

Turkish Post-Crisis Development Experience from a Comparative Perspective:

Structural Break or Business as Usual?

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“To suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium if we only trust to methods of laissez-faire is a doctrinaire delusion, which disregards the lessons of historical experience without having behind it the support of sound theory” (Keynes 1980: 21-22).

“The force, Luke, trust the force”. Obi Wan Kenobi - *Star Wars*

A. INTRODUCTION

The Turkish economy entered 2008 with a changing global tide that had been in its favor since the 2001 crisis. In particular, the U.S. sub-prime mortgage crisis has escalated with no end in sight and with an estimated cost of over \$1.3 trillion (as of September 2008) to global economy (International Monetary Fund (IMF) 2008a). In this crisis environment, developing countries, in particular, are “vulnerable to a credit pullback, especially in those cases where domestic credit growth has been fueled from external funding sources and large current account deficits need to be financed” (IMF 2008b: IX). As a result it is indeed a timely exercise to look at the accumulated evidence since 2001 to decide whether the recent performance of Turkey represents a demarcation line that marks its transition from semi-periphery to the center.

The ambitious program of deregulating and liberalizing goods and assets markets was assumed to bring about stability, enhance business confidence, facilitate portfolio diversification and better risk management, generate new investment and employment opportunities, and stimulate growth in developing countries. In retrospect, however, it has become almost impossible to call the countries that adopted this laissez faire ideology (or *utopia*) as success stories given the bitter memories of the last decade including the Argentine (1995, 2001), Brazilian (1999), Mexican (1994/5), Russian (1998), South East Asian (1997), and Turkish (1994, 2000, 2001) crises.¹ In fact, even the most die-hard advocate of unfettered liberalization and deregulation of financial markets, the IMF, now argue that the current financial crisis *is the result of regulatory failure to guard against excessive risk-taking in the financial system* and lack of *prudential regulation, accounting rules and transparency*, including a lack of public scrutiny over credit rating agencies (Strauss-Kahn 2008).

The Turkish economy went through one of the most radical transformations among developing countries since early 1980s and has been repeatedly pointed out both as the poster child and the scare crow of IMF and World Bank (WB) sponsored liberalization programs given its first hand experience with three financial crisis in 1994, 2000 and 2001, and its being the most important and devoted client of IMF. In fact, as of July 31, 2008, Turkey is not only the largest debtor of IMF accounting for 79 per cent of the total outstanding credits from the General Resources Account and 52 per cent of total outstanding credit and loans, but also has the highest quota/usage ratio with 608 per cent of its quota (IMF 2008c). Since the 2001 crisis, however, Turkish economy has surprised many of its critics by outperforming many other emerging markets on several fronts. The question I ask here therefore is whether the recent performance of Turkey is strong and sustainable to be called as a structural break with its ancient regime. The question is not a new one and many, including the WB, and IMF explicitly share and voice this suspicion in their publications. What I attempt to do here, therefore, is to provide a discussion of previous fault lines in the Turkish economy and to explore, in comparison with other major developing countries, whether they have been corrected or still continue to pose risks.

The paper is organized as follows: The next section discusses stylized facts on recent trends among emerging markets including: macroeconomic volatility, financial fragility and balance of payments constraints, and macroeconomic performance encompassing growth and investment, capital markets, and international trade. The final section concludes.

B. STYLIZED FACTS ON RECENT MACROECONOMIC TRENDS AMONG EMERGING MARKETS

1. Macroeconomic Volatility

Financial liberalization and deregulation programs of the 1980s and 1990s have created both opportunities and challenges for long-term investment and growth in developing countries. Focusing on the challenges side, increasing uncertainty and volatility in key macro and micro prices can be pointed out as the most common problem faced by developing countries. Consumption volatility, for example, has increased during the 1990s (Kose et al. 2003). Likewise, capital flow volatility during the 1990s compared to late 1970s and 1980s are found to be ‘high, rising and unpredictable’ (Gabriele et al. 2000: 1051) with significantly negative effects on investment (Demir 2008b). The stylized facts also show an increase in the volatility of stock markets as well as sales and earnings of firms in both developed and developing countries for the last three decades (Grabel 1995; Comin and Mulani 2006). In the case of GDP growth volatility, although it has declined across developed countries during the 1990s, the results have been more heterogenous among developing countries with an overall volatility twice as high as the developed ones (Montiel and Serven 2004). There is also substantial evidence showing that capital inflows have had significantly negative effects on profitability rates in tradable goods sectors through changing relative prices (Frenkel and Ros 2006). Excess volatility in exchange rates resulting from increasing capital flow volatility is also shown to raise inflation uncertainty and encourage speculative financial investments by real sector firms (Demir 2008a; Felix 1998; UNCTAD 2006).

Furthermore, as business portfolios became more and more diversified in the highly integrated global capital markets, the marginal benefit of acquiring country specific information has decreased, which discouraged investors from obtaining detailed information on each country

they invest in (Calvo 1998). As a result, it has become quite *rational* for investors to react even to small news that trigger financial turmoil even when there is no fundamental change in key economic indicators. Therefore, it is of little surprise that emerging economies are systematically becoming more vulnerable to both currency and banking crises after financial liberalisation (Weller 2001). In this respect, increasing volatility after financial liberalisation appears to become self-exacerbating as the investors shorten their time horizons either to benefit from speculative gains or to avoid excess risks (Grabel 1995; Keynes 1964: Ch. 12).

Looking at the recent experience of Turkey with volatility, we see that the standard deviation of real GDP growth has steadily increased from 3.3 to 5.5 and 6.3 per cent during 1980-88, 1989-1994, and 1995-2001, respectively. For the most recent period of 2002-2006 (2002-2007 with the new GDP series), however, it declined to 1.2 per cent (1.7 per cent). Comparatively speaking, we also observe a similar decrease in volatility to around 1 per cent level in Argentina after 2003, Brazil after 1995, Mexico, Chile and Thailand after 2001. On the other hand, in Egypt, Korea and Tunisia, it has been around 1 per cent level since early and mid 1990s.²

In addition, the volatility (measured by the average standard deviation of annual percentage change) of real short-term capital inflows has increased from 1.2 to 7.3, and 4.8 per cent during 1980-88, 1989-1994, and 1995-2001 respectively. Since then, however, it declined to 1.9 per cent during 2002-2007. Increasing short-term capital inflows (reaching \$181 billion in 2000 prices during 1990-2007) have also led to considerable appreciation of domestic currency and hurt tradable goods sectors. Between December 2001 and June 2008, average monthly multilateral real exchange rate (RER) appreciated by 48 per cent (CBRT). We also observed an increase in real (and nominal) exchange rate volatility (measured by 12 month standard deviation of monthly real exchange rate percentage changes) from 2.4 per cent during 1995-2001 to 3.4 per cent during 2002-2007.

On the inflation front, there have been major gains. Consumer inflation declined from an average of 72 per cent during 1989-2001 to 35 per cent during 2002-2003, and further down to 9 per cent during 2004-2007. Compared to other emerging markets, however, the decline was not unique or that impressive and is related to the new orthodoxy with respect to inflation targeting (Epstein and Yeldan 2008). During 2002-2007, other than in Argentina (12 per cent) consumer inflation (period averages) was substantially reduced also in other emerging markets such as in Brazil (7 per cent), Chile (3 per cent), Egypt (7 per cent), Korea (3 per cent), Mexico (4 per cent), Thailand (3 per cent), and Tunisia (3 per cent).

2. Financial Fragility and Balance of Payments Constraints

2.1 interest rates

Turkey continues to offer the highest real interest rate and uncovered interest arbitrage (UIA) among emerging markets. The uncovered interest parity condition defines the net arbitrage gain as the difference between domestic interest rates deflated by the (next period) average depreciation of domestic currency, and the corresponding foreign (i.e. U.S.) interest rates. As a simple proxy, it shows the net rate of return on investing in domestic short-term financial assets as opposed to foreign ones. The annual average UIA gain in Turkey has been two and sometimes three digit numbers reaching on average 10, 19 and 40 per cent during 1989-1994, 1995-2001 and 2002-2007 respectively (Figure 1). Among other emerging markets, only Brazil has offered

such a high level of arbitrage return reaching (annual monthly UIA averages) 106, 18, and 34 per cent during 1989-1994, 1995-2001 and 2002-2007 respectively. In contrast, during this time, the UIA averages for Argentina (151, 4.5, and 8.5 per cent), and Mexico (8, 19, and 3.6 per cent) were much lower (Figure 2).

<Insert Figure 1&2>

The annual real interest rate also continued its upward trend reaching 13 per cent on average during 2002-2007 compared to 10 per cent during 1995-2001 and 1.5 per cent during 1989-1994, despite a sudden drop in 2004 and 2005 (Figure 1). The downward trend is reversed in 2007 with rates jumping to 10 per cent from 7 per cent a year ago. During this time, the real interest rates in Argentina (37, 11, and 1 per cent) and Mexico (7, 5, and 3 per cent) were much lower than the rates in Turkey. Only Brazil with 73, 17.5, and 9.6 per cent real interest rates was similar to the Turkish case.

Despite the persistently high real interest rates, however, there have been some positive developments regarding the interest cost to private sector. Accordingly, the share of interest payments in total value added of the largest 500 private manufacturing firms that account for more than half of total manufacturing value added in the country declined from its peak of 94 per cent in 2001 to a low of 9 per cent in 2007. The period averages also highlight the downward trend in interest costs, which has been 14 per cent during 2002-2007 compared to 52 per cent during 1997-2001.

Nevertheless, looking over the last two decades, high interest rates have been disastrous for public finances. As a share of GNP, the public sector borrowing requirement (PSBR) reached 16.4 per cent while the share of interest payments in consolidated budget increased to 25 per cent by 2001 from around 4 and 1 per cent in 1981 respectively. By 2007, however, the PSBR dropped to 0 per cent with an average of 1.72 per cent during 2003-2007. Likewise, the share of interest payments in GNP steadily decreased to a low of 5.7 per cent in 2007 with an average of 9.4 per cent during 2002-2007 as opposed to 17 per cent in 2001. As a result, the share of interest expenditures in the consolidated budget dropped to around 24 per cent in 2007 with an average of 35 per cent since 2002. This is a remarkable gain given that it previously increased from 5 per cent in 1981 to 51 per cent in 2001. To service the public debt, the central government channeled 32 per cent of tax revenues to interest payments in 2007 as opposed to 103 per cent in 2001.³

The gains on the public finance front are impressive, yet the interest burden continues to drain one third of tax revenues that should instead be spent on long-term development goals including health and education, especially given that more than 10 per cent of the population is still illiterate and the share of university graduates in working-age population (25-64) is a bare 10 per cent (which is the lowest among all OECD countries that have an average of 36 per cent). Likewise, only 28 per cent of the working-age population has high school education as of 2006 that is again the lowest among all OECD countries and rank behind other emerging countries such as Chile with 50 per cent (OECD average was 68 per cent) (OECD 2008). The average shares of health and education expenditures from the consolidated budget were only 12 and 3.4 per cent during 2002-2007, respectively compared to 35 per cent for interest expenditures. Among other emerging markets, only Argentina and Egypt are transferring such high levels of public resources to interest payments. Overall, post 2001 interest rates continue to be unsustainably high that facilitates a significant amount of resource transfer from the public and real sectors to the financial rentiers.

2.2. the current account

Turkey has increasingly become a high current account deficit (CAD) country, accounting for 2.5 per cent of global total CAD in 2007 that put it among the seven worst deficit countries right behind US (49.4), Spain (9.3), UK (9.2), Australia (3.4), Italy (3.2), and Greece (2.9) (world percentage shares in parenthesis) (IMF 2008b). As a share of GDP, Turkish CAD increased from 1 per cent during 1995-2001 to around 3.8 per cent during 2002-2007 with a high of 6 per cent in 2007. Among other emerging markets this is the highest deficit, and countries such as Argentina, Brazil, Chile, Egypt, Indonesia, Korea, or Thailand all had current account surpluses during 2002-2007, while only Mexico and Tunisia had deficits of 1 and 2 per cent of GDP respectively (that are lower than their previous levels of 2 and 3 per cent during 1995-2001).

In terms of the financing of this deficit, however, there have been positive developments with foreign direct investment (FDI) inflows increasingly accounting for a larger share. Despite growing CAD after 2002 (reaching \$7.5, \$14.4, \$22, \$31.9, and \$37.8 billion in 2003, 2004, 2005, 2006, and 2007), an increasingly larger portion of the deficit was financed from FDI inflows. In 2007 (2006), for example, 59 per cent (63 per cent) of the CAD was financed this way. Regarding level effects, the total FDI inflows (in current prices) reached \$71 billion during 1980-2007, and 81 per cent (73 per cent) of this came during 2002-2007 (2002-2006).

Given the general consensus that identifies short-term capital flows rather than FDI as the main culprit behind increasing volatility and financial instability, this is indeed a positive development. Besides potential positive spill-over effects, a higher share of FDI flows vis-à-vis short-term capital flows can also help reduce the risk of a financial crisis.⁴ As a footnote, however, we need to point out that a major part of FDI inflows were Merger and Acquisitions (M&A) that raise questions about their future sustainability. Although 73 per cent of all FDI inflows during 1980-2006 came during 2002-2006, 83 per cent of these were M&A, mostly from privatization of State Economic Enterprises.⁵ In contrast, only 18 per cent of FDI inflows were M&A during 1987-2001.⁶ Therefore, the net effect of FDI on growth and investment is still indeterminate depending on the realization of investment and spillover effects.⁷

2.3. external debt

The changes in external debt indicators reflect the split persona of the recent macroeconomic performance of Turkey. While total gross external debt in dollar terms has more than doubled from \$114 billion in 2001 to \$284.4 billion at the end of second quarter of 2008, as a share of GDP it appears to have declined from its peak of 58 per cent in 2001 to 38 per cent in 2007, mostly thanks to the appreciating domestic currency and new national income series that has been revised upwards.⁸ Likewise, gross public external debt also increased from \$47 billion in 2001 to \$77.7 billion in the second quarter of 2008. As a share of GDP, however, the public external debt also declined from an average of 21 per cent during 1995-2001 to 18 per cent during 2002-2007, with a low of 11 per cent in 2007.

Likewise, private external debt has more than quadrupled from \$42 billion in 2001 to \$190.5 billion in 2008:2 (i.e. the second quarter), making it the primary culprit for the rapidly growing external debt. Accordingly, the private sector accounts for 67 per cent of gross total external debt in 2008:2 compared to a mere 37 per cent in 2001 (Table 1). Moreover, Non-financial corporations (NFC) have accounted for a larger portion of this debt since 2000.

Accordingly, the share of NFCs in gross external private debt increased from around 58 per cent in 2000 (72 per cent in 2001) to 65 per cent in 2008:2. In terms of nominal values, the NFC debt quadrupled from around \$30 billion in 2001 to \$124.7 billion in 2008:2 with annual growth rates of 18, 18, 33, and 35 per cent from 2004 to 2007 (and with a two-quarter growth rate of 22 per cent in 2008) (Table 1). Similarly, financial institutions increased their external debt obligations from around \$12 billion in 2001 to \$65.9 billion in 2008:2 with annual growth rates of 45, 41, 39 and 19 per cent from 2004 to 2007. Thanks to an overvalued exchange rate and high domestic interest rates, private sector preferred to borrow abroad in foreign currencies that exposed their balance sheets to a serious currency mismatch problem.

<Insert Table 1>

However, looking at the term structure of this debt we see some truly noteworthy improvements, especially given the maturity mismatch problem private firms faced during the 1990s. Accordingly, the share of short-term debt in total external debt obligations of NFCs decreased to 22 per cent by 2008:2, representing a significant change in NFCs debt structure given that the same ratio was 57, 25 and 33 per cent in 1994, 2001 and 2004 respectively. The improvement in the term structure was even more pronounced for financial institutions after 2001. Accordingly, the share of short-term debt declined from around 74 per cent in 1994 to 59 per cent in 2001 and further down to 30 per cent in 2008:2 (Table 1). Furthermore, the Central Bank of Turkey significantly increased its international reserves from its highest pre-crisis level of \$25 billion in 2000 to a record high of \$71.5 billion at the end of 2007. Also, the average short-term external debt/reserves ratio decreased from an average of 104 per cent during 1995-2001 to 70 per cent during 2002-2007 with a low of 58 per cent in 2007.

Nevertheless, given the above fault lines, Turkey continues to be viewed as a high risk country, both economically and politically, that contributes to a high risk premium in interest rates. Although the EMBI (JP Morgan Emerging Markets Bond Index) global yield spread has declined significantly from over 1000 basis points (bp) in 2001 to around 240bp at the end of 2007 on average, Turkey continues to pay over 300bp at the end of first quarter of 2008. Also, its risk ratings stay well behind those of other developing countries. According to Moody's, Standard and Poor's, and Fitch, as of May 2008 the ratings were Ba3, BB-, and BB- respectively, that were well below other emerging markets such as Chile (A2, A, A), South Korea (A2, A, A), Malaysia (A3, A-, A-), Tunisia (A3, BBB, BBB), Mexico (Baa1, BBB+, BBB+), Brazil (Ba1, BBB-, BB+) and Egypt (Ba1, BB+, BB+). Furthermore, based on the World Bank's *Worldwide Governance Indicators*, Turkey continues to rank at the bottom fifth percentile among 212 countries in terms of its political stability. Similarly, according to the Institutional Investor composite credit risk rating (that is composed of political, economic and financial risk measures), Turkey ranked 70th among 177 countries in September 2008, behind (ranking in parenthesis) South Korea (27), Greece (28) Chile (31), China (33), Mexico, (43), Brazil (52), Thailand (57) and Tunisia (60).

3. Economic growth and investment

The GDP growth that dropped to a startling -8 per cent (or -6 per cent with the new GDP series) in 2001 recovered with an impressive average of 7 per cent during 2002-2007 (especially given that the averages were 4, 3 and 3 per cent during 1980-1988, 1989-1994, 1995-2001,

respectively). The only emerging markets that did as well or better than Turkey during this period were China and India. However, on the investment front we see a disappointing picture. Gross fixed capital formation (GFCF) as a share of GDP has declined from an average of 24 and 22 per cent during 1989-1994 and 1995-2001, respectively to 20 per cent during 2002-2007. Although these are comparable rates to those of Argentina, Brazil, Egypt and Mexico, they are below the levels of successful industrialization examples such as South Korea with a 30 per cent and China with 40 per cent since 2001. In fact, declining fixed capital formation rates led UNCTAD (2003) to include Turkey in a group of deindustrialisers among other developing countries given the 25 per cent minimum (GFCF in GDP) that has been identified as the required threshold to generate high and sustained growth in middle-income developing countries (UNCTAD 2003:61). In terms of its composition, we find that the share of private gross fixed capital formation in GDP declined to 14 per cent (16 per cent with new GDP series) during 2002-2007 from 18 per cent during 1995-2001 and 17 per cent during 1989-1994 periods. Likewise, we observe a significant fall in the share of public investment expenditure in GDP from around 9 per cent during early 1980s to 7 per cent during 1989-1994, 5 per cent during 1995-2001 and 4 per cent during 2002-2007, with a low of 3 per cent in 2007, which marked its lowest level since 1980.

The share of industrial value added in GDP also steadily declined from 27 per cent in 1998 to 22 per cent in 2001 and 20 per cent in 2007. Meanwhile, the share of services in GDP increased from 60 per cent in 1998 to 69 per cent in 2001 and 73 per cent in 2007. Furthermore, we also observe a continuous decline in the share of manufacturing value added in GDP from around 22 per cent during 1995-2001 to 17 per cent during 2002-2007 with a low of 16.6 per cent in 2007, which is the lowest share since 1980. Comparatively speaking, however, Turkey is not the only country experiencing a decline in the share of manufacturing value added in GDP. Accordingly, between 1995-2001 and 2002-2007 it declined from an average of 19 to 17 per cent in Chile and from 21 to 18 per cent in Mexico, respectively and stayed at around the same level of 33 per cent in China, 18 per cent in Egypt, 28 per cent in South Korea, and 18 per cent in Tunisia. In contrast, the share of manufacturing value added in GDP increased from 18 to 23 per cent in Argentina, from 17 to 18 per cent in Brazil, from 27 to 28 per cent in Indonesia, and from 32 to 35 per cent in Thailand.

On the positive side, we did observe an increase in capacity utilization rate in private manufacturing from an average of 75 per cent during 1995-2001 to 78 per cent during 2002-2007. Furthermore, looking at the composition of gross private fixed investment we see that the share of manufacturing investments has increased from around 25 per cent in 2001 to 41 per cent in 2007. In terms of its components, we see that the share of machinery and equipment in gross private fixed investment increased to 59 per cent (63 per cent according to the new GDP series) during 2002-2007 compared to 51 per cent during 1995-2001. Increasingly appreciating domestic currency that made capital investment imports cheaper is probably the primary reason for this expansion.

The question why financial liberalization did not lead to investment growth in real sectors can be answered on the basis of such fault lines as high real interest rates, capital market imperfections and lack of credit availability, high macro volatility, risk and uncertainty, and declining public investment rates. Furthermore, I argue that following the liberalization wave of the 1980s and 1990s private real sector firms, in particular those with access to financial markets, adopted a portfolio view of investment and started to take into account the availability of

relatively quick and high returns in the booming financial markets and government debt instruments, especially in the presence of increasing volatility and uncertainty, profitability squeeze, and credit bottlenecks. In this picture, the existence of large public debts that are financed from domestic capital markets at high real interest rates further contributed to the rise of this new class of investors who chose short-term reversible financial investments over risky long-term fixed investments. In other words, increasing availability *and* accessibility of alternative investment opportunities in financial markets combined with domestic market rigidities and uncertainty have become instrumental in channeling real sector savings to short-term financial investments instead of long-term fixed capital formation and thus lead to deindustrialization in Turkey. For example, the ratio of financial revenues in total profits of top 500 manufacturing firms increased from around 22 per cent during 1982-1988 to around 42 per cent during 1989-1994 and further up to 160 per cent during 1995-2001, with a peak of 546 per cent in 2001 (ICI). Following 2001, however, it steadily declined with an average of 54 per cent during 2002-2007 and with a low of 26 per cent in 2006 that has been the lowest since 1986. After 2006, however, it started increasing once again reaching 36 per cent in 2007.

Looking at the effects of the difference between rates of return on fixed and financial assets (*Rgap*) using semi-annual panels of publicly traded industrial firms in Argentina, Mexico and Turkey, Demir (2008a) finds an economically and statistically significant positive relationship between *Rgap* and fixed investment spending in all three countries suggesting that increasing rates of return gap in favor of fixed (financial assets) increases (decreases) new fixed investment spending of private industrial firms. The results from Demir (2008a, 2008b) also highlight the negative effects of uncertainty and risk on new fixed investment decisions under multiple investment options. Accordingly, these papers find an economically and statistically significant negative effect of real exchange rate and inflation uncertainty, country risk, and short-term capital flow volatility on private fixed investment spending in Turkey, as well as in Argentina and Mexico. Furthermore, Demir (2008a) reports a significantly negative relationship between *Rgap* and the share of financial assets in total assets in all three countries. In this respect, declining output and capital volatility and decreasing real interest rates are positive developments for real sector investment prospects. This is also reflected by the falling share of financial revenues in the total profits of private firms.

Next, Figure 3 shows the changes in firm-level volatility (measured by the averages of four-year backward moving standard deviation of the variables) using Istanbul Chamber of Industry (ICI) data on top 500 largest private manufacturing firms during 1983-2005.⁹ Accordingly, the median volatility of profitability (measured by net profits before taxes to net sales ratio) has not changed significantly during 2002-2005 and stayed at around 5 per cent compared to 5, 4, and 3 per cent during 1995-2001, 1989-1994, and 1986-1988 respectively. Sales volatility also stayed at around 17 per cent compared to 19, 18 and 19 per cent during 1995-2001, 1989-1994, and 1986-1988 respectively. Value-added volatility, however, has increased substantially since 2001 reaching 53 per cent compared to 39, 33 and 34 per cent previously. We also observe a slight increase in employment growth volatility with an average of 13 per cent compared to 11, 11 and 9 per cent during 1995-2001, 1989-1994, and 1986-1988 respectively. When we look at the within group volatility (measured by average cross section standard deviation) we observe an increase in the standard deviation of all these variables across firms. Profit and value added volatility, for example, increased by 100 per cent while sales volatility increased by 60 per cent compared to the 1995-2001 period that reflects trend increases

compared to earlier periods rather than one-time increases) suggesting increasingly diverse firm performances.

<Insert Figure 3>

4. Capital market imperfections and credit availability

A major fault line that continues to limit firms' growth performance in Turkey is the lack of external investment financing. While the real private credit (from the banking sector and other financial institutions) to the private sector (as a share of real GDP) has increased to 18 per cent during 2002-2007 with a peak in 2007 at 26 per cent that is the highest level since 1980 (compared to 14 and 15 per cent during 1989-1994 and 1995-2001), it is still well below the high income OECD average of over 160 per cent or South Korea's 97 per cent. On the other hand, as a share of total deposit bank private credits (that account for 90 per cent of total banking sector credits), non-financial firms received only 60 per cent on average during 2002-2007 with a low of 56 per cent in 2007 compared to 71 per cent during 1995-2001. During this period, its average annual growth rate has been startlingly low at -5 per cent. In contrast, the share of households in deposit bank private credits has increased from an average of 14 per cent during 1995-2001 to 34 per cent during 2002-2007, reaching 43 per cent as of 2007 with an average growth rate of 17 per cent a year. Given the availability of high interest yielding government debt instruments and consumer credit, banks in Turkey prefer to finance public borrowing and household consumption rather than long-term fixed investment by the private sector. As of 2007, around 30 per cent of total interest income of commercial banks came from public sector securities, which is better than the 34 per cent of 2001 but is still substantially high (BAT). In 2007 (2002), 56 per cent (55 per cent) of total government domestic debt instruments were owned by the banking sector that correspond to around a quarter of its total assets (which was one third in 2002).

Compared to other developing countries, Turkey occupies a lower-end position in credit availability. During 2002-2007, (real credit to real GDP ratios in parenthesis) Brazil (33 per cent), Chile (75 per cent), Egypt (57 per cent), Thailand (92 per cent), Tunisia (65 per cent) all performed better while Argentina (12 per cent), Indonesia (21 per cent-that is half of its 1989-1994 and 1995-2001 levels of 40 per cent), and Mexico (16 per cent) performed similar to the Turkish case. As a result, private firms continue to face strict credit rationing and are forced to finance investments mostly from internal sources or short-term borrowing. As of 2007, the share of short-term debt in total external debt of top 500 private manufacturing firms was 70 per cent with an average of 75 per cent during 1997-2001 and 68 per cent during 2002-2007.

The low level of credit generation is even more striking given the radical increase in the share of foreign banks in Turkey since 2002. Although foreigners account for over 40 per cent of total equity in the banking system and majority foreign-owned banks control over 15 per cent of total assets at the end of 2007, their share in total credit is not significantly different than those of domestic private banks. Comparatively speaking, other emerging markets, such as Argentina, Brazil and Mexico also went through similar changes after liberalization with little or no improvement in their credit generation (or financial sector development and stability).¹⁰

Regarding capital market deepening, although money market in private securities remained quite underdeveloped, it has nevertheless improved since 2001. Accordingly, the share of private securities in secondary market transactions increased to 26 per cent during 2002-2007 from 7 per cent during 1996-2001 (reaching 39 per cent in 2007) (CMB 2008). In addition,

average stock market capitalization as a share of GDP increased from 21.6 per cent during 1995-2001 to 25.2 per cent during 2002-2007, a 25 per cent increase. In comparison with other emerging markets, however, the increase was not that impressive especially considering the increasing global liquidity during this period. Accordingly, market capitalization (growth rates in parenthesis) has increased from 29 to 57 per cent in Brazil (68 per cent), from 85 to 112 per cent in Chile (27 per cent), from 28 to 30 per cent in Mexico (ending with 45 per cent in 2007 compared to 20 per cent in 2001) and from 39 to 77 per cent in South Korea (69 per cent). Moreover, the share of foreign investors in Istanbul Stock Exchange increased significantly, from 52 per cent in 2003 to 72 per cent in 2007.

5. Trade performance¹¹

In this section I analyze the trade performance of Turkey with respect to other emerging markets, in terms of its structure and direction. In particular, I focus on the manufactures and technology-and-skill-intensive manufactures exports to the developed (North) and other developing countries (South) to determine whether there is any structural break in Turkey's trade pattern in recent years.¹²

Since “not all goods are alike in terms of their consequences for economic performance”, the structure of trade matters for economic development and growth (Hausmann et al., 2007:1). In particular, exports in high-technology intensive industries are likely to generate stronger spillovers (such as innovation and accumulation of physical and human capital) and linkages for development than lower technology and labor-intensive ones (Feder 1983; Hausman et al., 2007). An and Iyigun (2004) using a panel of 86 countries find that higher export content of skill-intensive goods generates higher per-capita GDP growth rates. Furthermore, Antweiler and Trefler (2002) point out the importance of scale economies for understanding the factor content of trade resulting from industry-level externalities. Moreover, Hausmann et al. (2007) for a large panel of countries and covering over 5,000 products show that countries that export more sophisticated goods with higher productivity levels also grow faster. Imbs and Wacziarg (2003) also examine the patterns of sectoral concentration within and across countries and find that (up to a threshold level of income) economic development is accompanied by increasing diversification of production rather than specialization.

Figures below show total and technology-and-skill-intensive manufactures exports as a share of total merchandise exports. As we can see from Figure 4, Turkey achieved a remarkable jump in its export structure with manufactures accounting for 83 per cent of its merchandise exports in 2005 compared to only 2 per cent in 1978. Its performance in this respect has been better than Argentina, Brazil, Egypt and Indonesia and more in line with those of Thailand, Mexico, Korea and Tunisia. We also see that Turkey has significantly increased its penetration into Northern markets starting from early 1980s, and accelerating after the Customs Union agreement with EU in 1995. As of 2005, manufactured goods exports to the North and the South as a share of total merchandise exports were 45 and 38 per cent respectively, which are significantly higher than their 1978 levels of 14 and 8 per cent (Figure 4). However, other than a sudden decline in exports to the North in 2005, we do not see a radical change during the 2000s. Comparatively speaking, the Turkish performance resembles those of Mexico and Tunisia, two countries that significantly increased their exports to the developed countries (mostly the US and EU, respectively) during the 1990s. Similar to China and Mexico, we also see an increase in the

share of Turkish manufactures in total developing country manufactured goods exports, reaching 2.27 per cent during 2002-2005 as opposed to 1.82 per cent during 1995-2001 (Figure 6). Likewise, the share of Turkish manufactures exports in total developing country exports to the North and the South has also increased from 1.93 and 1.66 per cent during 1995-2001 to 2.53 and 1.91 per cent, respectively (Figure 6).

<Insert Figures 4, 5, 6, 7>

When analyzing the structure of these exports to other developed and developing countries, we find that 42 and 49 per cent, respectively were high-end manufactures in 2005 as opposed to 17 and 7 per cent in 1978 (Figure 5). Since 2000s we also observe a significant increase in the share of Turkish technology-and-skill-intensive manufactures exports in *total* developing country exports of these goods, reaching 1.6 per cent in 2005 (despite the sharp decline in late 1980s) with an average of 1.55 per cent during 2002-2005 compared to around 1 per cent during 1995-2001 (Figure 7). Likewise, as a share of developing country exports to other developing, and developed countries, Turkish technology-and-skill-intensive manufactures accounted for 1.43 and 1.65 per cent during 2002-2005 as opposed to 1.08 and 0.94 per cent during 1995-2001 (Figure 7). Given that Turkey accounted for only 0.37 and 0.77 per cent of such exports to developed countries in 1978 and 1994 respectively, the 1.61 per cent of 2005 (and an all time high of 1.91 per cent in 2004) is quite significant and highlight increasing success of Turkish export penetration to developed country markets in high-end manufactures.

<Insert Figure 8&9>

Focusing on the net trade balance, however, we see that the surge in total and high-end manufactures exports came together with a corresponding increase in import dependence. Figure 8 shows that the net manufactures exports of Turkey to developed countries had been declining steadily up until 1997 when it reached -8.6 per cent of GDP. Since then, however, it recovered and reached -2.4 per cent in 2005 possibly reflecting dynamic gains achieved after the Custom Union agreement. Yet, we see a downward trend in net manufactures exports to other developing countries that became more visible after 1995. The contrasting trends in net exports to developed and developing countries may result from the changing structure of Turkish exports such that it is increasingly importing more lower-end, labour intensive and intermediate stage manufactures from other developing countries while increasing its export penetration into Northern markets. Figure 9 helps check this possibility by showing the trade balance in high-end manufactures. Accordingly, the trade balance in high-end manufactures with other developing countries also show a declining trend since early 1990s despite a short-lived recovery in 2001 and 2002, probably thanks to the sharp depreciation of the domestic currency. Yet, we continue to observe an upward trend in high-end manufactures balance with Northern countries. Nevertheless, it is too early to conclude whether the upward trend in trade balance with developed countries will be persistent to achieve a positive net balance in the medium run.

C. CONCLUSION

The current study analyzed the existing evidence on the macroeconomic outlook of Turkey in comparative perspective considering changes taking place since 2001. While observing

significant improvements, the current research does not find a structural break (or superior performance with respect to other emerging markets) in the macroeconomic fundamentals of Turkey vis-à-vis the pre-2001 regime. Despite improvements on several fronts (including declining GDP growth and short-term capital flow volatility, increasing FDI inflows, falling inflation rates, increasing official reserves of the central bank, increasing maturity structure of external debt, continuing improvement in export structure and increasing penetration into Northern markets, and increasing GDP growth rates)¹³, the pre-crisis fault lines (including low credit availability and capital market imperfections, high real interest rates, high share of interest expenditures from the central budget, sky-rocketing external debt, extremely high and worsening current account deficit, high country risk, low fixed capital formation rates, and falling industrial and manufacturing value added in GDP) continue to limit Turkey's future development prospects.

The experience of Turkey (and others such as Argentina, Brazil and Mexico) suggests that the policy makers need to consider a new strategy to link short-term distortions with the medium and long-term domestic development objectives with special attention given to the determinants of productive investment with high-value added technology-and-skill intensive output potential. The current evidence shows that the Turkish economy instead is increasingly becoming service-oriented without being ever fully industrialized. Overall, the reviewed stylized facts provide support to the view that successful development strategies require mechanisms to “both encourage and discipline private investors by raising profits above those generated by competitive market forces, and active policies to ensure those profits found outlets that would add to productive capacity, create jobs and help technological progress” (UNCTAD 2003: 64).

Given these findings, some policy recommendations that emerge are: a) opening long-term credit channels for fixed investments, b) providing macro and microeconomic stability that help reduce market volatility and real interest rates, and increase planning horizons of real sector firms, c) reducing real interest rates that not only depress real investment but also lure firms to engage in financial investments, d) redirecting public expenditures away from interest payments to education, health, physical and legal infrastructure as well as increasing spending on research and development, e) avoiding misalignment of the exchange rate that hurts the competitiveness of real sector firms and trade performance.

Finally, there is a broader set of questions regarding the role played by international capital flows in limiting the policy choices available to developing countries. In particular, given that financial liberalization has been the Pandora's Box, I suggest that there is an urgent need to reform the financial system so that domestic and foreign savings are directed towards productive rather than speculative investments. This will not only help reduce boom-bust cycles, but also decrease economic uncertainty in key macro and micro prices. Given that under liberalized financial markets the monetary policy is currently limited to the control of short-term interest rates, restoring control to financial markets would free central banks from the pressure to raise interest rates to curtail financial speculation and avoid capital flow reversals.

ENDNOTES

¹ For a thorough discussion of the Turkish and other developing country experiences with the IMF, and financial liberalization see Öniş and Şenses (2005) and Yeldan (2006).

² Unless stated otherwise, from here on the data are from the following sources: World Bank's (WB) World Development Indicators, IMF's International Financial Statistics (IFS), and Central Bank of Turkey (CBRT).

³ For a discussion of the sources of this high-interest hangover in Turkey, see Yeldan (2006).

⁴ UNCTAD (2003, 2006), on the other hand, argues that there is little difference between FDI and other short-term capital flows in terms of their stability and volatility.

⁵ Turkey is not alone on this trend. According to ECLAC estimates (2000), more than half of all FDI to Latin America during the 1990s was in the form of M&As.

⁶ FDI inflows by nonresidents are calculated from the IFS. M&As are from UNCTAD's Cross Border M&A Database.

⁷ Studies on Latin America highlight negative effects of FDI inflows on domestic firms. Mortimore and Peres (2001) (in the case of Argentina, Mexico and Brazil) find that domestic firms not only lost their markets to foreign firms but also their pattern of specialization changed towards traditional sectors such as natural resources.

⁸ For example, the new GDP series for 2006 is 27 per cent higher than the old GDP series. On average the new series is 28 per cent higher during 1998-2006 than the old one. For a discussion see, BSB (2008: 78).

⁹ The sample consists of 750 firms.

¹⁰ For example, see Moguillansky et al. (2004), Paula and Alves (2006).

¹¹ This section is partly based on Demir and Dahi (2008).

¹² The bilateral trade data in total and technology-and-skill-intensive manufactures are from the U.N. COMTRADE Database. The North includes high-income OECD countries while the South includes all low-and-middle income countries according to the World Bank definition. For industrial classification the second revision of the SITC is used. The sum of SITC categories 5-8 are used for total manufactures. For the trade in technology-and-skill-intensive manufactures, 75 SITC commodities (that fall into the 'medium' and 'high' technology" classification based on Lall (2000) and UNIDO (2004)) are selected including: 266-267, 512-513, 524, 533, 541, 553-554, 562, 572, 582-585, 591, 598, 653, 671-672, 678, 711-714, 716, 718, 721, 723-728, 736-737, 741-745, 749, 751-752, 759, 761-764, 771-776, 778, 781-786, 791-793, 812, 871-874, 881-882, 884-885, 951.

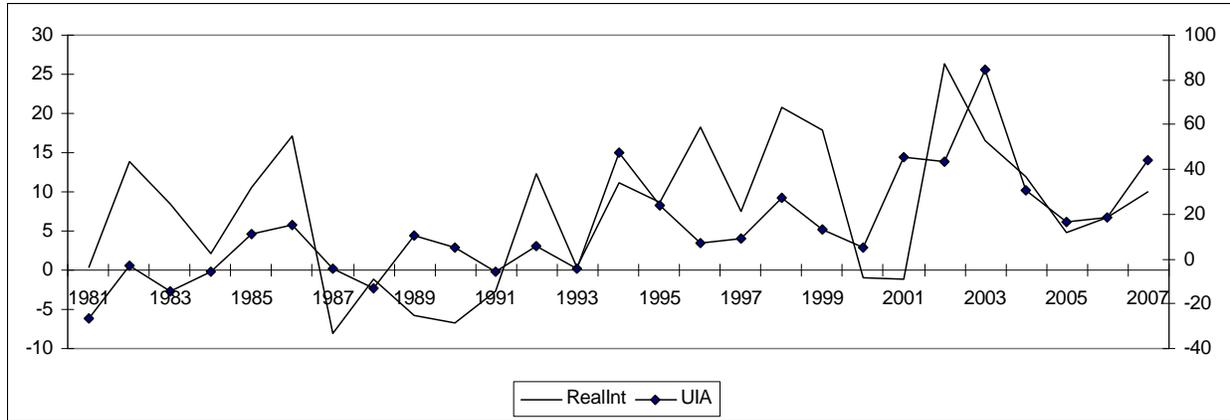
¹³ It is also argued that that there have been major gains on the institutional infrastructure front along with the post-Washington consensus. For a discussion see Öniş and Şenses (2005) and Öniş (2006).

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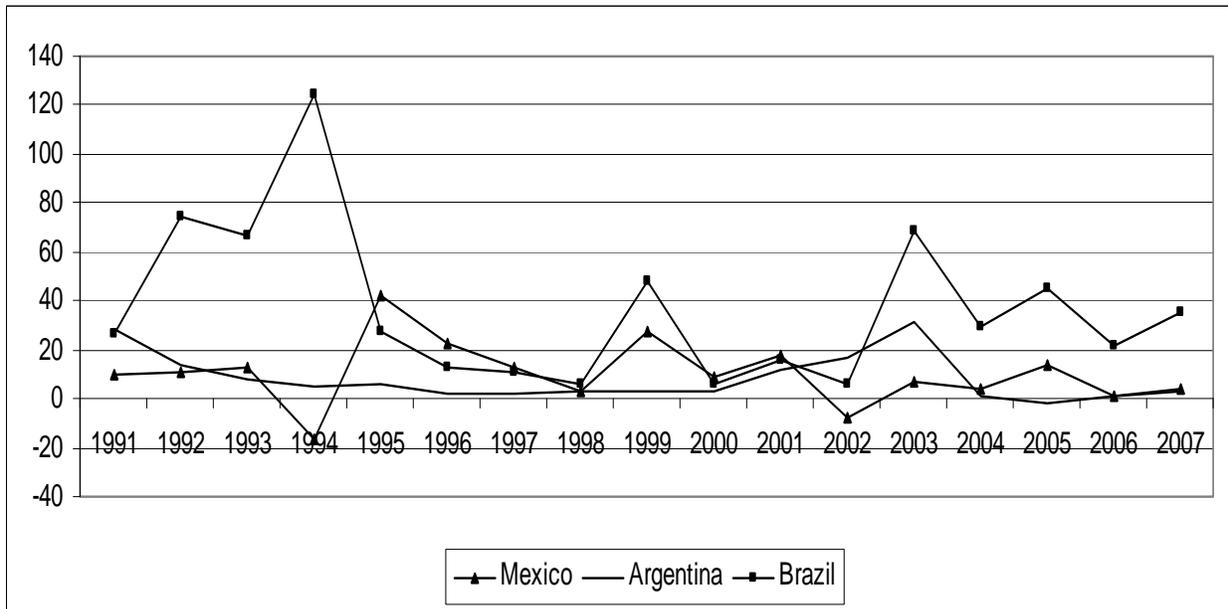
Figure 1: Uncovered Interest Arbitrage (UIA) and Real Interest Rate (RealInt) (per cent), Turkey



Source: IFS and Author's Calculations.

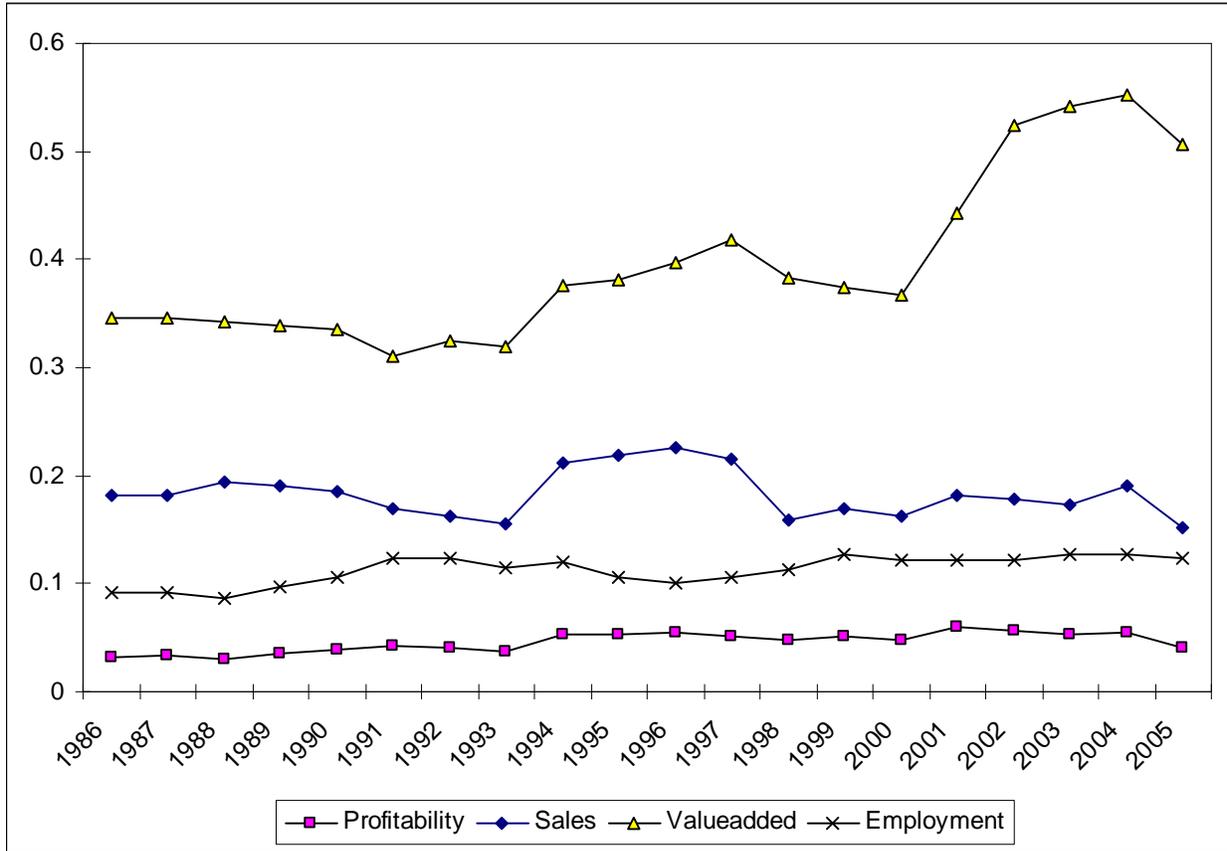
Notes: UIA (right axis) calculated as $[(1 + R_t)/(1 + \hat{E}_{t+1})] - (1 + R_t^*)$ where R is monthly domestic T-bill rate, \hat{E} is the next month's average rate of change of domestic currency per unit of U.S. dollar, R^* is monthly US T-bill rate. Real interest rate is the annualized average difference between monthly T-Bill rate (R) and the next period inflation rate (inf) ($[(1 + R_t)/(1 + inf_{t+1})] - 1$).

Figure 2: Uncovered Interest Arbitrage (per cent), Argentina, Mexico, Brazil



Source: IFS and Author's Calculations.

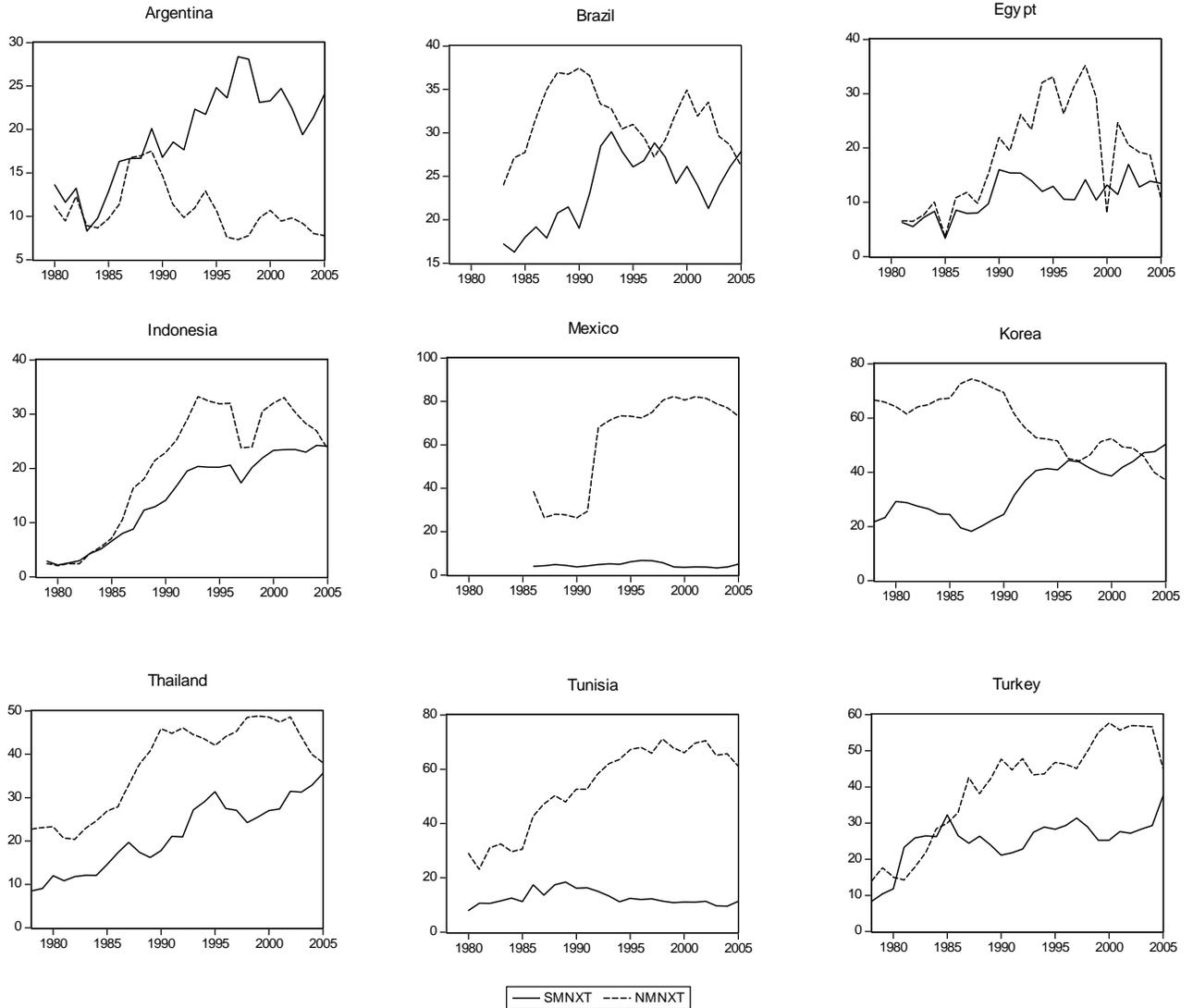
Figure 3: Firm Volatility: 1986-2005



Source: Istanbul Chamber of Industry largest 500 firm surveys, various years.

Notes: 691 private manufacturing firms included have at least 5 consecutive years of data. They accounted for 26 per cent of total manufacturing value added in GDP and 48 per cent of total exports of Turkey during 1983-2005.

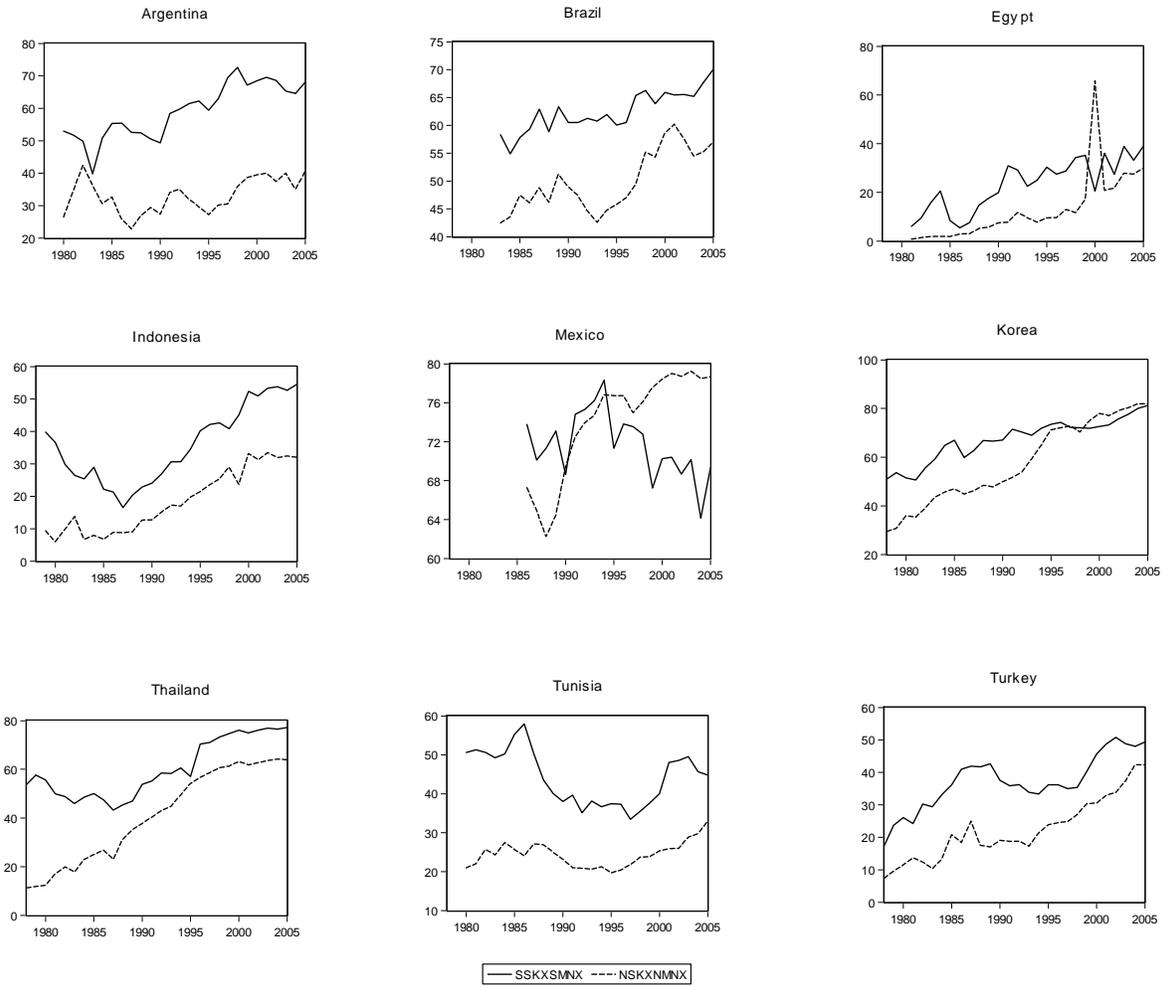
Figure 4: Share of Manufactures Exports to the North and South in Total Merchandise Exports
(per cent)



Notes: SMNXT and NMNXT refer to the share of manufactures exports to the South and North in total merchandise exports of country *i* respectively.

Source: COMTRADE and author's calculations.

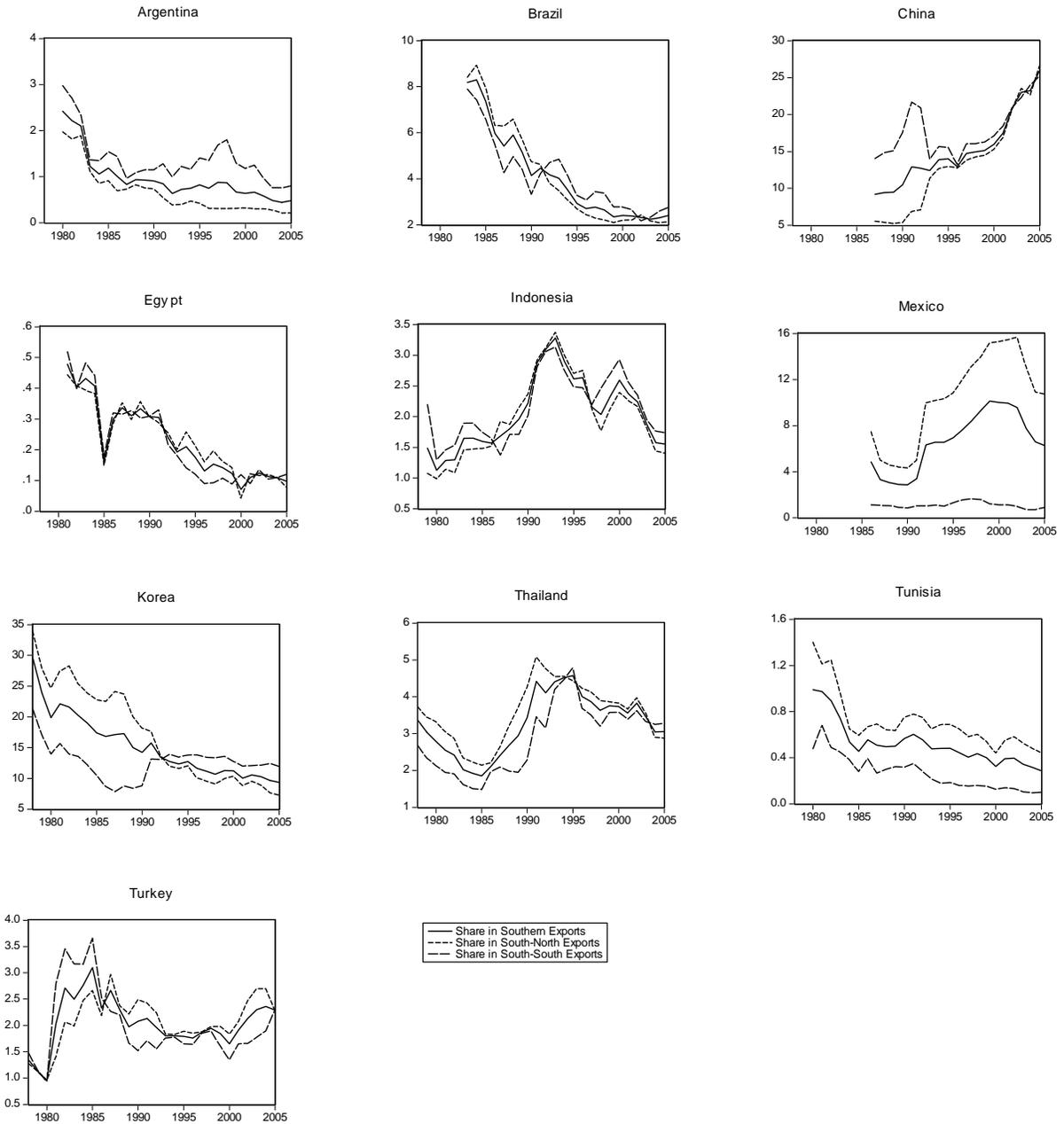
Figure 5: Share of Technology-and-Skill-Intensive Manufactures in Total Manufactures Exports to the North and South (per cent)



Notes: SSKXSMNX and NSKXNMNX refer to the share of technology-and-skill-intensive manufactures exports to the South and North in total manufactures exports of country i respectively.

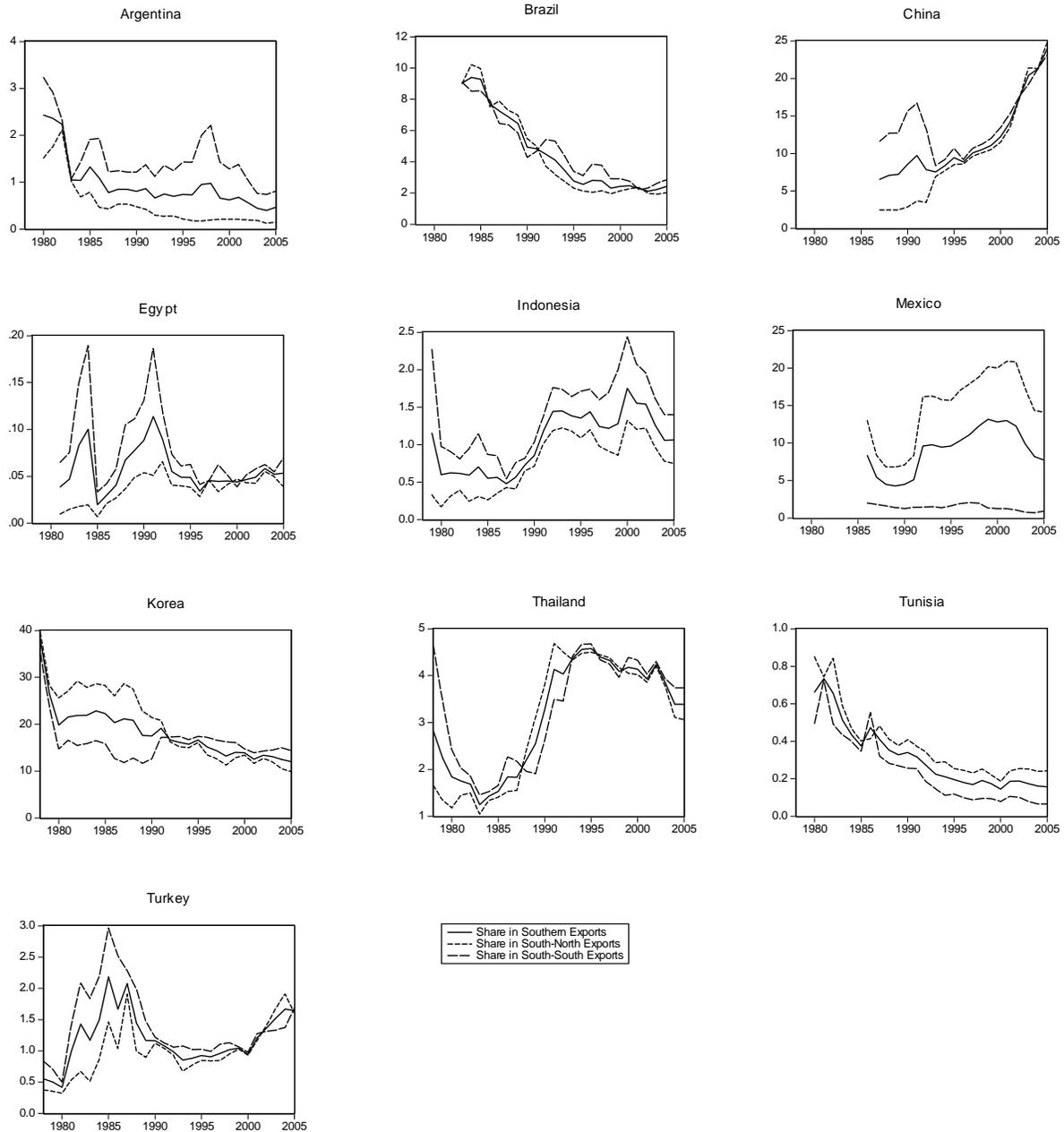
Source: COMTRADE and author's calculations (for figures 5-9).

Figure 6: Share of Major Emerging Markets in Total Developing Country Manufactures Exports
(per cent)



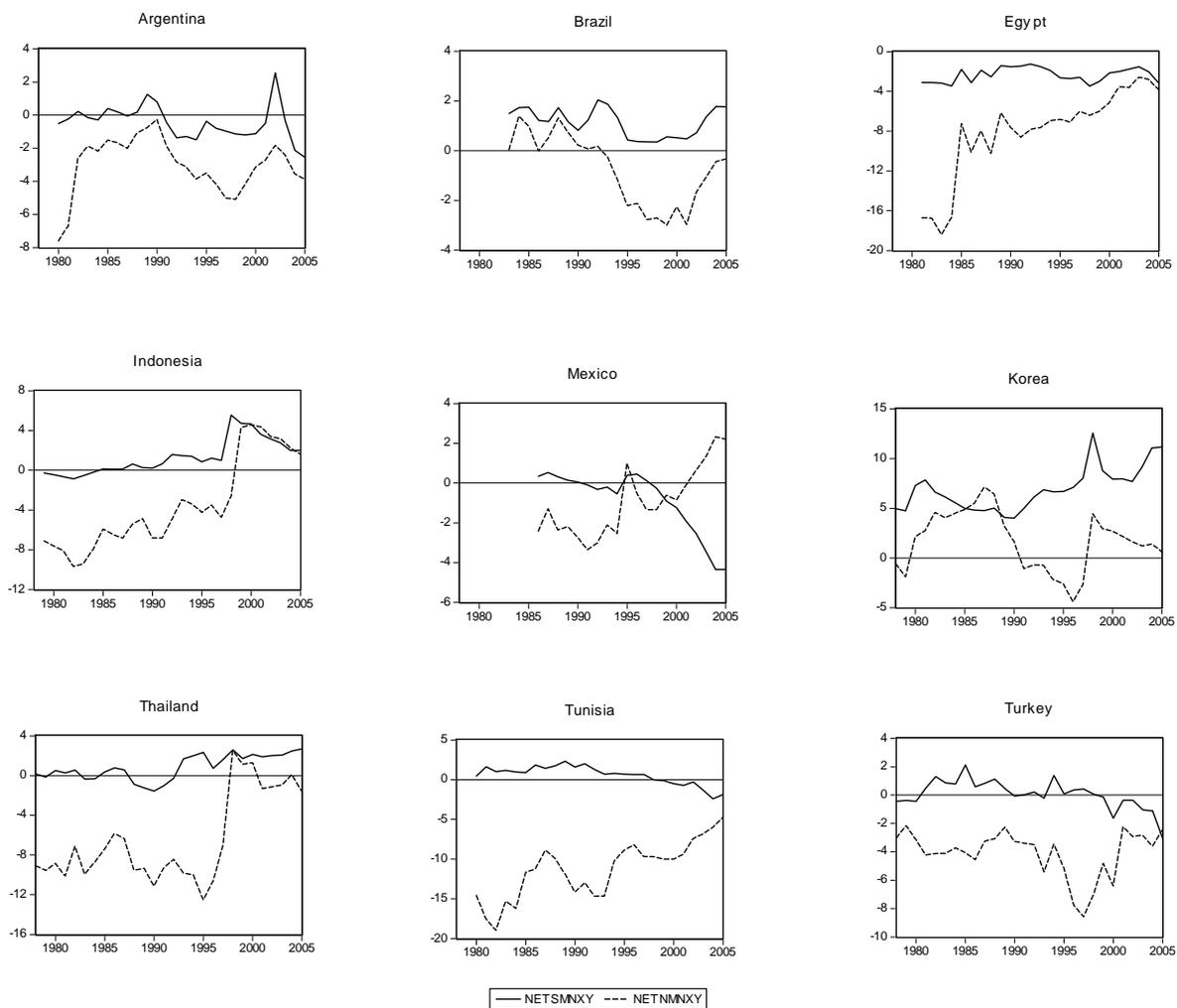
Notes: Share in Southern, South-South and South-North exports is the share of country i's manufactures exports in total Southern, South-South and South-North manufactures exports.

Figure 7: Share of Major Emerging Markets in Total Developing Country Technology-and-Skill-Intensive Manufactures Exports (per cent)



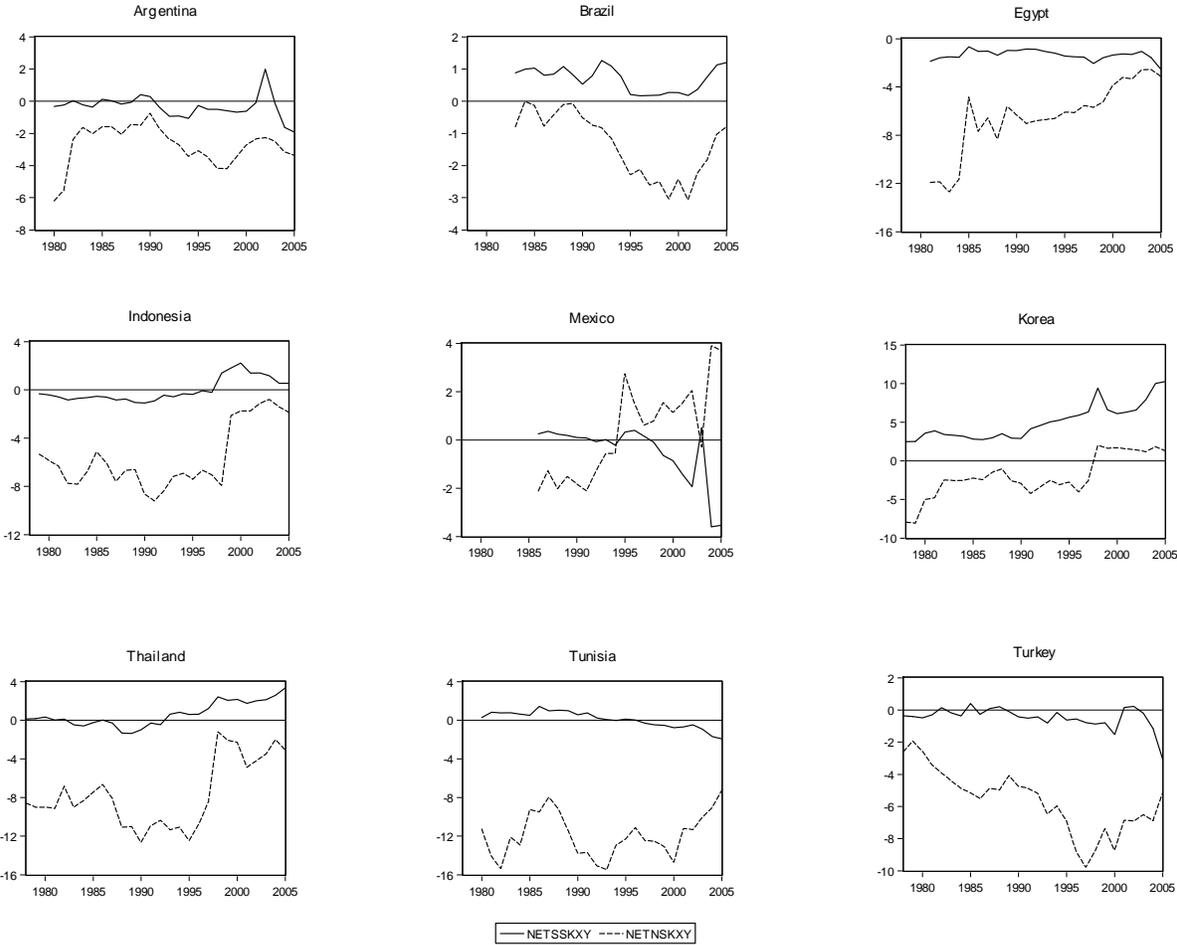
Notes: Share in Southern, South-South and South-North exports is the share of country i's technology-and-skill-intensive manufactures exports in total Southern, South-North and South-South technology-and-skill-intensive manufactures exports.

Figure 8: Net Exports of Manufactured Goods to the North and South as a share of GDP (per cent)



Notes: NETSMNXY and NETNMNXY refer to net exports (i.e. exports-imports) of manufactures to developing and developed countries as a share of GDP, respectively.

Figure 9: Net Exports of Technology-and-Skill-Intensive Manufactured Goods to the North and South as a share of GDP (per cent)



Notes: NETSSKXY and NETNSKXY refer to net exports (i.e. exports-imports) of technology-and-skill-intensive manufactures to developing and developed countries as a share of GDP, respectively.

Table 1: Gross External Debt Position of Non-financial and Financial Private Institutions

	Non-financial Corporations (NFC)				Financial Institutions (FI)							
			Total	Growth	ST/			Total	Growth	ST/	NFC/	Private/
	ST	LT	million USD	(%)	Total (%)	ST	LT	million USD	(%)	Total (%)	Private (%)	Gross (%)
1989	1,828	839	2,667		69	3,118	852	3,970		79	40	15
1990	3,272	1,186	4,458	51	73	5,373	939	6,312	46	85	41	21
1991	3,063	1,681	4,744	6	65	5,216	1,168	6,384	1	82	43	21
1992	4,531	2,565	7,096	40	64	7,157	1,137	8,294	26	86	46	26
1993	6,614	4,079	10,693	41	62	11,127	1,758	12,885	44	86	45	33
1994	5,639	5,206	10,845	1	52	4,684	1,657	6,341	-71	74	63	25
1995	7,598	5,627	13,225	20	57	6,659	1,890	8,549	30	78	61	29
1996	7,669	7,283	14,952	12	51	8,419	3,354	11,773	32	72	56	34
1997	8,095	11,394	19,489	27	42	8,503	5,531	14,034	18	61	58	40
1998	8,536	16,940	25,476	27	34	9,731	6,819	16,550	16	59	61	44
1999	9,063	20,012	29,075	13	31	11,591	7,344	18,935	13	61	61	47
2000	9,748	21,662	31,410	8	31	15,439	7,581	23,020	20	67	58	46
2001	7,654	22,691	30,345	-3	25	6,978	4,789	11,767	-67	59	72	37
2002	8,425	24,432	32,857	8	26	5,429	4,776	10,205	-14	53	76	33
2003	10,461	24,850	35,311	7	30	8,351	5,266	13,617	29	61	72	34
2004	14,039	28,275	42,314	18	33	12,714	8,540	21,254	45	60	67	40
2005	16,199	34,475	50,674	18	32	16,008	15,953	31,961	41	50	61	49
2006	17,766	53,015	70,781	33	25	18,275	28,943	47,218	39	39	60	58
2007	22,708	77,780	100,488	35	23	14,657	42,712	57,369	19	26	64	64
2008:2	27,990	96,699	124,689	22	22	19,851	46,009	65,860	14	30	65	67

Notes: ST and LT are short-term and long-term external debt in million USD, respectively. Total is the sum of ST and LT.

NFC/Private is the share of NFC external debt in gross private debt. Private/Gross is the share of private debt in gross external debt.

Source: CBRT and author's calculations.