7 percent of the GDP for 2000-2002 and privatization incomes calculated as 3,5 percent of the GDP for 2000, 3,4 percent and 2 percent for 2001 and 2002 respectively were identified as necessary to reduce the public borrowing requirement which had been regarded as the main factor behind high and chronic inflation in Turkey. Together with additional tax revenues, the ratio of public debt to GDP was projected as 58 percent, 56,5 percent, and 54,75 percent of the GDP for 2000,2001, and 2002 respectively.

According to the program, an exchanged rate pegged to a weighted basket of foreign currencies (0,77EUR+1USD) would be implemented through 18 months

without a band around the exchange rate. The value of the basket would increase by 20% in 2000 which was set in line with the year end WPI rate. At the end of the 18 July 2001, there would be a shift to a flexible exchange rate which could float within a band and progressively widen for the period 2000-2002.⁹³ The backbone of the program was pre-announcement of the exit from fixed exchange-rate based system to deal with inflationary inertia of the years. In sum, Turkish authorities, like the Mexican authorities, gave priority to lowering inflation to single digit figures, and saw the exchange rate regime as a very valuable tool for this purpose.

Another important leg of the program was the no-sterilization rule for the Central Bank of Turkey, limiting the amount of international reserves defining floor levels and that of net domestic assets defining ceiling levels as a requirement of performance criteria. Although the Turkish stabilization program seems to take into consideration the shortcomings of the previous exchange rate-based stabilization programs, both announcing exit date from pegged exchange rate system and controlling the international reserves of the CBT, the program left the economy defenseless against speculative attacks on currency and sudden stops of capital flows which was a very familiar consequence in the Mexican and the Thai crises. Erinc Yeldan argues that pacifying the role of the CBT and leaving the liquidity generating mechanism to speculative short term capital flows in the name of good governance was a big design flaw which had been over-looked by IMF's experts.⁹⁴

Yılmaz Akyüz and Korkut Boratav point out that the Turkish crisis has a number of features common to crises in emerging markets that implemented exchange-rate based stabilization programs leading to currency appreciation and relying on capital inflows attracted by arbitrage opportunities to finance growing external deficits. The program followed a similar path to those implemented exchange rate-based stabilization programs (Akyüz and Boratav, 2002). They argue that the

corruption of the disinflation program before inflation is taken under control and the ceasing of capital flows in a very short period in Turkey as opposed to other countries are regarded as clear evidences of shortcomings in the design of the program. Notwithstanding structural problems and fragilities in the Turkish banking sector whose earnings heavily dependent on arbitrage gains originated in spread between interest rates on Treasury bills and nominal exchange rate devaluation associated with inflation, the program compounded the difficulties of the banking sector which was vulnerable to disinflation.

Design Flaws Regarding Banking Sector Fragilities

The 1999 disinflation program seems to be coherent in its own context since it took into consideration the shortcomings of the pegged exchange rate based disinflation program in Mexico. However, given the fragilities of the Turkish financial system as well as the political environment, the program underestimated the fact that the Turkish banking sector was operating in an environment of high inflation, arbitrary regulation and monitoring, and the acute political influence of state banks which opened the way of the financial system to wait for a few triggering effects to lead to a full-blown crisis.

Turkish banks were used to operating in an environment of persistent inflation which led them to obtain arbitrage profits. The Turkish financial sector did not perform the traditional role of intermediation, directing savings into investments, and functioned to increase government borrowing rates which was more profitable because of high interest rates pushed by the government in the name of sustaining borrowing. They were financing government budget deficits by opening short positions.

Deregulation and deposit insurance guarantee without effective supervision made the banking sector dependent for their earnings on high inflation and high interest rates by lending to the government, which had become the single most important borrower in the domestic markets.

Emre Alper and Ziya Öni summarize the features of the banking sector prior to the stabilization program using the terms of “duty loss” and “open position” which were behind the high interest and inflation rates (Alper and Öni , 2003).

Subsidized lending in the agricultural and in small-medium sized business sector, extending loans to state enterprises which ultimately became non-performing loans by the state banks was covered as duty losses which in turn resulted in costly and heavily borrowing for them⁹⁵. The state banks were under the control of politicians and had been used to finance their populist activities.

Open position was a consequence of the operations of private banks taking short foreign exchange positions through borrowing in foreign currencies to finance long-term local government securities which resulted in maturity and currency mismatches. In such an environment, the pegged exchange rate stabilization program served, especially private banks, to take much more currency risk through opening short positions. Maturity mismatches was another structural weakness inherent to the Turkish financial system. While the shortest maturity for government security was 15 months, 99 percent of liabilities of banks prior the program were based on over night repo.⁹⁶.

Open foreign exchange positions together with maturity mismatches were the consequence of the absence of an efficient supervisory system that limits over-borrowing. Erinç Yeldan and Ahmet Ertu rul emphasize the fragility of the banking sector, pointing to the fact that the ratio of short-term debt to central bank’s reserves was not under 100 percent for years, while it should not have been above 60 percent.

Within this framework, the Turkish financial system was within the danger zone for a decade (Yeldan, 2002:6; Ertu rul and Yeldan, 2003: 5).

Emre Alper argues that what makes Turkey different from other emerging market countries is not the lack of regulatory arrangements but weak implementation of rules in practice because of political influence (Alper, 2003: 10). For example, the supervisory system was under the mandate of both the Central Bank and the Treasury until the Banking Regulatory and Supervisory Association (BRSA) was established in 2000. However, their policies were prone to political influence due to the involvement of the Economy Ministers in the regulatory procedure and due to the lack of power to confront both the politicians and banking lobbies resisting regulatory actions. In a fragmented political system, it is not possible for the Minister involved to initiate regulatory action (Alper, 2003:10). Since the public sector, in need of financing for its deficits, wanted to have as many banks as possible in the system to meet its financing needs, the regulatory authority could not enforce banks to implement certain rules. In a political environment characterized by weak and fragmented party system and unstable coalition governments, the optimal action for politicians and bureaucratic institutions under influence of politicians was to delay actions regulating the banking system. Alper argues that the unwillingness of foreign banks to invest in Turkey was also an evidence of the absence of well regulated and effectively supervised banking system.

The experiences in both Mexico and Thailand demonstrated the failure of exchange rate- based stabilization programs in an era of high capital mobility. In this respect, setting exchange rate as an anchor of the disinflation program of Turkey was the biggest error at the very beginning. Such policy exacerbated current account deficits eliminating currency risk for both domestic and foreign investors which made the country rely on capital inflows to finance its deficit. Pacifying the Central Bank

through no-sterilization rule limited the ability of the bank as a lender of last resort in the case of financial panic. Hence, no-sterilization rule for the Central Bank together with adaptation of the pegged exchange rate system were the main design flaws of the 1999 stabilization program.

As a result of the disappearance of foreign exchange risk which guaranteed arbitrage gains through the program, short-term capital inflow in the form of bank loans and portfolio investments boosted. The first outcome of decreasing uncertainty was a sharp decrease in nominal interest rates and increase in the monetization of the economy which resulted in an increase in consumption that boosted economic growth and slowed down the inflation. However, since inflation did not decline as fast as expected and remained over the level of devaluation, the Turkish Lira appreciated, which boosted import while export did not perform as well as import. The outcome of the combination of decreasing interest rates, inflation, and real appreciation of the Turkish Lira was increasing deficits which were financed through unsustainable short-term capital flows. As in Mexico and Thailand, on the one hand, the pegged exchange rate regime, on the other hand, a positive climate due to EU negotiations and the initial improvements in program targets in terms of inflation and interest rates created sufficient conditions for foreign investors to flow into Turkey. Given the catastrophic effect of sudden reversal of capital flows triggered by financial panic as experienced in Mexico and Thailand prior to the crises, the vulnerability of Turkey increased through the implementation of the program⁹⁷.

Although uncontrollable external factors such as the increase in the interest rates of industrialized countries, hikes in oil prices, and appreciation of the US\$ vis-à-vis EUR during 2000 had adverse effects on the implementation of the stabilization program, their effect was exacerbated due to the flaws inherent to the design of the program. The no-sterilization rule involved in the program which pacified the role of

the Central Bank of Turkey in eliminating the adverse effect of capital flows on the economy was one of the weakest dimensions of the program which contributed to the outbreak of the crisis⁹⁸. When one of the important banks in the financial system, namely Demirbank, fell into difficulty in committing to its liabilities and was in need of liquidity, the Central Bank did not inject liquidity because of the constraints on its ability to influence domestic credit expansion in accordance with the performance criteria of the disinflation program.

Thus, the IMF-led program not only increased the exposure of the banking sector to currency risk aggregating open positions, but also made the system defenseless to speculative attack, eliminating the role of the Central Bank of Turkey as a lender of last resort. This is another indication of the fact that the IMF does not take into consideration client countries' domestic dynamics and ignores the lessons from the past experiences.

Implementation Flaws

As opposed to claimed by the IMF, Turkish authorities generally implemented the monetary and fiscal targets of the program. In fact, the crisis was one that is the crisis of success in terms of committing to the exchange rate basket and to the no-sterilization rule.

The criticism regarding the delays in implementation of structural reforms is a matter of the design, which is expected to be emphasized at the very beginning of the program. Maybe, the Turkish authorities would have fulfilled the requirements of the structural reforms if they were not directed firstly to concentrate on solely reducing inflation as if it was the core issue. Thus, the sequence of the reforms has a vital

importance for the success of the program, which cannot be underestimated in assessing the role of the IMF in the context of the Turkish Financial Crisis.

The stabilization program was initiated by a three-party coalition government. In such a political environment, the coherence among coalition members is very crucial for the success of the program. However, the IMF assumed that political resistance by interest groups could be overcome and politicians would behave in the interests of long-term economic considerations relating to the welfare of the whole society without being concerned with short-term political gains. Given the adverse effects of coalition governments on the implementation of strict programs as in Thailand, assuming that passing laws and creating regulatory institutions would ensure automatic success in implementation was very optimistic. This optimism is a consequence of underestimating the political and institutional problems in the process of constructing an effective regulatory state (Alper and Öni ,2002). Alper and Öni argue that in spite of the apparent cohesion among coalition members, they were reluctant to give up traditional populist policies, pointing to the resistance of mainly NAP to the sale of Turkish Telekom and the reduction of agricultural support prices which were part of the program. The success of the program depended on the elimination of resistance to reforms.

As experienced in other emerging market crises, investor confidence is a very crucial element for the sustainability of the program. In the Turkish case also, investors' confidence which depended on the commitment of the coalition government to the program was vital for the success of the program. In this respect, the IMF contributed to the implementation flaws by neglecting to what extent the political and economic characteristics of Turkey were appropriate to implement the program before introducing it, since the ability of the government in maintaining a stream of good news is vital for the steady availability of capital flows.

Putting more emphasis on the elimination of budget deficits and privatization and less weight on longer-term banking regulations regardless of the ability of the three-party- coalition government to fulfill the requirements of the program was a gamble, given the detrimental effect of implementing such a program in an environment of capital account liberalization and a fragile structure of banking system. As mentioned by Hakan Tunç, the crises in November 2000 and February 2001 were consequences of a lost gamble (Tunç, 2003).

In their studies, Erinç Yeldan (2002), Korkut Boratav and Erinç Yeldan (2001), Emre Alper and Ziya Öni (2001) argue that the crisis had its roots in premature liberalization initiations in 1989. In this view, Turkey was in a zone of danger since the rate of short-term debt to the Central Bank's international reserves was almost over 100% throughout the 1990s which was an impact of the opening of capital account in 1989.⁹⁹ In this regard, restricting the direction of interest rates with the amount of capital flows and anchoring inflation to the exchange rate served to increase rather than eliminate the vulnerability of the economy, ensuring the liberalization of the international capital flows to satisfy the needs of the foreign capital centers. Turkey received about USD15,2 billion capital inflow during the first ten months of the program, due to on the one hand improvements in decreasing cost of public borrowing and of inflation, on the other hand, the positive effect of EU negotiations as an external anchor. However, as witnessed in Mexico and Thailand, the positive contributions of capital flows to economic growth through private consumption and investments are temporary since they are in short-term maturity and very volatile which expose the economy to risk of reversals. Furthermore, their apparent positive effect enabled the authorities to delay structural reforms which were vital for maintaining the stability of financial markets. Ignoring the vulnerabilities of the Turkish financial system culminated in a process of becoming integrated with

international financial markets, the fixed exchange rate based disinflation program exacerbated the reliance on short-term capital flows, eliminating currency risk and limiting the Turkish authorities to manage the vulnerabilities imposing no-sterilization rule for the Central Bank. Hence, the weak banking system and an over-reliance on inflows of hot money made the country highly vulnerable to crises of confidence so that when the inevitable tensions of a rapid adjustment emerged, the currency peg could not be maintained.

The Thai crisis as well as the Mexican crisis had demonstrated that liberalizing the financial sector without having much experience in international markets together with unsupervised bank and non-bank high debt-equity corporate sector is doubly dangerous. Although the restructuring of the financial system was the most emphasized dimension of the post-crisis lesson that the IMF was assumed to learn, the crisis in 2001 in Turkey was an evidence of the fact that the IMF did not learn to improve mechanisms that prevent it from failing systematically. Hence, the Turkish financial crisis of 2000-01 which was the end result of the underestimation of economic and political fragilities culminating through the liberalization process prior to the stabilization program, is a good example in understanding the failure of the IMF in crisis prevention as well as in crisis management.

A comparison of the Mexican crisis of 1994 and the Thai crisis of 1997 with the Turkish Crisis of 2000-2001 discloses four common points in the period preceding the crises: 1) pegged exchange rate system, 2) increase in short-term capital inflows, 3) unstable political environment, 4) surge in investors' expectations and financial panic. Among them the most important one in terms of its detrimental effect on the economy is the second factor which is the consequence of premature capital account liberalization imposed by the IMF and other international financial institutions that exposed the countries concerned to financial crises.

While the essential problem of Turkish economy was identified as chronic inflation and the goal was to diminish inflation to single digits by reducing public sector requirements, the program neglected the structural weaknesses in the banking sector which was the major actor of the vicious cycle of borrowing and chronic inflation. As Nazım Ekinci and Korkut Ertürk argue, the main problem in Turkey was debt and its sustainability. According to them, the IMF program could not encourage less speculative capital flows over time to finance government debt which was described as the soft belly of the program.¹⁰⁰ In that context, the crisis was caused by speculative capital reversals which were an impact of the capital account opening process.

The Evolution and Management of the Crisis 2000-2001

The program worked well at first in terms of decrease in inflation, public borrowing requirement, the cost of public borrowing. Interest rates on government paper declined substantially. At the end of 1999, the wholesale price index was 62.3 percent, while at the end of 2000, it was 32.7 percent. The consumer price index showed the same trend. At the end of 2000, the consumer price index was 39 percent while it had been 64.9 percent in 1999. As a result of fiscal policy applied to both revenue and expenditure, targets were met at the end of the year. The public sector borrowing requirement which was considered to be the main factor behind the inflation decreased by 3,3 percentage point with respect to the previous year. Regarding the fiscal targets, the currency was depreciated along the pre-announced exchange rate basket until the devaluation in February 2001. The Central Bank of Turkey met all performance criteria regarding restriction on monetary expansion until

the crisis in November 2000 (Table 15,16). A comparison of targets and realizations reveals that almost all of the fiscal reforms and monetary policies were working well as planned. Realization of budgetary revenues exceeded their targets by 3,6% in 2000 and 5,1% in 2001, expenditures reached almost their target value in 2000 while it exceeded the target value by 1,7% in 2001, and more importantly than the primary surplus was increased by 6% in 2000 and 6,7% in 2001(Yeldan, 2002; Akyüz and Boratav, 2002). Raising the primary surplus and adopting income policies aimed at controlling spending reduced the borrowing requirement of the government. Extending borrowing maturity and decreasing the interest rates on Eurobonds Turkey issued in the international market was another indicator of investors' confidence in Turkey's commitment to the implementation of the program.

Turkish authorities successfully attained the main legs of the program without significant deviation. In fact, each letter of intent which was signed after the quarterly reviews of the adjustment program confirmed the strong commitment of the Turkish government to the program and emphasized the attained targets. Standard & Poor's raised the long-term credit rating of Turkey in April 2000 which signaled that the Turkish authorities were successful in implementing the program targets.

However, the November 2000 crisis revealed the soft belly of the program. Though foreign exchange risk had been minimized by the announcement of the future values of the currency basket on a daily basis, the inflation rate had been realized above the target and the Turkish lira was appreciated in real terms. Decreasing interest rates and import based private consumption accelerated current account deficits which reached a record level of 9,8 billion USD by the end of 2000. The sustainability of current account deficit dependent primarily on the sustainability of capital flows at least for the second half of the year was a key factor in understanding the impact of the capital flows for Turkey¹⁰¹.

Assured of a predictable exchange rate under the peg, the banking sector had taken advantage of easy profit opportunities by borrowing foreign currency at low interest rates in order to buy government debt at much higher interest rates. This typical reaction to the peg was a common factor in the Mexican and Asian financial crises.

The crisis in November 2000 was apparently a banking crisis which resulted from illiquidity in one of the major banks in Turkey, namely Demirbank. The fault of Demirbank was to take excessive risk believing in the program. In fact, Demirbank took a gamble with the stabilization program, investing in long-term government securities that make up almost 10 percent of total government securities, taking currency risk by opening foreign exchange positions. The triggering factor was the demand of the BRSA in mid November for private banks to reduce their open positions to legal limits by the end of the year. Demirbank could not fulfill this requirement since it had used most of the government securities as collateral to borrow from abroad. The crisis became deeper as other banks demanded foreign currency to meet their obligations which resulted in a rush on foreign currency and cutting lines by first-tier banks to the inter-bank markets together with the inability of the Central Bank to inject liquidity into the markets- as a requirement of performance criteria defined in the disinflation program- which resulted in overshooting interest rates and increasing cost of borrowing.

Following the November crisis, there was capital outflow at the end of the year and international reserves diminished. Despite this injection of liquidity in the week of 22-30 November by the Central Bank, overnight rates climbed to triple digits around 28 November as capital outflow accelerated due to growing fears that the program was no longer sustainable. When the Central Bank decided to inject liquidity into the system in November 2000 in violation of quasi-currency board rules, it created fears

that the program and currency peg were no longer sustainable, and the extra liquidity merely flowed out via the capital account and drained reserves.

The panic was contained with a \$7.5 billion IMF emergency funding package. The IMF had to hurriedly approve the loan package since the failure of the disinflation program could have damaged its already sullied credibility in the world. Another important factor behind that urgency was certainly related to Turkey's pivotal role in advancing U.S policy goals in the Middle East. The government reaffirmed its commitment to the previous inflation targets, pledged to speed up privatization and banking reforms, took over a major bank that had been at the origin of the illiquidity problem and announced a guarantee of all bank liabilities. The situation seemed to stabilize at the beginning of 2001. All in all, the crisis resulted in USD 6 billion outflow which was mitigated by a-USD 7,5 billion- IMF assistance in December.

With the injection of funds and renewed support from the IMF, the collapse of the program was avoided for the time being. The IMF seemed to manage the liquidity problem well in 2000, but could not stop the February 2001 crisis. Although it is argued that the February crisis was not an extension of the former one, it was certainly the result of the design flaws of the stabilization program underestimating the negative effects of overhauling the banking system in the Turkish financial system. The IMF and the Turkish authorities made no changes in the exchange rate regime which had been regarded as the most important aspect of the program to break inflationary inertia after the first crisis besides some revisions regarding monetary and fiscal quantitative targets.

Whatever the triggering factors, whether the policies of BRSA such as asking banks to reduce their open positions until end of the year, the liquidity problems of Demirbank in November, or the prime minister's statement that Turkey was in the midst of a political crisis following his disagreement with the president, or devaluation

expectation as in Mexico and Thailand, the crises of 2000- 2001 in Turkey have been assessed as a price paid for delayed reforms related to regulation and supervision of the financial sector initiated in 1989 (Öni , 2003; Akçay, 2003, Tunç, 2003).The analysis of Nazım Ekinçi and Korkurt Ertürk states that the November 2000 crisis was only an impact of the free movement of capital flows which left the country since they believe in that they reached the upper limit of their arbitrage gains (Ekinçi and Ertürk, 2004). In their view, the surge in capital flows could not be explained by delays in structural reform, deviation from program targets, fragilities in the banking sector, or current account deficits. They emphasize the importance of capital reversal which had begun in August 2000, earlier than the turmoil in November, as giving the explanation of what had happened. Therefore, the capital reversals were as much result as the causes of the banking crisis of November 2000, which was the natural outcome of quasi-currency board system of the IMF-directed program.

Under the program, on the one hand, there was a continuous increase in the ratio of current account deficit to foreign exchange rate reserves and to the GDP. On the other hand, there was significant increase in the ratio of short-term debt to international reserves of the Central Bank, which were both common features of crises in Mexico and Thailand. Since current account deficits were financed through short-term capital flows, the direction of flows was important for the sustainability of the debt. According to the analysis of Ekinçi and Ertürk, speculative investors who thought that their capital gains would diminish if they did not realize their gains (since the margin between the rate of devaluation and interest rates narrowed significantly with the onset of the program), began to leave the country irrespective of any triggering factors (Ekinçi and Ertürk, 2004:14-16). As seen in the table 12 and 13, under the program, while the amount of capital flows increased, they were in the short-term maturity and in the form of speculative investments and bank loans which

are prone to sudden reversal. In that sense, the stabilization program was accountable for the crisis, exacerbating risky investments and over-borrowing. Turkey could not impose any restriction on capital flows in both directions as a requirement of Article VIII obligation.

As understood from the statement of Horst Kohler, the managing director of the IMF, after of crisis in November 2000, the Fund did not want to accept the adverse effect of liberalization on developing countries, insisting on the continuation of privatization and liberalization:

Finally, the renewed resolve of the authorities to revamp the privatization program and the new drive to liberalize key goods and services markets, including the areas of telecommunication and energy, are key steps to improve economic efficiency, reduce the public debt, and increase foreign exchange reserve. The authorities will move swiftly in privatizing Turk Telecom as well as state assets in the electricity markets. They are further preparing the groundwork for liberalizing the tobacco and sugar markets¹⁰².

It seems that the IMF aimed at restoring market confidence by giving signals to investors about the willingness of the Turkish government to fulfill the requirements of the programs by approving the third and fourth reviews of Turkey's economic program in December 2000 which was supported by an IMF stand-by credit.

However, the IMF did not assume any flaws inherent within the program, arguing about strengthening the existing program with additional financial aid. The Letter of Intent which was signed on 30 January 2001 clarifies the continuation of the pre-announced exchange rate as the anchor of the program without mentioning the adverse effect of exchange rate based stabilization program on the fragile banking system. Naturally, the IMF focused on the effects of external factors, policy slippages regarding privatization, disputes among coalition members of the government, the weak banking system, political conflict at the highest level of the government, as the main factors leading up to both crises in November 2000 and February 2001, rather

than the ability of Turkish authorities to implement its program, given difficulties at many fronts at the phase of launching.¹⁰³

Michael Deppler, the director of the European Department at the IMF, gives the following explanation for the failure of the program:

It did not fail because of cavalier design. Failure was due to a combination of bad luck (rising oil prices and a general shift away from emerging market debt) and authorities' failure to deal with in a timely way emerging problems (an aggregate demand boom and an irresponsible banking system) that said, the program design was, with hindsight, probably too brittle for Turkish conditions.¹⁰⁴

Ercan Kumcu's diagnosis was that the crisis was a consequence of the IMF's concern regarding the requirements of performance criteria of the program in the midst of the crisis¹⁰⁵. Kumcu points out that although the presence of many unfavorable factors such as delays in the privatization program, disputes among coalition members of the government, argument between the Prime Minister Bülent Ecevit and the President Ahmet Necdet Sezer, the IMF's misguided readings of the crisis conditions and its concerns about reducing the loss of Turkey's international reserves prevented it from finding a workable approach to calm down the panicky markets which eventually led to the abandonment of the anti-inflation program, resulting in depreciation of the currency by 30 percent.¹⁰⁶

Güven Sak and Fatih Ozatay argue that fragilities of the banking sector were the real reasons and the current account deficits and real appreciation of the Turkish Lira would not have been enough on their own to precipitate the crisis in 2000-2001 (Sak and Özatay, 2003). They point that the level of international reserves was USD 24,4 billion just two days prior to the November turmoil which was the highest level since the end of 1999. Furthermore, the source of public sector borrowing requirement was not the central bank's resources, and the maturity of government borrowing was at least two years, and net foreign borrowing was positive in the period preceding the

crisis (Sak and Özatay 2003: 6-7). Although it is not possible to predict the timing of the crisis properly, focusing mainly on weak economic fundamentals brings the question of why the crises did not erupt in 1998 or 1999 instead of 2000 into one's mind. In this sense, the IMF on its own triggered the crisis promoting the fixed exchange rate based stabilization program as a response to the culminated problems of Turkish economy since the late 1980s.

It is true that high inflation, current account deficits, high indebtedness are undesirable factors and improving them in the context of sustainable economic growth is very crucial. However, the occurrence of the last crises suggests that these are all impacts of a greater problem which was also experienced in Mexico and Thailand: financial sector fragilities stemming from a premature financial liberalization process. Therefore, as Erinç Yeldan points out, the IMF's claim regarding Turkish authorities' unwillingness to commit to the requirements of the program which surged investors' sentiment only served to mask the real causes on the evolution of the crisis. The analysis of Nazım Ekinci shows that the analyses published by leading international investment institutions such as Morgan Stanley reveal positive statements on Turkey's reforms in spite of the presence of different views among government parties on social and political reforms¹⁰⁷. In similar line, some international rating agencies such as Standard and Poor's, FITCH upgraded Turkey's long term foreign currency sovereign credit note in April 2000 reflecting Turkey's improvement on the way to structural reforms and macro-economic stability and Turkey's economic strength in the face of tests like the earthquake and the Russian financial crisis without revealing any concern about increasing current account deficits or the delay in structural reforms until the crisis in November¹⁰⁸. These kinds of assessments in the period just before the crisis reflect the unexpectedness of the crisis which is characterized by sudden reversal of capital flows triggered by financial panic as in most emerging market crises.

The disinflation program of Turkey also demonstrates the fact that the IMF strongly believes that there is no alternative to liberalization to accomplish stabilization. Other alternatives such as capital controls on capital flows in any direction have been presented as that they lessening confidence in emerging markets. To prevent the use of any other policy, the Article VIII of Agreement was embodied within the disinflation program, stressing the commitment of the government not to impose any restrictions on payments or transfers for current international transactions, not to impose or intensify restrictions on imports for balance of payment purposes, and not to conclude bilateral payment agreements which are inconsistent with Article VIII, or incur external arrears¹⁰⁹.

The crisis of 2000 has revealed the fact that the IMF forgot one of the most important lessons drawn from the Asian crisis, that accomplishing the restructuring of the banking sector and reforming the way of finance is not possible over a short period of time. The inability of the Turkish authorities to maintain a stream of good news can be evaluated as a cause for the failure of the program from one perspective. However, pushing longer term targets for implementation in a short period without differentiating Turkey's situation from crises-afflicted countries is a clear evidence of the fact that the IMF offers one size tailored dress to all emerging market countries.

The following statement of Stanley Fischer reflects the irony regarding the difference between theory and practice:

Each of the major international capital market-related crises since 1994—Mexico, in 1994, Thailand, Indonesia and Korea in 1997, Russia and Brazil in 1998, and Argentina and Turkey in 2000—has in some way involved a fixed or pegged exchange rate regime. At the same time, countries that did not have pegged rates—among them South Africa, Israel in 1998, Mexico in 1998, and Turkey in 1998—avoided crises of the type that afflicted emerging market countries with pegged rates.¹¹⁰

While arguing the difficulty originating from pegged exchange rate implementation, Fischer attributed the crisis to banking sector problems and widening current account deficits rather than to the design of the exchange rate arrangement.¹¹¹

As opposed to the first crisis, The Central Bank did not provide liquidity to the markets that resulted in skyrocketed interest rates and the failure of public banks to fulfill their commitments to the markets. As Hakan Tunç points out, the political crisis between the President Ahmet Necdet Sezer and the Prime Minister Bülent Ecevit was the triggering factor for the crisis, but it is not certain that there would not have been a crisis if such a political dispute did not take place given the fact that the stabilization program increased the vulnerabilities of the banking sector.

As mentioned by Gazi Erçel, former president of the Central Bank of Turkey, the success of the stabilization program and crisis prevention within this context depended on political stability and high credibility which in turn require taking into consideration the political and economic fragilities of the country concerned¹¹². He describes the requirements of crisis prevention as effective banking regulation and management of short-term capital movements. Then, was not any one including the IMF, aware of whether Turkey's economic and political domestic indicators fit to launch the 1999 disinflation program? Was it not possible to forecast that the IMF-directed program would increase the fragilities of the Turkish economy looking at the experiences of Mexico and Thailand which had followed similar programs which resulted in the crises of 1994 and 1997? The Turkish financial crisis once more revealed that Washington-based stabilization prescriptions bring instability rather than stability to developing countries, since the domestic dynamics of these countries are different from those of industrialized countries.

The Turkish financial crisis is another episode resulting from the IMF's typical approach that does not make any concessions from liberalization and assumes that

capital account liberalization is an irreversible process. Given the fact that pegged exchange rate-base stabilization and capital account liberalization cannot be implemented simultaneously due to accelerating over-borrowing syndrome as in Mexico and Thailand, Turkey was imposed on to adopt exchange rate as anchor to diminish inflation. Launching an adjustment program without taking into consideration economic and political weaknesses prior to the program is another evidence of that approach.

The failures of the IMF were twofold in the Turkish financial crisis: Firstly, the IMF could not manage the vulnerabilities of the Turkish economy since it dealt with its own priorities rather than Turkey's. For instance, the IMF was aware of the adverse effect of changes in investors' sentiments regardless of the soundness of macroeconomic fundamentals in the country, and the necessity of strengthening the banking system before the Turkish disinflation program was launched. Although the difficulties were acknowledged in the introduction of the letter of intent signed in December 1999, the sustainability of the program was left at the hands of foreign investors who had been given the advantage of obtaining arbitrage gains by eliminating currency risk via the program. Furthermore, determining the privatization of some important state enterprises such as Turkish Airlines, TUPRA , POA , PETKIM, SEKA, ERDEM R as performance criteria on the ground that lower domestic borrowing, setting deadlines for some important laws such as telecommunication law, electricity, and tobacco laws within a year, cutting state subsidies for some sectors, reducing tariffs to third part countries to EU's levels, and emphasizing the commitment to the obligations of Article VIII of the Fund's Articles of Agreement are all set as inevitable priorities for the program ends, all in accordance with the Washington Consensus.

The second dimension of IMF failure is the mismanagement of the crisis of 2000 which contributed to the generation of the second crisis within three months, in February 2001, as a result of the IMF's insistence on commitment to fixed exchange rate and to the Central Bank's reserves underestimating its costs for Turkey that will last for years. The IMF failed to understand that quasi-currency board system was the source of the liquidity crises that rendered the markets vulnerable to financial panic although it admitted the destabilizing effect of highly leveraged positions in banking and the corporate sector within "an environment of poorly sequenced and poorly supported liberalization" in the aftermath of the Asian crisis.¹¹³ The Turkish stabilization program is an evidence of the fact that the IMF's concern regarding premature financial liberalization remains at conceptual level. The Independent Evaluation Office of the IMF suggest that the IMF must be fair regarding capital account issues, highlighting the fact that the ambiguity in the role of the IMF with regard to capital account issues has led to lack of consistency in the work of the IMF across countries.¹¹⁴

Brett D. Schaefer argues that Turkey was another victim of the U.S's faulty policies which had to be bailed out through the IMF's standard loan package¹¹⁵. He mentions that the IMF's dedication to currency pegs, high taxation, and bailouts that reward the imprudent financial policies of the Turkish stabilization program was no different from other episodes in Mexico (1995), Asia (1997–1998), Russia (1998), and Brazil (1999). In each case, the IMF supported a peg as a way to create currency stability, failed to predict the ultimate collapse, and blithely went on recommending the policy.

Since the IMF-directed stabilization program was introduced as having no alternative to stabilize the economy, no one including Turkish authorities, who were assumed to know the situation the best, questioned the coherence of the program. On

the one hand, the IMF stresses the importance of sequenced liberalization to be able to handle capital flows and subsequent reversals. On the other hand there is a stabilization program launched in a prematurely liberalized financial system that requires strengthening the financial system as performance criteria. Furthermore, it leaves Turkey defenseless against the sudden reversal of capital flows via the quasi-currency board system. Even in the case of absence of such a system, it is very difficult to cope with capital reversals that lead to the deterioration of central bank reserves leading to crisis as witnessed in Thailand and Mexico.

Although the IMF is generally opposed to using capital controls as a crisis management policy on the grounds that it becomes persistent once implemented, the Fund accepts the implementation of controls on capital inflows in situations of weak domestic institutional and regulatory environment as a means of coping with external market pressures as a part of a broader policy package.¹¹⁶ In that regard, could not capital controls be included in the disinflation program of Turkey to minimize the destabilizing effect of the capital flows given that the difficulties in Turkish financial system culminated through premature financial liberalization prior to the crisis? In that respect, could not the November crisis in 2000 have been avoided? Furthermore, as a flexible institution, could not the program be revised with the elimination of the Central Bank's no-sterilization which brought the February 2001 crisis and with abolition of the program announcing the free float of the Turkish Lira?

To sum up, the IMF's priorities which centered on the liberalization and integration of markets in the name of global stability lead it tailored one size type prescriptions irrespective of country specific conditions. The Turkish disinflation program and the subsequent crises were the reflections of that commitment.

CHAPTER 7

CONCLUSION

The main purpose of this study is to present how capital account and financial liberalization imposed by international financial institutions, mainly the IMF, on emerging market countries regardless of country specific conditions can contribute to financial crises in the context of the crises in Mexico (1994), in Thailand (1997) and in Turkey (2000-01). These crises are important cases in the sense of the fact that they challenged the role of the IMF as an institution committed to the principles of the Washington Consensus. In this general framework, my claim is that the Turkish financial crisis of 2000-2001 is linked to the disinflation program of 1999 which was directed by the IMF.

A greater understanding of the causes and nature of financial crises is essential for their better management as well as for designing policies to reduce their likelihood. According to existing literature on crises, there is no single factor that can explain the emerging market crises since they are consequences of a combination of several factors such as deterioration in macroeconomic fundamentals, political instability, borrowing by the private and public sectors in different proportions, interest rate differentials among countries, loss of trade and exchange rate competitiveness because of appreciation of local currency, structural weaknesses in financial sector and corporate sector, change in investor expectations, and capital outflows.

Although a consensus has emerged regarding the causes at the root of crises in developing countries, the recurrence of crises with increasing frequency has raised some concerns about whether the above mentioned factors are merely impacts and

play a triggering role in a system which has become vulnerable to their effects as a consequence of a broader economic and political set of policies.

In fact, the comparison of the Mexican crisis of 1994 and the Thai crisis of 1997 with the Turkish financial crisis of 2000-01 and the stabilization program that preceded the Turkish crisis aims to demonstrate on the one hand, that the crises have a common ground, i.e. premature financial liberalization due to globalization; on the other hand that the IMF had a major role preceding the crisis by imposing Washington originated neo-liberal policies on developing countries and deepening the effect of the crisis by misdiagnosing the causes at the root of the crises. Since each country has unique characteristics, diversity in development levels as well as in other institutional factors must be taken into consideration in formulating economic strategies even if the crises originate from similar combination of causes.

The importance of comparing the Mexican and Thai crises with the Turkish case is to present that the Turkish financial crisis was a result of the IMF-led adjustment program which took into consideration neither the past experiences in other emerging market crises nor Turkey's own economic and political difficulties before launching the program. The natural consequence of this ignorance was to offer an identical prescription that gave an identical result, namely a severe financial crisis.

The three crises in the scope of this study have common features in terms of both political and economic conditions in the period leading up to the crises and the involvement of the IMF in dealing with them. However, the Turkish financial crisis differs from the others in terms of the fact that it preceded an IMF-sponsored stabilization program.

The most striking parallel among the three cases was the pegged exchange rate-based policy and the surge in capital flows preceding the crisis. The initiation of liberalization had been preceded by severe balance of payment crises in 1982, 1984

and 1979 in Mexico, Thailand, and Turkey, respectively. A market-based and outward-oriented approach under the auspices of international financial institutions, one of which was the IMF, was introduced as the best way to overcome the difficulties stemming from state-based growth strategy which eventually did not change the result since financial liberalization process coupled with the insufficient financial regulatory framework. In fact, the last crises in these countries were “the crises of success” in terms of their performance in financial and capital account liberalization suggested as a way of avoiding meltdowns and becoming an active partner of the international financial system.

The comparison demonstrates that the issue is, in fact, not the adoption of a fixed or semi-fixed exchange rate regime. The issue is when such an exchange rate regime is implemented.

Liberalization and capital account openness began in the 1980s and increased its pace in the 1990s in almost all the cases. However, in the case of Mexico and Thailand, the exchange rate based programs had been initiated before they totally opened their capital accounts to the impact of international markets, i.e. Mexico undertook its program in 1989, but the crisis was in 1994; Thailand fixed the baht to a basket of US Dollar and Japanese Yen in 1987, but the crisis erupted in 1997. Contrary to Mexico and Thailand, Turkey’s pegged exchange rate-based disinflation program was launched when Turkey had already liberalized its financial system. As mentioned in the related chapter, that is an important reason for the corruption of the program just within 11 months after its implementation before inflation was brought under control.

Another parallelism is that, the years preceding the stabilization program in Turkey and the crises in Mexico and Thailand were election years. In that respect, the political climate was sensitive to economic turmoil. The crisis in Mexico erupted in

December 1994 in the aftermath of the election in April 1994; the crisis in Thailand occurred in June 1997 after the election in November 1996, and the stabilization program of Turkey was signed in December 1999 following the general election in April 1999. Furthermore, in Mexico political turmoil such as a peasants' rebellion in January 1994, and the assassination of the presidential candidate prior the elections created pressure on the markets. Although it was not as severe as in Mexico, various political battles within the government and between the government and the opposition occurred in the period leading up to the crisis in Thailand. Although Thailand was familiar with being governed by coalition governments; the incumbent prior to the crisis government was a six-party coalition as there was a three-party coalition in Turkey at the time of the launch of the disinflation program.

The IMF attributes the crises to political instability in assessing the Mexican and Thai crises. While considering that political stability to be crucial in taking decisive steps in the name of stability, the IMF itself approvingly accepted a very ambitious disinflation program of an 8 month- three party coalition government of Turkey that each had different ideologies. In this respect, the IMF contributed to the failures in the implementation of the program.

Notwithstanding similarities, there are also impressive differences among them. Mexico and Turkey had been struggling with persistent and high inflation rates which had a destabilizing effect on the economy. Thailand was clearly in a better position than Mexico and Turkey in terms of its growth rate, inflation rate, and high saving rates. That is why the Thai crisis was thought of as unexpected. These experiences confirm that neither fixed exchange rate commitment nor deterioration in macroeconomic fundamentals on their own were sufficient for subsequent crises. Nevertheless, neither in Thailand nor in Mexico and Turkey was supervision and controls adequate to prevent or to face a financial crisis, because premature

liberalization in the name of accelerating economic growth in developing countries made their economy vulnerable to panic.

Another common point among the three cases the IMF's response to the crises. For instance, in Mexico, the interest of the U.S led to urgent response of the IMF to the crises and the U.S contributed directly with the amount of \$20 billion on for stability in the region as well as in other emerging market countries. In the Thai crisis, any direct contribution such as the offer of the Asian Monetary Fund to handle the crisis was strongly opposed, which turned the crises into a global financial crisis known as the Asian Crisis that had long lasting effects. Although the Turkish crisis was not expected to have global effects as much as the Mexican and the Thai crises, its geopolitical significance for the U.S as well as for other Western countries was the main factor behind the IMF's rescue packages. In both the November and February crises, the IMF urgently approved new loans to compensate for its failure.

Although the IMF's response to these crises varied from country to country, the basic approach was the same in each case. In general, the letters of Intent were a package of fiscal and monetary polices which essentially consisted of tight monetary policy such as reducing subsidies and tax reform, bank restructuring through closure of unviable banks, deregulation, and privatization of state-owned enterprises in such major sectors as energy, telecommunication, and transportation. Especially while dealing with the Thai crisis and designing Turkey's disinflation program, these macroeconomic policies and structural reforms were embodied in letters of intents on the grounds of rebuilding reserves and of restoring foreign investor confidence in these countries.

While the priority was set as to help restore confidence to the economies affected by the crisis, what was neglected was that investors had shown confidence before the crisis, pouring their money into these countries in search of obtaining high

arbitrage returns regardless of whether these countries had sound macroeconomic policies or not.

The main approach of the IMF in dealing with the Mexican and Thai crises was to achieve the return of foreign capital, ignoring the fact that the rapid deregulation process that rendered these countries vulnerable to reversals in capital flows and downturn in economic activity was part of the problem, not the solution. As understood from the design of the Turkish disinflation program and policy responses to the crisis in November 2000, the IMF maintains the same ignorance. The natural consequence of this assumption was to provide liquidity conditioned to tight monetary and fiscal policies enhanced with structural reforms at the midst of the crisis. As in Thailand, the IMF prescriptions did not necessarily renew investor confidence. Furthermore, those countries could not return to solid economic growth despite the implementation of fiscal and monetary targets. For example, in Mexico the GDP rate decreased sharply and the inflation rate remained below pre-crisis level for the following four years, the unemployment rate almost doubled. Similarly, in Thailand, the growth rate never reached pre-crisis levels and unemployment rate doubled. In Turkey, despite the significant improvements recorded in inflation and interest rates on government bills, both the ratio of current account deficit to GDP and that of short-term debt to GDP increased during the implementation of the program which compounded the vulnerability of the country to a crisis. Furthermore, GDP growth declined and unemployment rate increased at the end of 2001. Hence, in practice, the involvement of the IMF in crisis resolution process is nothing else but to guarantee the repayment of creditor countries' loan.

The IMF contributed to the crisis of 2000-01 in Turkey by ignoring the vulnerabilities of Turkish economic and political difficulties which have been culminated as a result of premature capital account liberalization. Defending the

undeniable benefits of liberalization as a source of economic growth and acknowledging the adverse effects of premature liberalization on developing countries after the Asian crisis, the IMF, nevertheless introduced fixed exchange rate- based inflation reduction program for Turkey.

The analysis of the three crisis-hit countries shows that the crises were not independent from the general argument of the international financial institutions centered on promoting financial liberalization. In this respect, these incidents challenge not only the role of the IMF in crisis resolution but also and more importantly capital account liberalization imposed on them as a way of integration with global capital markets for the sake of sustainable economic growth.

As a matter of fact, these three countries have been the most faithful students of the IMF in terms of following its basic principles such as opening their capital markets to the international financial community. However, since these countries were not encouraged to minimize the cost of liberalization on their financial system as much as to impose capital account opening, the process of rapid liberalization resulted in an increase in the ratio of short-term indebtedness to reserves which increased the likelihood of crisis. As understood from the comparison of Mexican, Thai, and Turkish crises, the IMF does not pay attention to the adverse effects of short-term indebtedness on financial systems and yet, has pushed further capital market liberalization at the midst of the crises as a component of its lending packages. Structural adjustment policies which included budgetary targets as well as structural reforms were formulated according to the key elements of the Washington Consensus which represents an ideological purpose aiming at minimizing the role of the state and promoting more market friendly economy.

Both the Mexican crisis in 1994 and the Thai crisis in 1997 were the costs of premature financial liberalization process in terms of increased financial fragility

which had been characterized by lack of prudential regulation and supervision system and weak institutional development. The imbalances in Turkish economic and political life have also been associated with premature financial liberalization, but the crises in 2000 and 2001 were certainly consequences of the IMF's program because it had been involved in Turkey's macroeconomic management both prior to the crisis and after the crisis to restore stability and credibility.

What lies behind the failure of the IMF is underestimating the domestic needs of the Turkish economy and fragilities prior the program which accumulated since the opening of capital account in 1989.

The Turkish financial crisis of 2000-01 has also revealed the fact that the IMF has not learnt from its past experiences, especially from Asian Crisis. While acknowledging the inevitability of "orderly" liberalization to avoid its adverse effects on developing countries, the IMF seemed to ignore that Turkey had already adopted full capital liberalization that exposed its economy to reversal of capital flows before the approval of the disinflation program of 1999. Is it sufficient to emphasize the necessity of strengthening prudential regulatory and supervisory mechanisms once domestic financial liberalization becomes irreversible? Institutional development and structural reforms need to be emphasized earlier in the liberalization process if the main concern is really to minimize its adverse effects on the stability of the economy in general and of the banking sector in particular.

The IMF is generally accused of misunderstanding the causes at the root of the crises and forcing identical prescriptions on developing countries. Given the fact that the U.S Treasury and other G-7 countries who dominate the decision making process of the IMF naturally vote large sums of assistance on the condition that the IMF imposes policies that benefit their business and labor elements, is it not natural that the

IMF's Washington based prescriptions ensuring the liberalization of international capital flows look like each other?

The recent crisis demonstrated that while the IMF was created to promote global economic stability, its policies actually contributed to instability not only by imposing the same type of fiscal and monetary policies, but also by overstating the problems within these countries rather than emphasizing the positive features of the client countries. What the IMF did in Thailand was to exacerbate the turmoil in the financial sector by overemphasizing the weaknesses in the financial sector and the necessity of the closure of unviable financial institutions.

Although the recent reports by the IMF acknowledge the detrimental effects of premature liberalization in emerging market countries, it does not encourage even temporary capital controls as a way of avoiding financial crises in the fear that constraints become permanent once implemented. Therefore, the IMF's warnings regarding the destabilizing effect of premature financial liberalization remain at a conceptual level as long as this concern is not institutionalized through the amendment of the articles of agreement.

This study concludes that the Mexican, Thai and Turkish type of financial crises will never end since liberalization of capital accounts creates crisis prone-systems. It is not possible to prevent totally recurrence of emerging market crises as long as alternative mechanisms to the existing policy responses are not developed. Although it admitted the catastrophic effects of premature capital account liberalization after the Asian crisis and presented its new approach as "orderly liberalization", the IMF neither set a concrete policy to accomplish it in already fully liberalized countries nor welcomed alternative strategies such as using capital controls. In fact, there is no coherence in its approach since it considers liberalization as an irreversible process due to its strong commitment to the benefits of

liberalization. That is why it did not welcome the Malaysian type crisis management model and why it ignored the structural weaknesses inherent to its adjustment programs as witnessed in the Turkish disinflation program.

It was well known that Turkey had some difficulties which had been created by the liberalization of both trade and finance in the process of integrated to international financial markets accompanied a rapid deregulation process prior to the disinflation program. What led Turkey to ask financial assistance from the IMF was to overcome the destabilizing effects of inflation which was assumed at the heart of the problems. However, the IMF presented its typical receipts to Turkey as if it was a country in crisis by taking into consideration neither its own diagnosis regarding the detrimental effect of rapid liberalization nor Turkey's accumulated problems since the liberalization of capital account in 1989. Additionally, it enhanced the existing vulnerabilities offering a monetary regime based on pegged exchange rate regime. The natural consequence of repeating past errors was two crises within three months.

After the collapse of the disinflation program, a new one called "Strengthening the Turkish Economy" was put into practice, again backed by the IMF, which stated its priority as to be the re-structuring of the banking sector by tightening fiscal policies and increasing interest rates in order to stabilize "increasing public sector debt" while floating exchange rate regime. At that point there is an important question that should be asked: If the crises which resulted in the collapse of the disinflation program of 1999 was because of the failure of the Turkish authorities in its implementation, as the IMF claimed, why did the IMF approve a new program in May 2001 based on floating exchange rate regime rather than insisting on implementation of the previous one? Focusing on diminishing inflation and presenting it as the major problem of the Turkish economy rather than dealing with the causes at the root of inflation was nothing but masking the broader difficulties originating in premature

liberalization. The Turkish financial crises of 2000-2001 which was another bust phase showed that the commitment of the IMF to the basic principles of the Washington Consensus presented in the form of orderly liberalization is at the source of both emerging market crises and the one size fits all prescriptions.

In the world of open economies, the crises cannot be explained merely by governments' unsound economic policies, as claimed by the IMF and macroeconomic fundamentals. In an environment of free movement of capital, countries become unstable and, sooner or later, they will fall down as Mexico, Thailand, and Turkey. If they cannot manage a healthy balance of trade and capital flow which requires them to liberalize their financial systems gradually, the crisis is there waiting for a triggering factor, whose timing and severity depends upon where and how it erupts.

It appears that as long as developing countries cannot develop their own strategies to deal with economic and political problems in tranquil times, they have to obey the IMF's Washington consensus-based "one size fits all" policies including inappropriate prescriptions that could have unfavorable consequences for them.

END-NOTES

¹ The term Washington Consensus was set by John Williamson in 1990 to refer to a set of policies which Washington based institutions, i.e. the World Bank., the International Monetary Fund, the U.S Treasury thought would be good to rescue Latin American countries from high inflation and low growth cycles. But Williamson in his later studies argues that the term has been used as a synonym for neo-liberal thought which he did not intend. See John Williamson. "Did Washington Consensus Fail?" Available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=488>

² Gowan, Peter. 2006. "The Globalization Gamble: The Dollar-Wall Street Regime and its Consequences." Available at <http://www.attacberlin.de>.

³ Since the crisis in 1997-1998 in Asia originated in Thailand in July 1997 and expanded to almost all Asia, I have chosen the Thai Crisis for my study.

⁴ See Press Release No:95/10. February 1,1995 for Mexico; IMF's Occasional Paper 178 (1999) by Timothy Lane. et.al for Thailand, and Press Releases of No 99/66.December 21,2000, and No:01/23. May 15,2001 for Turkey.

⁵ Almost all studies analyzing the cause of financial crises refer to the study of Paul Krugman, published in 1979. See Robert.P. Flood, Bhandari Jagdeep S.and Agehor, Pierre-Richors (1991) "Speculative Attacks and Models Of Balance Of Payment Crises"; Andrés Velasco and Ricardo Hausmann (2004) " The causes of financial crises: moral failure versus market failure", NBER Working Paper Series. Available at <http://www.nber.com>

⁶ Ibid.

⁷ Obstfeld, Maurice. (1994). "The Logic of Currency Crises" available at <http://www.nber.com>

⁸ Obstfeld, Maurice. (1996). "Models of currency crises with self-fulfilling features." *European Economic Review* vol.40 pp:1037-1047.

⁹ Definition of twin crisis referring to the relation between banking crises and currency crises is given by G. Kaminsky and Carmen Reinhart as following: "If a banking crisis is followed by a balance-of-payments crisis within 48 months, it is twin crisis. Kaminsky, Graciela L., Reinhart, Carmen M. (1999), "The Twin Crises: The Causes of Banking and Balance of Payments Problems," The American Economic Review, vol 89, pp. 473-500.

¹⁰ Articles of Agreement. Available at <http://www.imf.org>.

¹¹ It is quoted from the front page of the IMF's official web-site at <http://www.imf.org>

¹² Anna J.Schwarz. (2000). "Do We Need a New Bretton Woods." *CATO Journal*. vol.20 no:1 Spring/Summer 2000.

¹³ Evrensel, Ay e. (2002). "Effectiveness of IMF- Supported Stabilization Programs in Developing Countries." *Journal of International Money and Finance*. 21(2002) 565-587.

¹⁴ Camdessus, Michael. 1998. "The IMF's Role in Today's Globalized World" A speech addressed at IMF's Bundesbank Syposium in July 2, 1998. Available at <http://www.imf.org>

¹⁵ The best known defenders of this argument are Joseph E. Stiglitz, Jeffrey Sachs, Martin Feldstein, James Tobin, Robert Wade and Frank Veneroso. These scholars criticize the IMF in the context of the Asian crises and mainly blame the IMF for both not being able to recognize the subsequent crisis and not managing it well.

¹⁶ Chenier, Ann E and Vincent, Ferraro. 1993. "The Political Economy of the International Monetary Fund: The Politics of Adjustment." A paper prepared for delivery at the 1993 Annual Meeting of the International Studies Association, Hyatt Regency, Mexico, 23-27 March 1993.

¹⁷ Independent Evolution Office (2005). Report on the IMF's Approach to Capital Account Liberalization. Available at <http://www.imf.org>

¹⁸ Fischer, Stanley.1997. "Asia and the IMF." IMF Seminar.19 September 1997. Available at <http://www.imf.org>

¹⁹ UNCTAD. The Trade and Development Report (1998).

²⁰ Schoenfelder, Lindsey. 2003. "Challenging the Washington Consensus." An interview with Joseph Stiglitz at 7 May 2002. Published in *The Brown Journal of World Affairs*. Vol. IX. iss:2 Winter/Spring 2003.

²¹ Stiglitz, E.Joseph. 2001. "Failure of the Fund: Rethinking the IMF response." *Harvard International Review*. Summer 2001: 23. 2 pp:14-18

²² Ibid. p.15

²³ CATO Handbook for Congress. Policy Recommendations for the 108th Congress: International Financial Crisis and The IMF. pg: 643-652 CATO Institute. Washington D.C.

²⁴ Moberg, David. 2000. "How to Fix The IMF: First Do No Harm." Accessed at <http://www.inthesetimes.com>

²⁵ Kruger, Anna. p.48-50

²⁶ Musa, Michael and Savastano, Miguel. 1999. "The IMF Approach to Economic Stabilization". IMF Working Paper WP/99/104

²⁷ Fischer, Stanley. 1998. "IMF Deputy Stanley Fischer on the IMF and the East Asian Crisis" Accessed at <http://www.j-bradford-delong.net>

²⁸ Ibid.

²⁹ Joseph Stiglitz criticizes the IMF's policies in the context of the Asian Financial Crisis, arguing that the crisis in East Asia was a natural consequence of Washington based monetary and fiscal policies which focus on reducing the weight of the state in the economic realm which is presented as the source of the crisis by the IMF. In his view, the IMF not only contributed to the crisis by imposing financial liberalization on Asian countries but also mismanaged the crisis by offering wrong prescriptions. For detail, see. *Globalization and Its Discontents* (2002).

³⁰ In the studies of Dani Rodrik (2005), Ziya Öni and Fikret Öncü (2003), it is argued that alternative ways to rapid liberalization based economic growth is always possible. China, India and Malaysia are presented as the best evidences of that argument.

³¹ The origin of the Meltzer Report goes back to the necessity to create an official view about the legislation authorizing \$18 billion of additional U.S. funding for the International Monetary Fund in November 1998. For this purpose, the U.S Congress established the International Financial Institution Advisory Commission to recommend future U.S. policy toward seven international institutions: the International Monetary Fund (IMF), the World Bank Group (Bank), the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), the African Development Bank (ADB), the Bank for International Settlements (BIS), and the World Trade Organization (WTO). The report is called as the Meltzer Report because the commission was chaired by Professor Allan H. Meltzer. See Report of the International Financial Institution Advisory Commission chaired by Allan Meltzer. March 2000. Available at <http://www.house.gov/jec/imf/meltzer.pdf>

³² Articles of Agreement of the International Monetary Fund. Article 3. Section:1. Available at <http://www.imf.org>

³³ Ibid. Article 12. Section:5. Available at <http://www.imf.org>.

³⁴ LaFalce. John J.1998. "The Role of the United States and the IMF in the Asian Financial Crisis" Available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=301>

³⁵ The notion of the Post-Washington Consensus is used to refer to a synthesis of state based development model and market based development model. The IMF's emphasis on the necessity of orderly liberalization which gives weight to the importance of the state's regulatory role in overcoming failure of premature financial liberalization has been perceived as a new Washington based consensus. Joseph Stiglitz is regarded as the one who played an important role in this regard. See. Ziya Öni and Fikret İnces. 2003.

³⁶ Banco de Mexico Annual Report (1996). Available at www.banxico.org.mx.

³⁷ Camdessus, Michel. 1995. "Drawing Lessons from the Mexican Crisis: Preventing and Resolving Financial Crises--the Role of the IMF", a speech addressed at the 25th Washington Conference of the Council of the Americas on "Staying the Course: Forging a Free Trade Area in the Americas" Washington, D.C., May 22, 1995 Available at <http://www.imf.org>

³⁸ Edwards, Sebastian. 1997. "The Mexican Peso Crisis: How Much Did We Know? When Did We Know It?" NBER Working Paper Series, Working Paper 6334. <http://nber.org/papers/w6334>

³⁹ Quiroga, Flores Aldo. 2001. "Mexico:Crisis and the Domestic Policies of Sustained Liberalization." Pp. 179-211 in *The Political Economy of International Financial Crises. Interest Groups, Ideologies, and Institutions*. eds. Shale Horowitz and Uk Heo. Lanham.Boulder.New York. Oxford: Rowman & Littlefield Publishers Inc.

⁴⁰ Edwards, Sebastian and Savastano, Miguel A. 2000. "The Mexican Peso in the Aftermath of the 1994 Currency Crisis" Pp. 183-240 in *Currency Crises*. ed. by P. Krugman. Chicago and London: The University of Chicago Press.

⁴¹ Ros, Jaime and Boulion Cesar. 2001. "Mexico: Trade liberalization, growth, inequality and poverty" Chapter 9. English version in *Liberalización, Desigualdad y Pobreza: América Latina y el Caribe en los 90*. ed Enrique Ganuza, Ricardo Paes de Barros, Lance Taylor. and Rob Vos. Available at <http://www.undp.org/rblac/liberalization/docs/Ch9-Mexico.pdf>

⁴² Quiroga, F. Aldo. Ibid. p:191

⁴³ León, Roberto Salinas. "An Overview of the Mexican Economy in 1995 Problems and Prospects for Macroeconomic Stabilization." Accessed at <http://www.mexico-trade.com/macro.html>

⁴⁴ Edwards, Sebastian.1997. Ibid. pp:10-11

⁴⁵ After the Mexican crisis., much has been written to explain the causes and the role of the IMF and the U.S in the management of the crisis.

⁴⁶ Stephanny Jones Griffith argues that the Mexican crisis, though having special features, was not unique, emphasizing the role of the pace of financial and capital account liberalization in the Mexican crisis. See. Griffith Jones, Stephany. "Global Capital Flows: Should They Be Regulated?" Accessed at <http://www.palgrave.com>

⁴⁷ Ibid. p: 114

⁴⁸ It is quoted from Bill Clinton's Speech at the signing ceremony of NAFTA, 14 September 1993 <http://www.drpsychotic.com> Accessed at 03/03/2006

⁴⁹ The World Bank (1994). Mexico Country Economic Memorandum. Available at <http://www-wds.worldbank.org>.

⁵⁰ Sebastian Edward gives explanations of the World Bank and of the IMF on developments just several weeks before the Mexico crisis: According to the World Bank's explanation in November 1994 "Economic growth is expected to surge, reaching the highest level in five years, as a period of post election stability is anticipated" and the IMF's World Economic Outlook, just two weeks before the crisis, mentioned that "larger output increases are projected for 1995 as aggregate demand-in particular private investment-expands"

⁵¹ In many studies conducted by economy and political science academicians, in reports of the World Bank and of the IMF, it is emphasized that exchange rate based stabilization programs initially help to decrease inflation rate but after a while the decrease becomes slower and because of interest rate differentials the real exchange rate appreciates which causes increase in current account deficits. If current account deficit is financed with short-term capital flow which is a very possible outcome of pegged exchange rate based stabilization program, the financial system becomes very vulnerable to swings in capital flows.

⁵² Stephany Griffith-Jones gives the details of the Mexican Peso Crisis aiming to reduce inflation in the context of the Mexican government macroeconomic policies which was in line with the financial and capital account liberalization policies imposed and praised by the IMF.

⁵³ The Independent Evaluation Office Report. 2005. "Report on the Evaluation of the IMF's Approach to Capital Account Liberalization." pg: 26

⁵⁴ This is the largest-ever financing package approved by the IMF for a member country, both in terms of the amount and the overall percentage of quota. The U.S administration proposed average \$50 billion rescue package for Mexico. However, because of strong opposition in Congress to the package the Clinton administration could approve only \$20 billion using the treasury's own authority, but it reached the initial amount proposed by Clinton by the contribution of IMF's \$17,8 billion and of the Bank of Settlement's (BIS) \$10 billion packages. The U.S package was also the largest ever use of this facility. IMF (1995) and Nora Lusting (1996)

⁵⁵ Bill Clinton in his speech to the National Governor Association emphasized that it was very important to act fast for several reasons such as the possibility of the crisis spreading to other Latin American countries and eventually to all the developing world, the potential illegal immigration problem, and loss of export and job facilities to gain support from the Congress and American society.

⁵⁶ See Stanley Fischer's statement regarding Mexico's adjustment program. "IMF Management Welcomes Mexico's Comprehensive Economic Program s. IMF's News Brief (1995). No: 95/2 February 3, 1995.

⁵⁷ IMF Press Release. No: 95/10 February 1, 1995

⁵⁸ Since I could not reach original 1994 Article IV Consultation Report, I have used information mostly from the report prepared by the United States General Accounting Office (GAO) on the Mexican Crisis. The report examines the origins of Mexico's financial crisis; assesses the extent to which the U.S. government and the International Monetary Fund (IMF) were aware of Mexico's financial problems throughout 1994, and provided advice to Mexico; describes the U.S. and international response to the crisis, including an assessment of the terms and conditions of the agreements implementing the U.S. portion of the assistance; provides an analysis of the statutory authority for the Secretary of the Treasury's use of the Exchange Stabilization Fund (ESF) to fund the assistance package; and examines the initial efforts of Mexico to recover from the crisis, including Mexico's access to international capital markets. GAO Report (1996) "Mexico's Financial Crisis Origins, Awareness, Assistance and Initial Efforts to Recovery" February 1996.

⁵⁹ IMF Annual Report 1996 p. 28

⁶⁰ LoGerfo, James and Montinolo R.Gabriella. 2001 Thailand: Episodic Reform, Regulatory Incapacity, and Financial Crisis. ed. in *The Political Economy of International Financial Crisis Interest Groups, Ideologies, and Institutions*. by Shale Horowitz and Uk Heo. Rowman & Littlefield Publishers Inc.

⁶¹ Thailand's capital account and financial liberalization path between 1988 and 1997 has been analyzed in detail by Pedro Alba et.al (1999) in "Financial Liberalization and The Capital Account: Thailand 1988-1997." pp:1-60 available at <http://www.worldbank.org/research>

⁶² Ibid. pp:16-24

⁶³ Jansen, W. Jos. 2000. "The Effects of Capital Inflows in Thailand, 1980-1996. Monetary and Economic Policy Department, De Nederlandche Bank, Amsterdam, Netherlands. pp:1-33 Available at <http://ideas.repec.org/p/dnb/staffs/46.html>

⁶⁴ Ibid. p: 399

⁶⁵ There were about 15 domestic banks and 14 foreign banks in Thailand for the period 1980-1996. Financial institutions are the second important component of the Thai financial system. There were about 90 financial institutions before the crisis, 50 of them were closed down by the Thai government. Their activities had been subjected to strict restrictions until the 1990s but with capital account liberalization they could expand their facilities investing in riskier projects to obtain higher yielding.

⁶⁶ Flatter, Frank. 1999. "Thailand, the IMF and the Economic Crisis: First in, Fast out ?" Available at http://qed.econ.queensu.ca/faculty/flatters/writings/ff_thailand_brookings.pdf

⁶⁷ A G-24 Discussion paper by K.S, Jomo reviews the circumstances leading to the onset of the East Asian crises of 1997/to assess whether and how the East Asian "models" may have contributed to the crises. See. K.S, Jomo 2001. "Growth After the Asian Crisis: What Remains of the East Asian Model?" UNTACD, G-24 Discussion Paper Series.No:10, March 2001. Available at <http://www.unctad.org>.

⁶⁸ The Independent Evaluation Office Report (2005) p. 33-34

⁶⁹ Michael Camdessus.. 1997. "Lessons from Southeast Asia." Press Briefing Singapore, November 13, 1997. Available at <http://www.imf.org>.

⁷⁰ See IMF's Occasional Paper 178 (1999) by Timothy Lane, et.al p:21

⁷¹ K.S, Jomo (2001).Ibid. p.23

⁷² Ibid. p.24

⁷³ Ibid.

⁷⁴ Letter of Intent. of Thailand , 26 May 1998.

⁷⁵ IMF Annual Report (1998).

⁷⁶ Lafalce. Jhon J. LaFalce. John J.1998. " The Role of the United States and the IMF in the Asian Financial Crisis" available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=301>

⁷⁷ Bullard, Nicola. Bello Walden, and Malhatro Kamal. 1998. Taming The Tigers: The IMF and the Asian Crisis available at <http://www.cidse.org/pubs/tamingtigers.html>

⁷⁸ IMF Press Conference, 24 April 1997 available at <http://www.imf.org>.

⁷⁹ IMF Press Conference , 18 September 1997 available at <http://www.imf.org>

⁸⁰ Sakakibara, Eisuke.2000. "East Asian Crisis: Two Years Later." A speech given at the twelfth Annual Bank Conference on Development Economics by The World Bank in Washington, D.C., on April 18-20,2000

⁸¹ Lipcy, Y Phillip. "Japan's Asian Monetary Fund Proposal." Stanford Journal of East Asian Affairs. Volume 3. No.1 Spring 2003 pp:93-104available at <http://www.stanford.edu>.

⁸² Ibid. p. 99

⁸³ C. Fred Bergsten is director of the Institute for International Economics, which is regarded as one of the most influential think-tanks in the U.S He was also a former assistant secretary for international affairs of the US Treasury. Therefore, his views give important messages regarding the stance of the U.S in crises management and prevention as well as the role of the IMF. His testimony to the Committee on Banking and Financial Services on November 13,1997 titled as "The Asian Monetary Crisis: Proposed Remedies " is available at <http://financialservices.house.gov/banking/111397fb.htm>

⁸⁴ Malaysia's experience was analyzed in detail by Jomo, K.S. 2001. "Malaysia's September 1998 Controls: Background, Context, Impacts, Comparisons, Implications, Lessons." UNCTAD G-24 Discussion Paper Series. No:36, March 2005, New York and by Kaplan, Ethan and Rodrik Dani. 2001. "Did the Malaysian Capital Controls Work?" Available at <http://ksghome.harvard.edu>.

⁸⁵ IMF Issues Briefs. (2000). "Recovery from the Asian Crisis and the Role of the IMF." No: 00/05. 23 June 2000. Available at <http://www.imf.org>

⁸⁶ IMF Press Briefing on 1998 Annual Report by Fischer, Stanley. 11 September 1998.

⁸⁷ IMF Annual Report 1996 . World Economic Outlook. p.27 available at <http://www.imf.org>

⁸⁸ IMF Annual Report 1998

⁸⁹ Concerning the liberalization path in Turkey and its drawbacks, see. Dani Rodrik (1990), Oya Celasun et, al (1999), Korkut Boratav and Erinç Yeldan (2001). Ziya Öni (2004),

⁹⁰CBRT(2002) The Impact of Globalization on the Turkish Economy. Available on site <http://www.tcmb.gov.tr>

⁹¹ Ibid.

⁹² IMF, Letter of Intend, December 1999

⁹³ Ibid.

⁹⁴ Monetary base is defined as the sum of the net foreign assets and net domestic assets of the Central Bank. Containing upper ceiling of net domestic assets of Central Bank means limiting monetary expansion to increases in the stock of foreign reserves. In this sense, the system was left to the effect of foreign capital flows. Yeldan, Erinç. "Behind 2000/2001 Turkish Crisis: Stability, Credibility, and Governance, for Whom" p.5 . Available at <http://www.bilkent.edu.tr>

⁹⁵State Banks, namely Ziraat Bank and Halk Bank have been used as political vehicles for the incumbent governments.

⁹⁶ Cevdet Akçay (2003) and Emre Alper (2001) point that maturity mismatches and open foreign exchange rate positions were the basic factors that made the Turkish financial system fragile in the process of becoming a member of international financial markets without adequate by institutional development.

⁹⁷ The details of the 1999 Disinflation Program and its shortcomings have been analyzed in detail in the studies of Emre Alper and Ziya Öni (2001,2002,2003), Erinç Yeldan (2002,2003), Korkut Boratav, Yılmaz Akyüz (2002) in the context of premature financial liberalization process .

⁹⁸ See Emre Alper (2001), Erinç Yeldan(2001), and Ahmet Ertürk and Erinç Yeldan (2003).

⁹⁹ In their analysis, Erinç Yeldan, Emre Alper, Korkut Boratav, Ziya Öni claim that Turkey was another victim of premature financial liberalization whose problem was neglected at the phase of design of the stabilization program.

¹⁰⁰ Ekinci, Nazım and Ertürk,Korkut. 2004. "Turkish Currency Crisis of 2000-1." Revisited. Department of Economic Paper Series. Working Paper. Mo: 2004-1. pp. 1-23. Available at <http://www.econ.utah.edu>

¹⁰¹ According to CB's Annual Report (2001), the source of current account financing was primarily bond issues by the Treasury while short-term capital dominated after August. The Treasury issued US \$7.5 billion of bonds in 2000. See CBRT's Annual Report (2001). p:49.

¹⁰² IMF's Press Release. 21 December 2000. No: 00/80

¹⁰³ For instance both Michael Deppler, Director, European I Department and Carlo Cottarelli , Assistant director, European I Department International Monetary Fund, disagree with Turkish intellectuals, Korkut Boratav and Ercan Kumcu, regarding their diagnosis that the crisis was a failure of the IMF. See Michael. Deppler,2001. "IMF Worked with Authorities to Solve Turkish Problem". A letter to the Editor, Financial Times, May 2001 and Carlo Cottarelli 2001. "Turkey Always had Control of its Economy." A letter to the Editor, Financial Times June 2001 and the IMF Country Report (2000). No:01/89. Accessed at <http://www.imf.org>

¹⁰⁴ Deppler, Michael. 2001. "IMF Programmes with Turkey have Changed Over Time." Letter to the Editor. Financial Times. July 20,2001. Accessed at <http://www.imf.org>

¹⁰⁵ Kumcu, Ercan.2001. "The IMF's Blunder in Turkey" Financial Times, 13 March 2001. Accessed at <http://mailman.lbo-talk.org>.

¹⁰⁶ Ibid.

¹⁰⁷ Ekinci, Nazım and Ertürk,Korkut.

¹⁰⁸ Anadolu Agency: News in English, 27/04/2000.
Available at <http://www.hri.org/news/turkey/anadolu/2000/00-04-27.anadolu.html>

¹⁰⁹ Letter of Intent of Turkey. 9 December 1999.

¹¹⁰ Fischer, Stanley. 2001. "Exchange Rate Regimes: Is the Bipolar View Correct?" Distinguished Lecture on Economics in Government American Economic Association and the Society of Government Economists Delivered at the Meeting of the American Economic Association New Orleans, January 6, 2001 available at <http://www.ceterisparibus.net>

¹¹¹ Fischer, Stanley. 2001. Ibid. p.19.

¹¹² He mentioned his view on crisis prevention and crisis management in a conference held on 16 December 1998 at the Istanbul Stock Exchange.

¹¹³ The IMF acknowledged the importance of orderly liberalization for emerging market countries assessing the Asian crisis in its annual report in 1998. In that regard, it suggests strengthening prudential regulations in order to minimize the cost of capital account liberalizations.

¹¹⁴ Independent Evaluation Office (IEO). 2005. "Report on the Evaluation of the IMF's Approach to Capital Account Liberalization."

¹¹⁵ Schaefer, D. Brett. 2001. "Turkish Crisis Created Opportunity For Needed Economic Reform. Heritage Foundation Executive Memorandum." No: 723 February 28,2001. pp:1-2

¹¹⁶ IMF Annual Report 1998. p. 46.

TABLES:

Table 1: IMF Members' Quotas and Voting Power

Member Country	Quota (% of Total)	Vote (% of Total)
United States	17,40	17,08
Japan	6,24	6,13
United Kingdom	5,03	4,95
Germany	6,09	5,99
France	5,03	4,95
Italy	3,31	3,25
Saudi Arabia	3,27	3,22
China	2,98	2,94
Canada	2,98	2,94
Russia	2,79	2,74

Source : <http://www.imf.org>

Table 2: Mexico: Macroeconomic Performance Indicators. 1988-1998

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Growth Rate	1,2	4,2	5,1	4,2	3,6	2,0	4,4	-6,2	5,2	6,7	4,8
Inflation	51,7	19,7	29,9	18,8	11,9	8,0	7,1	52,0	27,7	15,7	18,6
Real Exchange Rate (1988index=100)	100,0	94,6	89,9	82,0	75,0	70,8	73,6	106,6	94,7	85,5	86,4
Private Saving Rate(% of GDP)	17.5	14.8	13.2	10.6	10.5	11.6	11.4	15.8	16.7	17.2	17.4
Export (%GDP)	13.9	14.0	14.1	14.2	14.4	15.2	17.2	23.9	26.8	27.9	29.2
Imports (%GDP)	11.7	13.2	15.0	16.6	19.2	19.2	22.3	20.2	23.5	27.1	29.5
Direct investment (%GDP)	1.6	1.5	1.1	1.8	1.6	1.5	3.5	3.1	2.9	3.7	2.9
Portfolio investment (%GDP)	0.5	0.2	1.4	4.9	6.6	10.1	2.6	-3.2	4.2	1.5	0.4
Gross foreign Debt (%GDP)	43.7	36.6	32.1	30.1	28.4	27.5	27.1	31.0	31.1	26.9	24.9
Gross domestic Debt (% GDP)	22.4	23.4	20.9	16.8	11.8	10.2	10.8	9.5	6.9	7.3	8.7
Current Account Deficit (%GDP)		-2,8	-3,0	-5,1	-7,4	-6,5	-7,9	-0,6	-1,8	-3,7	-

Source : Banco de Mexico Annual Report 1996 and Jaime Ros and César Bouillon .

Table 3: Mexico: Foreign Investment Flows. 1988-1995 (Billions of Dollars).

	1988	1989	1990	1991	1992	1993	1994	1995
Total Foreign Investment	3,9	3,5	6,0	17,5	22,4	33,3	19,2	-3,2
- Direct Investments	2,9	3,2	2,6	4,8	4,4	4,4	11,0	7,0
- Portfolio Investments	0,1	0,4	3,4	12,8	18,0	28,9	8,2	-10,1
- Stock Markets	--	0,5	2,0	6,3	4,8	10,7	4,1	0,5
- Securities in domestic currency	--			3,4	8,1	7,4	-2,2	-13,9
- Securities in foreign currencies	0,1	-0,1	1,4	3,1	5,1	10,8	6,3	3,2
Foreign Exchange Reserves	4,9	5,9	9,4	17,1	18,4	24,19	6,1	9,6

Source : Banco de Mexico Annual Report 1996 and Robert A. Blecker (1997)

Table 4: GDP Growth in Asian Countries. 1991-1997

	1991	1992	1993	1994	1995	1996	1997
Korea	9.13	5.06	5.75	8.58	8.94	7.1	5.47
Indonesia	6.95	6.46	6.5	15.93	8.22	7.98	4.65
Malaysia	8.48	7.8	8.35	9.24	9.46	8.58	7.81
Philippines	-0.58	0.34	2.12	4.38	4.77	5.76	9.66
Singapore	7.27	6.29	10.44	10.05	8.75	7.32	7.55
Thailand	8.18	8.08	8.38	8.94	8.84	5.52	-0.43
Hong Kong	4.97	6.21	6.15	5.51	3.85	5.03	5.29
China	9.19	14.24	12.09	12.66	10.55	9.54	8.8
Taiwan	7.55	6.76	6.32	6.54	6.03	5.67	6.81

Source : Narisa Laplamwanit 1999.

Table 5: Inflation Rate in Asian Countries. 1991-1997

	1991	1992	1993	1994	1995	1996	1997
Korea	9.3	6.22	4.82	6.24	4.41	4.96	4.45
Indonesia	9.4	7.59	9.6	12.56	8.95	6.64	11.62
Malaysia	4.4	4.69	3.57	3.71	5.28	3.56	2.66
Philippines	18.7	8.93	7.58	9.06	8.11	8.41	5.01
Singapore	3.4	2.32	2.27	3.05	1.79	1.32	2
Thailand	5.7	4.07	3.36	5.19	5.69	5.85	5.61
Hong Kong	11.6	9.32	8.52	8.16	8.59	6.3	5.83
China	3.5	6.3	14.6	24.2	16.9	8.3	2.8
Taiwan	3.63	4.5	2.87	4.09	3.75	3.01	0.9

Source : Narisa Laplamwanit 1999.

Table 6: Current Account Deficits in Asian Countries. 1990-1997 (%GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
Korea	-0.69	-2.83	-1.28	0.3	-1.02	-1.86	-4.75	-1.85
Indonesia	-2.82	-3.65	-2.17	-1.33	-1.58	-3.18	-3.37	-2.24
Malaysia	-2.03	-8.69	-3.74	-4.66	-6.24	-8.43	-4.89	-4.85
Philippines	-6.08	-2.28	-1.89	-5.55	-4.6	-2.67	-4.77	-5.23
Singapore	8.33	11.29	11.38	7.57	16.12	16.81	15.65	15.37
Thailand	-8.5	-7.71	-5.66	-5.08	-5.6	-8.1	-8.1	-1.9
China	3.09	3.27	1.33	-1.94	1.26	0.23	0.87	3.24
Taiwan	6.82	6.94	4.03	3.16	2.7	2.1	4.05	2.72

Source : Narisa Laplamwanit 1999

Table 7: Government Fiscal balances in Asian Countries. 1990-1997 (%GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
Korea	-0.68	-1.63	-0.5	0.64	0.32	0.3	0.46	0.25
Indonesia	0.43	0.45	-0.44	0.64	1.03	2.44	1.26	0
Malaysia	-3.1	-2.1	-0.89	0.23	2.44	0.89	0.76	2.52
Philippines	-3.47	-2.1	-1.16	-1.46	1.04	0.57	0.28	0.06
Singapore	10.53	8.58	12.35	15.67	11.93	13.07	14.1	9.52
Thailand	4.59	4.79	2.9	2.13	1.89	2.94	0.97	-0.32
China	-0.79	-1.09	-0.97	-0.85	-1.22	-1	-0.82	-0.75
Taiwan	1.85	-2.18	-5.34	-3.88	-1.73	-1.09	-1.34	-1.68

Source : Narisa Laplamwanit 1999.

Table 8: Net Capital Flows to Thailand. 1990-1997 (% of GDP)

	1990	1991	1992	1993	1994	1995	1996
Current Account Deficit	-8,3	-7,7	-5,6	-5,0	-5,6	-8,0	-7,9
Net Private Capital Inflow	11,7	12,3	9,1	9,0	8,5	13,0	9,5
FDI	2,9	2,3	1,9	1,7	1,0	1,3	1,6
Portfolio – equity	0,5	0,0	0,0	3,0	-0,4	1,3	0,9
Portfolio-bonds	-0,1	-0,1	0,5	1,7	2,9	1,2	0,2
Long-term bank lending	2,0	3,4	1,5	0,0	0,0	1,8	4,7
Short-term bank lending	6,5	6,7	5,2	2,5	5,1	7,5	2,2

Source : Stiglitz and Yusuf 2002.

Table 9: Net Flows of Private Financial Account into Thailand. 1990-1997 (Billions of USD).

	1990	1991	1992	1993	1994	1995	1996	1997
1. Bank	1,594	-259	1,933	3,599	13,925	11,236	5,007	-6,442
1.1 Commercial Bank	1,594	-259	1,933	-4,039	3,837	3,103	4,28	-4,735
1.2 BIBF	0	0	0	7,638	10,087	8,133	4,579	-1,707
2. Non-Bank	9,333	10,544	7,435	6,717	-1,910	9,561	13,183	-1,916
2.1 Foreign Direct Investment	2,531	1,848	1,979	1,437	902	1,168	1,454	3,205
2.2 Other Loans	4,495	5,638	2,725	-2,420	-5,838	1,530	5,451	-3,786
2.3 Portfolio Investment	450	151	556	4,848	1,095	3,283	3,485	4,501
2.3.1 Equity Securities	450	36	454	2,682	-409	2,220	1,123	3,875
2.3.2 Debt Securities	0	115	102	2,166	1,564	1,164	2,362	626
2.4 Non Resident Baht A/C	1,342	2,057	1,754	2,682	2,036	3,381	2,913	-5,850
Total Private Capital Net	10,927	10,284	9,348	10,316	12,014	20,797	18,190	-8,358

Source: Ammar Siamwalla et.al.. November 1999.

Table 10: Thailand: Macroeconomic Indicators. 1995-2001.

	1995	1996	1997	1998	1999	2000	2001
GDP	8,8	5,9	-1,4	-10,5	4,4	4,8	2,2
CPI	5,8	5,9	5,6	8,1	0,3	1,6	1,6
Unemployment	1,8	1,5	1,9	4,4	4,2	3,6	3,2
Current Account Deficit % GDP	-8,1	-8,1	-1,9	-12,8	-10,1	-7,5	-5,4
Fiscal Deficit % GDP	2,94	2,3	-0,7	-2,5	-2,9	-2,4	-2,1

Source :Bank of Thailand Annual Reports (1998,1999,2000,2001) and Narisa Laplamwanit 1999

Table 11: Turkey: Macroeconomic Indicators. 1996-2002

	1996	1997	1998	1999	2000	2001	2002
GDP	7,0	7,5	3,1	-4,7	7,4	-7,5	8,1
CPI (1)	82,3	85,7	84,6	68,8	39,0	68,5	29,7
Unemployment Rate	5,8	6,9	6,4	7,4	8,4	10,3	10,3
Capital Accounts (Billions USD)	8,763	8,965	905	4,935	9,610	-14,198	1,832
PSBR/GNP	9,0	7,7	9,0	15,3	11,9	16,4	12,7
Current Account Deficit (Billions USD)	-2,4	-2,6	2,0	-1,4	-9,8	3,4	-1,5
External Debt Stock/GNP	45,4	44,1	47,0	55,4	58,9	79,2	72,2
Import (% of GDP)	23,9	25,2	22,2	22,0	27,1	27,9	28,5
Export (% of GDP)	12,7	13,6	13,1	14,4	13,8	21,1	19,9

Source: Central Bank of the Republic of Turkey (CBRT) Annual Reports 1998-2003.

(1) Annual percentage change, (1994=100)

Table 12: Turkey: Capital Accounts, Current Accounts and Reserves. 1999-2001 (Billions of USD)

	1999	2000-I	2000-II	2000-III	2000-IV	2001-I	2001-II	2001-III	2001-IV
Capital Account	4,670	3,435	4,535	2,966	-1,491	-3,060	-6,342	-1,154	-3,326
Direct Investment (Net)	138	-20	190	-427	369	1,574	109	427	659
Portfolio Investment (Net)	3,429	2,091	1,608	2,333	-5,010	-2,868	-348	-741	-558
-Securities Purchases of Residents	-759	102	-337	-369	11	-22	89	-135	-720
-Securities Purchases of Non-Residents	968	-83	3	762	-5,319	-3,292	178	-603	-106
- Bond Issues	3,220	2,072	1,942	1,940	298	446	-615	-3	268
Current Accounts.	-1,4	-2,3	-3,3	-1,2	-3,0	-0,5	1,2	2,0	0,6
Reserves (Change)	-5,614	-517	-1,653	-726	-2,542	3,138	1,556	-1,688	-312

Source: CBRT Annual Reports (2000, 2001).

Table 13: Turkey: Capital Flows By Sectors. 1999-2001

	1999	2000	2001
Net Capital Flows	4,935	9,610	14,198
- Public Sector	1,205	6,110	99
- Banks	1,885	4,636	-8,773
Bond Issue	83	142	-3
Short-term	1,685	4,85	-7,642
Long-term	117	-363	-1,024
- Other Sectors	3,003	5,830	-1,475

Source : CBRT Annual Report (2001).

Table 14: Basic Characteristics of the Turkish Financial System. 1995-2000

	1995	1996	1997	1998	1999	2000
Total Assets of the Banking Sector /GNP	52,2	59,4	65,9	69,4	92,1	82,8
Volume of Inflows (billion USD)	76,427	8,824	19,110	19,288	122,673	209,432
Volume of Outflows (billion USD)	75,626	8,055	18,386	19,225	120,603	204,691
Net Short-Term Capital Flows (billion USD)	3,713	5,945	1,761	2,601	759	4,035
Current Account Balance /GNP	-1,4	-1,3	-1,4	1,0	-0,7	-4,8
Total Foreign Debt/GNP	42,8	46,2	47,8	50,9	55,7	58,3
Short-Term Foreign Debt/CB Reserves	126,7	104,2	95,1	105,4	98,9	127,6

Source: Ümit Cizre and Erineç Yeldan. 2005.

Table 15: Turkish Stabilization And Crisis: Macroeconomic Targets And Performance

	1999	2000		2001	
	Actual	Target	Perf.	Target	Perf.
GNP Growth Rate	- 6,1	5/5,5	6,1	-3/ 5 to 6	-9,4
WPI Inflation	62,9	20,0	32,7	57,6 (10 to 12)	88,6
CPI Inflation	68,8	25,0	39,0	52,5 (10 to 12)	68,5
Average T-bill Nominal interest rates	106,2	-/-	38,0	81,1	100,4
Real interest rates (Backward looking)	25,2	-/-	-11,4	23,7	-/-
Real interest rates (Forward Looking)	32	-/-	-6,5	36,4	-/-
Primary Balance	-2,2	2,2	2,5	5,5	5,5
Net Interest Payments	22,1	17,2	21,9	22,6	25,0
PSBR (inc. CBT profits)	24,2	15,0	19,1	17,1	19,5
Operational balance	-12,4	-7,4	-6,6	-3,2	-/-
Net debt	61,0	58,0	58,4	78,5	98,5
Net domestic debt	40,9	-/-	38,8	44,3	53,9
Current account balance	-7,0	-1,5 to -2	-4,8	-0,6 (-1,5 to -2)	-1,5
Net external debt Expenditures (Trillion TL)	34	<34	37,0	44,3	51,8
	42,418.90	46,713.30	46,602.60	-/-	-/-
Revenues (Trillion TL)	28,286.50	32,585.50	33,756.40	-/-	-/-

Source: Yılmaz Akyüz and Korkut Boratav (2002)

Table 16: Performance Criteria of the Central Bank of Turkey and Realizations

	Net Domestic Assets	Net Domestic Assets	Net International Reserves	Net International Reserves
	Target	Actual	Actual	Actual
31 December 1999	-12,000	-1,437	12,000	16,757
31 January 2000	-12,000	-1,260	12,000	16,657
31 March 2000	-12,000	-1,295	12,750	17,339
30 June 2000	-12,000	-1,307	12,750	17,874
31 December 2000	-12,000	-1,060	13,500	12,488

Source: CBRT Annual Report (2000)

BOXES:

Box : 4.1. Main Steps in the Liberalization Process of Mexico

YEAR	MAJOR STEPS
1985	July: <u>First stage of the trade-liberalization program</u> : Elimination of import licenses for capital and intermediate goods, and reduction of the number of tariff categories.
1986	July: The agreement to enter GATT was signed.
1987	December: <u>Second stage of the trade liberalization program</u> : The elimination of import licenses is extended to imports of consumer goods. The degree of tariff dispersion and the average tariff are reduced.
1988	October/ November: Start of financial liberalization: The elimination of credit quotas (to high-priority sectors) and the obligatory reserve requirements. Eradication of some interest-rate ceilings.
1989	April: Eradication of all interest-rate ceilings. May: Reform of regulation of direct foreign investment. July: Opening of stock market to foreign investors (through liberalization of the neutral- investment regime). Initial agreement on the external debt reduction plan with creditor banks (Brady Plan).
1990	February: Signing of agreement on external debt reduction with creditor banks. Some restrictions on investment in bonds, stabilization bonds and treasury bills (except CETES) were already eliminated in July 1989. December: Opening of money market to foreign investors with the eradication of restrictions to portfolio investments in government bonds and initiation of negotiations on free-trade agreement (NAFTA).
1991	February: Recognition of the Mexican stock exchange as an offshore designated securities market by the US SEC. Privatization of TELMEX (initiated in December 1990) and privatization of main banks.
1992	April: 10-per cent ceiling on foreign currency deposits (and minimum requirement of investing 15 per cent of those liabilities in foreign currency). October: End of NAFTA negotiations. November: Expansion of restrictions on foreign currency-denominated bank indebtedness (measures of April). December: Signing of NAFTA by governments of the three member states.
1993	December: New Law on Foreign Investment, substituting the 1973 Act (which established as a general rule a maximum foreign ownership of 49 per cent of enterprise capital).
1994	January: NAFTA becomes effective.

Source : Jaime Ros and César Bouillon (2001).

Box: 5.1. Main Steps in the Liberalization Process of Thailand

YEAR	MAJOR STEPS
1987	-Removal of separate interest rate ceiling for lending to priority sectors. -List of authorized business for commercial banks and finance companies was broadened to include custodial services, loan syndication, advisory services regarding mergers and acquisition feasibility studies.
1989	-Removal of interest rate ceiling on time deposits of commercial banks
1990	-May: IMF article VIII obligations were assumed in 1990. -Removal of requirement on minimum denomination of promissory notes that finance companies can issue.
1991	-January: Removal of interest rate ceiling on savings deposits at commercial banks. June: Removal of interest rate ceiling on commercial bank lending.
1993	-March: The Bangkok International Banking Facility (BIBF) was established. -Commercial Banks required announcing Minimum Retail Rate calculated from actual costs of deposits and operating costs as reference lending rates for retail prime borrower.

Source: Pedro Alba, et.al." Financial Liberalization and the Capital Account: Thailand 1988–1997."

Box : 6.1. Main Steps in the Liberalization Process of Turkey

YEARS	MAJOR STEPS
1980	<p>- The 24th January 1980 Decisions were announced in order to curb inflation, to fill in the foreign financing gap, and to attain a more outward oriented and market-based economic system.</p> <p>-Ceilings on deposit and lending interest rates were removed.</p>
1981	<p>The Quota List for import was abolished and a large number of items were transferred from the Liberalized List 2 to the less restrictive Liberalized List 1.</p>
1984	<p>January : A new import regime was represented. The former three lists were replaced with new lists: The Prohibited List, the List of Imports Subject to License, and the Fund List. Under the new regime, all commodities that were not explicitly prohibited could be imported.</p>
1985	<p>The Prohibited List was phased out; banned commodities were reduced from 500 to 3 items,</p>
1986	<p>January: Istanbul Stock Exchange as a secondary market platform for the government securities began to operate.</p> <p>April: The Interbank Money Market at the Central Bank was activated.</p>
1988	<p>October: All kinds of deposit interest rates were freed.</p>
1989	<p>- The number of goods subject to licenses was reduced from 33 to 16, while tariffs and levies on imports were reduced substantially.</p> <p>- Full capital account liberalization was accomplished in 1989 with the announcement of the Decree No. 32 which entails the followings:</p> <ul style="list-style-type: none">* Removing all restrictions on selling and purchasing foreign exchange and the securities listed at the Stock Exchange and the securities issued upon the permission of the Capital Markets Board for the residents and non-residents,* Obtaining foreign credits is liberalized; non-residents are allowed to open Turkish lira accounts and to transfer principal and interests accruing to these accounts in Turkish lira or foreign exchange.* Non-residents are allowed to buy and transfer foreign exchange and send Turkish lira abroad without any limitation.

Source : CBRT.(2002). "The Impact of the Globalization on the Turkish Economy."

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