A WORLD BANK COUNTRY STUDY

Turkey

A Strategy for Managing Debt, Borrowings, and Transfers under Macroeconomic Adjustment

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ABSTRACT

Developing countries facing a debt burden have had to cope with issues of both external and internal adjustment. This study on Turkey examines both external and domestic debt aspects in the context of a macroeconomic adjustment effort that started nearly ten years ago. The study analyzes how Turkey, after undergoing a major rescheduling in 1978-82, has been able to re-establish market access and to obtain significant amounts of voluntary new money from international commercial sources, a feat which few developing countries outside of Asia have achieved. It is a task that other countries will face over the coming years. How Turkey was able to sequence this and to penetrate various markets is a subject of broad interest. The study also analyzes institutional questions and issues of liability management, again topics germane to other countries.

Overall, the study analyzes the transfer problem in Turkey -- the external transfer that needs to be made to foreign creditors and the necessary "internal transfer" from the private to the public sector. The internal transfer problem arises because most of the external debt is held in the public sector, which therefore needs to service the debt. In order to do so, the public sector has been resorting to domestic finance, which in turn complicates the task of domestic adjustment, specifically the level of real interest rates, inflationary finance, and savings and investment levels. In order to sustain the external transfer, the public sector will increasingly be called on to generate additional resources to reduce the burden on the private sector.

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CURRENCY EQUIVALENT
(Period Averages)

	Turkish Lira per US$1.00
1980	76.04
1981	111.22
1982	162.55
1983	225.46
1984	366.68
1985	521.98
1986	647.51
1987	857.20
1988	1,421.00
1989 (December)	2,350.00

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

CB	-	Central Bank of Turkey
EBC	-	External Borrowings Committee
EBF	-	Extrabudgetary Fund
EER	-	Effective Exchange Rate
ELF	-	Exchangeable Loan Facility
FMS	-	Foreign Military Sales
JLTPR	-	Japanese Long-Term Prime Rate
LIBOR	-	London Interbank Offer Rate
MIMCs	-	Moderately Indebted Middle-Income Countries
NICA	-	Non-Interest Current Account
NPR	-	Nominal Protection Rate
PPF	-	Public Participation Fund
PSBR	-	Public Sector Borrowing Requirement
REPO	-	Repurchase Agreement
SEE	-	State Economic Enterprise
SIMCs	-	Severely Indebted Middle-Income Countries
SIS	-	State Institute of Statistics
SPO	-	State Planning Organization
VAT	-	Value Added Tax

INTRODUCTION

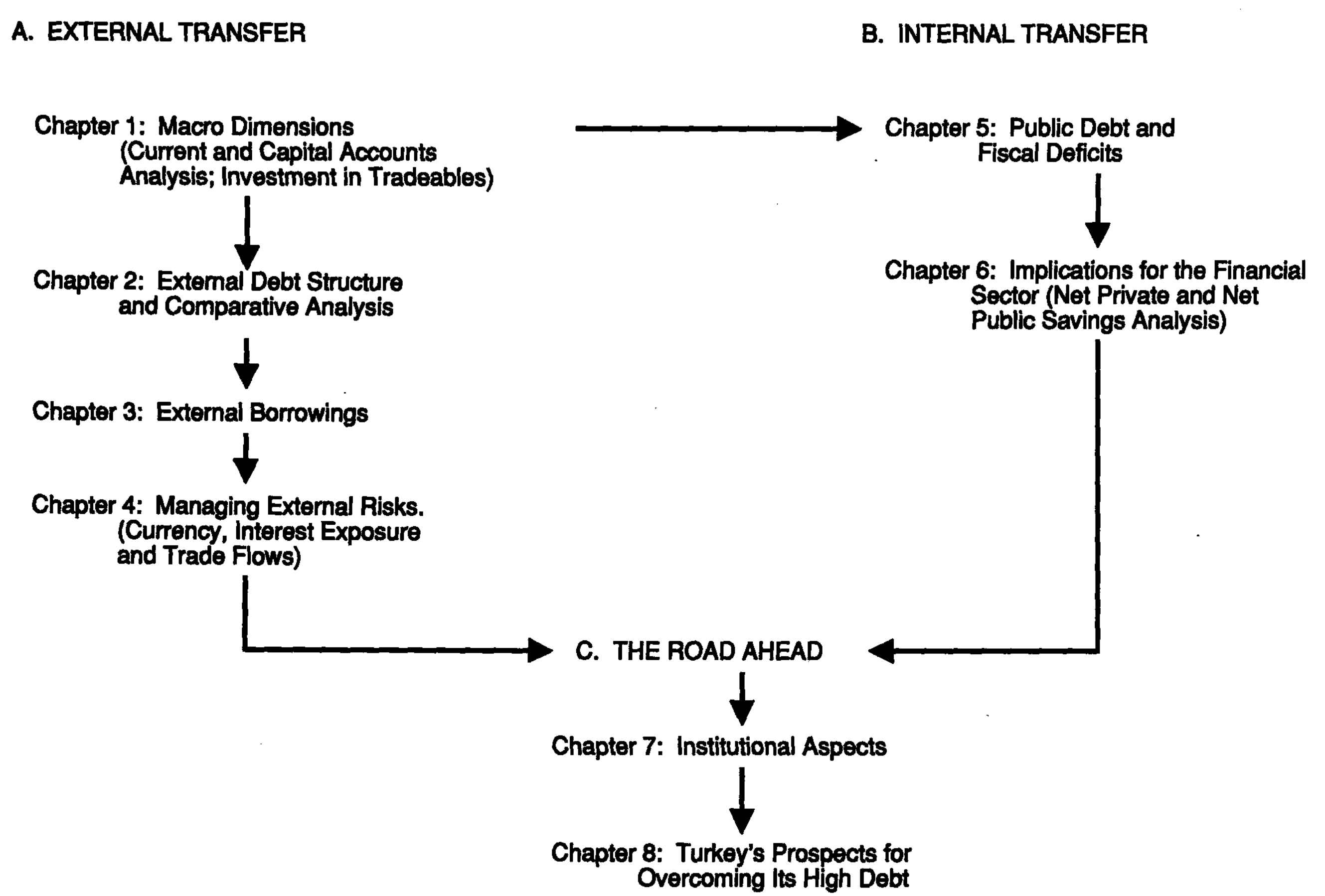
1. This report is the third in a series that have tackled the central question facing Turkey's economy: how to overcome a high debt burden, while at the same time pursuing programs of stabilization, adjustment and growth. Few countries have been able to balance these daunting (and at times competing) goals. After eight years of an economic reform program that has been largely successful, although some major problems persist, such as inflation, Turkey is on the way to overcoming its debt burden. The External Debt, Fiscal Policy and Sustainable Growth Report, (hereinafter referred to as the "Fiscal Policy Report") [1/] (No. 7162-TU) dated September 9, 1988, analyzed how output growth can be maintained while exercising prudent creditworthiness criteria. The report demonstrated how fiscal policy can play an important role in reconciling external economic targets with internal balances. Of importance to the current exercise, the Fiscal Policy Report argued against applying excessive external restraint (i.e. against aiming at too sharp a reduction of the growth rate and against too rapid a lowering of the current account deficit). Rather, it stressed the need for substantial fiscal adjustment, in order to reduce inflation and to achieve a consistent macroeconomic framework over the medium term.

2. The Country Economic Memorandum (Report No. 7378-TU)[1/] dated October 12, 1988 analyzed economic developments of 1987-88 within a medium term economic framework that envisaged sustainable growth, fiscal improvements, and inflation reduction. That report, too, stressed the need for the Government to reduce the fiscal deficit and to consolidate its successful performance on the external sector. Both reports were discussed with the authorities, who agreed with the Bank's concerns and analyses. Throughout this period, the Government and the Bank increased their dialogue on both short-run and medium-term issues, as Turkey strived to reinforce the stabilization program.

3. Debt problems cannot be viewed only from an external or internal angle. Thus, the current report looks at Turkey's total debt -- external and domestic public debt -- in order to develop the linkages between the two and to obtain a closer reading of the likelihood that Turkey will work its way out of these combined problems. While the report is organized into three parts -- external transfer, internal transfer and future outlook -- the issues are part and parcel of the broader issue of the viability and sustainability of current economic policies in Turkey. The structure of the report is depicted in the following diagram:

[1/] These two reports are internal, unpublished documents of the World Bank.

KEY THEME:
THE TRANSFER PROBLEM AS THE MEANS TO WORKING ONE'S WAY OUT OF DEBT



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4. As shown in the diagram, Chapter 1 of the report examines the key macro aspects that will determine the extent of Turkey's borrowings and debt service in the future. Specifically, this involves analysing the external transfer through the current account and examining the relationship to the capital account. An important element in the foreign transfer picture is the degree to which Turkey will be able to continue its export drive, which in turn depends on investment and output in the tradeable, as distinct from the non-tradeable sector. Essentially, the chapter is examining the first of the "two gaps" often discussed in the economic literature -- the trade gap (Part II of the report covers the second gap).

5. Chapter 2 analyzes the structure of Turkey's external debt, using the key ratios for past and projected debt, and it compares these to the ratios of several other countries. The dynamics of the debt hump is examined and several important conclusions are drawn.

6. Chapter 3 analyzes how Turkey sets its financing plan and borrowing targets, and how it accesses external markets to achieve the planned borrowings (and specifically which borrowings), as well as the supply constraints of various financing instruments in foreign capital markets.

7. Chapter 4 examines questions concerning the optimal mix of currencies in Turkey's external debt stock (assessing these against indicators such as the distribution of Turkey's trade). The chapter also analyzes the appropriate mix of interest rate exposure (floating rate debt versus fixed rate debt) for Turkey. The chapter draws some important conclusions regarding how Turkey can better protect itself from both currency swings and interest rate movements. Finally, the chapter sets out some criteria by which Turkey could manage its liabilities more actively in future and the prerequisites to achieve this.

8. Part II of the report examines internal transfer issues, by looking at net savings (investment minus savings gap), which is the mirror image of the trade gap analyzed in the first part of the report. Chapter 5 looks at fiscal deficits and their financing, while Chapter 6 assesses the impact on the domestic financial sector by looking at the structure of domestic public debt and the financing pressures implied by the fiscal imbalances. The chapters use the methodology of the real fiscal deficit, and looks at what is sometimes referred to as the third gap -- the fiscal gap -- in order to assess economic sustainability in the medium term.

9. Part III of the report looks at the overall system and process for debt management (Chapter 7), that exists within the Government agencies and makes some suggestions for change in order to tighten up the control process and to achieve greater efficiencies between debt management, borrowings orchestration and assets/liabilities control. The policy role of the External Borrowings Committee is considered and several suggestions are made for intensification of its functions. Aspects of domestic debt management are also discussed briefly.

10. The final chapter takes stock of where Turkey stands today in regard to both foreign and domestic debt questions, as well as in relation to its economic adjustment program. A number of strategic questions are posed and

various suggestions are made for the Government's consideration. The purpose is not to provide a blueprint -- indeed in a rapidly evolving world with many interdependencies between domestic and foreign markets and between economic and financial issues, it is more important to develop flexible criteria by which the Government can continue to refine its own strategy. It is essential that any strategy be sufficiently robust to enable Turkey to weather both good and difficult times, so that a consistent medium term course can be maintained.

EXECUTIVE SUMMARY

Background

1. Whether a country, once having been confronted by a major debt crisis, can effectively work itself out of the consequences of such a situation is a matter that remains largely unproven. Turkey is one of a half dozen countries, at most, that are on the path to achieving this, but the journey is far from complete. The next two years will be crucial for Turkey, during which it will be facing an unprecedented amount of debt amortization, largely to the OECD countries, while at the same time it will continue to address its domestic economic problems -- particularly the fiscal deficit and inflation.

2. The extent of a country's ability to work its way out of a debt problem is essentially a macroeconomic question. Financing techniques, comprehensive and sound borrowing programs, and risk-hedging measures can all help, but are secondary to the question of whether a country has the appropriate macro framework in place to produce the external transfer needed. Thus, this report assesses Turkey's macro framework, concentrating on those aspects germane to debt questions. The report provides detailed analysis on external and domestic debt (in relation to fiscal policy) and extends the work contained in two other Bank reports on Turkey. 1/

3. When Turkey experienced debt service difficulties in 1978-1982 and had to negotiate rescheduling, it was clear that it would face periods of negative net foreign transfers (i.e., having to transfer resources abroad), in contrast to the past period of receiving positive transfers from abroad. It was also clear that Turkey would require some time to work its way out of its macro problems and overcome its debt burden. Turkey's effort to sustain an adjustment program over eight years is well known -- economic growth has been high (an average of over 5 percent per annum during 1983-88), investment and savings have both risen significantly as shares of GNP (to around 25 percent) and the current account deficit has fallen by nearly eight percentage points of GNP (from a deficit of 6 percent in 1980 to a surplus of 2 percent of GNP in 1988).

Macro Setting

4. Beginning in mid-1988, a sharp downturn in economic activity dampened Turkey's previously overheated economy. The GNP grew by only 3.4 percent in 1988 and is expected to grow by only 1.8 percent in 1989. This compares to growth of 7.4 percent in 1987 and 8.1 percent the year before. Some fiscal improvement was achieved in 1988 -- official estimates show that the public sector borrowing requirement (PSBR) declined to 6.4 percent of GNP in 1988, down from 7.8 percent of GNP in 1987 (excluding net lending). Other measures of fiscal performance also show similar improvement (para. 32). Public investment fell by 3 percent as a result of broad cutbacks in public expenditures. Imports stagnated (1 percent growth) with the sharpest fall observed in the last quarter. However,

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1/ External Debt, Fiscal Policy and Sustainable Growth Report (September 1988) and Turkey Country Economic Memorandum (CEM), October 1988.

due to booming tourism revenues, terms of trade improvement, and moderate export growth, the current account swung from a deficit of 1.4 percent of GNP in 1987 to a surplus of about 2 percent of GNP in 1988 ($1.5 billion surplus). This outcome took some pressure off the borrowing program, and it allowed the Central Bank to build up reserves and to retire short-term debt. Aided by favorable exchange rate movements between the US dollar and the other currencies prominent in Turkey's external debt stock, Turkey's total debt fell for the first time in many years -- from $40.9 billion in 1987 to $39.1 billion in 1988. Foreign investment more than tripled to $350 million 1988. These factors combined to reduce the external debt to GNP and external debt to export ratios (to 55 percent and 200 percent respectively, compared to 60 percent and nearly 250 percent in 1987).

5. Inflation, as measured by the December-over-December change in the Wholesale Price Index (WPI), rose from 49 percent at the end of 1987 to 70 percent at the end of 1988. This was the first year during the 1980's that a movement in the PSBR was not accompanied by the same directional movement in inflation. Given the leads and lags related to both fiscal and monetary aggregates, a significant drop in inflation has yet to occur. The sharp fall in the economy's growth rate has exerted some downward pressure on inflationary expectations, but not enough to bring about a meaningful decline in such expectations. Inflation currently remains around 70 percent and with signs of economic growth picking up again, the prospects for inflation abatement in the short-term are uncertain.

6. The Government's program for 1989 called for economic growth of 5.0 percent, reduction of inflation to 50 percent by December 1989 (with a GDP deflator of 58 percent), and a PSBR/GNP ratio of 5 percent. The surplus in the current account was expected to decline to $820 million and the external debt stock to remain at around $40 billion. On the fiscal side, the Government program envisaged continued improvement in the fiscal balances of the central government, State Economic Enterprises (SEEs) and extra-budgetary funds (EBFs), recognizing that in 1988 the EBFs, and to a lesser extent the local governments, did not fully achieve their planned improvements. In April 1989 the economic growth estimate for 1989 was lowered (to 3.7 percent) and the PSBR target was lowered to 4.6 percent of GNP. Latest estimates for 1989 indicate economic growth of 1.8 percent, inflation of 70 percent, a PSBR of 5.6 percent and a current account surplus of around $700 million (0.8 percent of GNP) for the year as a whole.

7. The Sixth Five Year Plan (1990-94) contains several important targets that bear upon debt aspects. The Plan envisages an average economic growth of 7 percent per annum, starting with 5.7 percent in 1990 and rising steadily thereafter. Inflation is expected to fall to 13.5 percent by 1994. The current account is expected to be in surplus in all years. The debt to GNP ratio is expected to decline to 25 percent by 1994 and the debt service ratio to improve to 21 percent. Three debt management objectives in the Plan are to increase the share of medium and long-term debt in total debt, to reduce the share of short term debt, and to increase the share of the private sector in foreign financing.

PART I: Working One's Way out of Debt -- The External Transfer

8. After emerging from a serious external debt crisis requiring a major rescheduling, Turkey implemented a comprehensive economic reform program, which aimed at reorienting the economy towards market forces and providing an increased role for the private sector. The program emphasized, inter alia, growth in exports and in GNP as means to deal with increasing debt service requirements. Future debt service requirements were on a increasing trend, and adjustment to a reduced trade deficit was required: capital inflow could no longer play the dominant role in supply of foreign exchange. Thus, Turkey faced a classical transfer problem: domestic production would have to increase relative to domestic demand, if a greater surplus of real resources was to be transferred abroad.

9. Turkey's export growth in the past is indeed impressive, averaging 15 percent per annum in the period 1983-1988 in current dollar terms. The corresponding import growth has been 6 percentage points lower, but since the starting point was a substantial trade deficit ($3 billion), these disparate growth rates did not bring down the trade deficit until 1988. Industrial exports provided almost 100 percent of the increased exports during this period. The strong growth of exports in the early 1980s and lately the equally strong growth of tourism have provided the necessary cushion of foreign exchange to service the external debt. Workers' remittances from abroad have generally remained strong as well.

10. A review of the export figures underlines the key role performed by the industrial sector, which grew by more than two percentage points faster than the GNP during 1983-1987. Disaggregated price indices show that a stimulus to increased manufacturing production can indeed be seen in increasing relative prices of manufactured goods. Such an increase in the relative prices of tradeable goods is expected in a country increasing its transfer abroad, since it induces consumers to shift to non-tradeables and producers to shift to tradeables, both of the groups contributing to a larger exportable surplus. The process of changing relative prices has been driven by two mechanisms. The prices of tradeable goods were increased directly, through aggressive real exchange rate depreciations (averaging 5 percent per annum during 1983-1988), and the prices of non-tradeable goods have been compressed through a downward pressure on real wages. In October 1988 the real effective exchange rate began to appreciate as a result of Central Bank intervention and this trend continued in 1989, driven mainly by market forces.

11. Gross fixed investment was significantly stepped up during the 1980's. Yet, contrary to what would be expected under a scenario of rising external transfer needs, investment has increasingly been undertaken in non-tradeable sectors. Private investment in housing has been increasing rapidly, and the public sector has reduced its investments in manufacturing, increasing those in infrastructure. The manufacturing industry inherited excess capacity from the late 1970's, and growth in production and exports was therefore possible through increased capacity utilization. However, due to high inflation and high real lending rates, investment in the manufacturing sector has generally been low compared to the sector's role in the economy. This is a worrying feature since a sustained external transfer will demand significant increases in investments in the tradeable sectors.

12. Four scenarios for the current account of the balance of payments were formulated (illustrative the Government's Plan Case plus a High, Mid and Low case), in order to explore how the gaps in the current account and the capital account can be closed. It should be emphasized that these are illustrative scenarios and <u>are not formal projections</u> of the Turkish economy in the medium-term. Turkey is fairly well balanced in its trade, both across subsectors and with respect to trade partners, thus not as vulnerable to terms of trade shocks as less diversified economies. The three scenarios are, however, quite different, illustrating the difficulty in interpretation of the large, unexpected surplus on the current account in 1988. If the events in 1988 are seen as structural shifts (e.g., the continued strong growth in tourism) Turkey is likely to run surpluses or small deficits in the future, and debt ratios would decline. If, on the other hand, a combination of adverse external shocks and weak domestic policies occur, a future with strained finance is possible. A situation of running either large current account surpluses or large deficits would both be "costly" to Turkey. In the former case Turkey would resemble a capital-exporting country, and would have to rely more on domestic financing of its development program. In the latter case, Turkey would be borrowing too much from abroad. Thus, a balanced current account seems to be the appropriate goal to be strived for.

13. The scenarios produce a need for gross disbursements in 1989 of $4.2 billion in the High-Case, $5.4 billion in the Mid-Case and $5.9 billion in the Low-Case. The differences in the required gross capital inflows increase over the years, even though only a moderate negative terms of trade shock is assumed. In the High- and Mid-Cases external borrowing needs are assumed to be covered increasingly by financial markets, because of the declining net flows from official creditors. In the Low-Case, obtaining the necessary external financing looms as a problem and the contributions of financial markets in particular show a fall-off. Simulations of future flows, based on the World Bank's data base of external debt stock, provide valuable insights into the importance of managing the current account closely and of matching borrowing needs to debt service obligations. It shows that Turkey faces a challenge of accessing a broader private market for its debt, even for scenarios with only slightly increasing external debt. On the current account and gross disbursements side, 1989 is turning out to fall between the Mid- and High-Cases mentioned above. However to achieve consistency with targets over the medium term, a full economic program for 1990 and beyond needs to be assessed. (Elaboration of such a program, however, is beyond the scope of this report).

<u>External Debt Structure</u>

14. In most respects, Turkey's external debt ratios improved in 1988 over 1987. Debt to GNP, debt to exports, and total debt declined as mentioned above. Short-term debt fell from 21.8 percent of total debt in 1987 to 20.5 percent of total debt in 1988. This was the first time in many years that a decline in total debt occurred, and was a result of appreciation of the dollar, as well as Turkey repaying more short-term debt than had been anticipated, due to its improved foreign exchange reserve position. Since the debt to GNP and debt to export ratios are typically used as measures of creditworthiness, the improvements in both are significant for Turkey. While the latter is important in measuring the amount of resources that can be used for debt service in the short run, the former is more of a long-term measure of indebtedness.

15. Turkey's debt service ratio remained at around 38 percent in 1988, due to large-scale amortization of principal and high interest costs. The improved reserve position, however, allowed Turkey to repay over $1 billion of short-term debt. Interest payments to exports fell from 15.9 percent in 1987 to 14.2 percent in 1988.

16. A cross-country composition comparison shows that Turkey -- as one of the Moderately Indebted Middle-Income Countries (MIMCs) -- has a debt burden similar to that of Indonesia and heavier than that of Tunisia, Korea, Portugal, and Hungary. Turkey's burden is heavier than Tunisia's or Korea's reflecting the smaller proportion of concessional funds that Turkey receives (compared to Tunisia) and the early stage of Turkey's export drive (compared to Korea). Korea has also managed to lower the cost of its international finance through off-shore Asian borrowings. On the other hand, Turkey's debt burden is not as onerous as the Severely Indebted Middle-Income Countries (SIMCs).

17. Nevertheless, Turkey's debt ratios point to difficulty in the road ahead. The current debt servicing burden is comparable between Turkey and the other indebted middle income countries. Some of the SIMCs have regularly rescheduled their debt since 1982, thus securing some short-term relief and lower debt service ratios. The SIMCs improved profile (those that have secured improvement) may have been achieved at the cost of a heavier <u>future</u> debt service, in addition to short-term costs connected with being cut off from the international voluntary loan market and having to incur more expensive trade finance. In contrast, Turkey's active financing in international markets has been accompanied (and is partly driven) by increased trade -- both export and import finance arising from strong economic growth prior to 1989 -- and by a desire to preserve access to international commercial markets.

18. It is important to understand the dynamics of the "debt hump" (the hump in debt service is more relevant than a hump in debt stock). When Turkey emerged from its reschedulings in 1981, its future debt service was projected to be small until 1986, but to jump in 1986, as grace periods expired. However, it was also expected that debt service would then decline slowly as the principal was repaid. This gave rise to the notion that "the hump" in debt service would start to get smaller. In reality, as the debt service was partially financed by new borrowings, this logic turned out to be incorrect. Instead of decreasing, debt service increased in 1987 and 1988, and is expected to continue to rise in the medium term, with the rate of growth dependent on the size of the current account deficits, as well as the terms of new borrowings. Since Turkey has been repaying low cost debt carrying longer maturities, and financing this through higher cost debt carrying shorter maturities, the hump in debt service has tended to become a "moving hump." However, Turkey had few options, as concessional lending dried up and Turkey itself rejected any thought of requesting additional reschedulings or seeking debt relief -- a stance which deserves the international community's wholehearted support.

19. Whether Turkey will experience a decline in its external debt service hump in the foreseeable future rests on at least four factors: (i) the performance of the current account; (ii) the terms at which Turkey borrows its new money; and (iii) the extent to which Turkey can gain some efficiencies or savings through more active liability management; and (iv) the exogenous effects of movements in world interest rates and cross-currency exchange rates. To

obtain a decline in debt service in nominal terms, Turkey would have to run sizeable current account surpluses for several years in a row, in order to build up foreign exchange reserves and retire its debt faster than is now anticipated. This may happen, but it is not a necessary condition for maintaining creditworthiness. The key aspect is for the debt service ratios (debt service to exports, interest to exports, interest to GNP) to decline over the medium term. The projections do show such an improvement occurring in the ratios, beginning in 1991.

Financing Plan and New Borrowings

20. When the Government formulated its financing requirements for 1989-91, it estimated that it would need to borrow from abroad about $5.0 billion annually gross (in project credits plus non-project credits) or $15 billion over the period stated. The Government based its borrowings plan on several factors, including the external transfer outlook, the outlook for the current account deficit) and the implied net transfer of private savings to the public sector.

21. A sources and uses projection of financing needs in 1989 shows that the Government will need to obtain about $3.8 billion this year (compared to $4.8 billion last year). The decline is made possible by the improved current account picture and reserve increases. Medium- and long-term borrowings of $2.0 billion are required, of which over $1 billion would be in balance-of-payments financing. The latter is required to help to meet debt service requirements of $7 billion in 1989. For Turkey to have had sufficient funds in place to meet this external debt servicing, the authorities have had to pay attention to: (i) the ability of the economy to maintain strong export growth and continued buoyancy in tourism revenues, which has provided the basic foreign exchange resources needed to service the debt; (ii) the ability to lower the real fiscal deficit and to reduce inflation (continuing process), so that other financing pressures are reduced; and (iii) the receptivity of the foreign markets to Turkish paper and loan requests.

22. An examination of Turkey's borrowings in both 1988 and 1989 shows that the programs were extremely large (about 80 loans per year), diverse, and well balanced. The currency composition at 1988 borrowings matched the existing stock of debt, the sequencing was even (unlike in previous years) and project financing declined as a proportion of total borrowings, due to the cutbacks in investment expenditure implemented in the course of the year. Borrowings from financial markets increased. A scrutiny of the terms obtained shows that the weighted average interest rate on all borrowings was 7.9 percent. This looks low, but is explained by the fact that two-thirds of the borrowings were in currencies which carry low interest rates as a tradeoff for the expectation that those currencies would appreciate over the term of the loan. The weighted average maturity that Turkey incurred was 7.5 years, shorter than that needed if Turkey is going to reduce its debt hump. All efforts should be devoted to trying to obtain longer maturities, be these on syndicated bank loans or on bond issues. In 1989 Turkey resorted increasingly to Euro-dollar borrowings.

23. In early 1988, acting entirely on its own initiative, Turkey resorted to international bond financing through the offering of Deutsche-mark bonds in the West German capital markets (without any formal link-up with the West German governmental agencies, unlike the case of the Mexico-US Treasury offering in

1988). The seven German bonds have raised substantial amounts (over DM 2 billion) at spreads which narrowed considerably over time. These operations confirmed the view that one of the most important determinants of costs is the degree of "presence" in the market. Increased presence helps to lower the spread and fees charged over the base rate, possibly more than any other factor.

24. The criteria that determine success in the syndications market are not necessarily the same as those for the bond market. The crucial role of accurate estimation in pricing and the discrete outcomes (either success or failure of a given offering) make bond financing a specialized activity. This form of financing represents an area of growing potential for Turkey, and the authorities might look broader to the Zurich, Luxembourg, and Tokyo bond markets as potential sources of the future.

Managing External Risks

25. Even if Turkey arranged the most cost-effective borrowings possible, it can be argued that significant potential exists for reducing risk and realizing savings or avoiding unanticipated costs through risk-hedging measures. Main areas of risk involve currency and interest rate movements.

Currency Composition

26. Over the period 1982-88, about $9 billion of the increase in Turkey's external debt can be attributed to changes in cross-currency exchange rates. The large proportion (68 percent) of non-US dollar currencies in Turkey's portfolio of liabilities has resulted in these large movements in the dollar measured debt stock and debt service. Such swings are likely to continue in the future, (although possibly by less than in the 1984-87 period), given the volatility of exchange rate changes and given the currency composition of Turkey's external debt stock and of its new borrowings contracted in 1987-88 -- which were (heavily) skewed toward non-US dollar currencies. To evaluate whether these large swings imply significant risks regarding Turkey's real debt service burden, it is necessary to evaluate whether Turkey's ability to generate foreign exchange moves in line with cross-currency exchange rate changes. Several criteria are important:

(i) the status of net liabilities (external liabilities minus external assets, such as foreign exchange reserves) needs to be managed;

(ii) the country's overall financial and economic exposures, rather than only the Government's (public) indebtedness;

(iii) the tradeoffs between the expected effective costs/benefits of particular financial instruments; and

(iv) Turkey's ability to generate foreign exchange -- which in turn breaks down into policies regarding currency baskets, trade patterns, currency composition of non-interest current account flows, and the terms of trade in relation to cross-currency exchange rates.

27. Analyzing Turkey's assets and liabilities using the above criteria, it appears that its external debt is reasonably balanced in terms of currency composition and this picture has improved in 1989 with increased dollar borrowings. There are, however, some imbalances with respect to the Japanese yen and the Swiss franc and lesser so to the US dollar. It would be advisable to limit, and possibly reduce, the share of Japanese yen liabilities and to continue to increase the share of US dollar liabilities in Turkey's external debt. The imbalance with respect to the Swiss franc is less serious, as the large amount of trade with West Germany and the large share of DM-denominated flows will tend to compensate for the Swiss franc exposure, as the Swiss franc and the DM are highly correlated. In the short term, the US dollar share of medium- and long-term debt service remains relatively high (40 percent) compared to the US dollar share in the medium- and long-term debt stock (26 percent), as US dollar debt service payments will be coming due earlier. This implies that the currency mismatch is somewhat reduced in the short term. Beyond 1990, the mismatch increases as yen and other non-US dollar debt service payments come due. It thus becomes more important either to achieve a more diversified trading pattern and currency composition of non-interest current account flows -- that is, more net trade with Japan and a higher amount of net yen inflows -- or to limit, and possibly reduce, the amount of Japanese yen borrowings, or both.

Interest Exposure

28. At the end of 1988, floating rate debt constituted approximately 48 percent of total external debt, up 11 percentage points from 1984. Since small movements in the level of international interest rates can result in large swings in Turkey's debt service, Turkey faces a relatively large nominal exposure to interest rate changes. It is, therefore, advisable that Turkey significantly reduce the amount of floating rate debt, including short-term debt. An additional argument for taking on fixed rate debt is that the growth in Turkey's floating rate debt has occurred mainly in the last three years when commercial borrowing expanded and when interest rates were relatively low. Conversely, interest rates are now rising and might continue to rise over the medium term. A prudent target would be to have a maximum of 40 percent of total debt at floating rates (including short-term debt). It should be feasible to achieve this target over the near term through new borrowings and (limited) interest swaps. In implementing tighter external liabilities management and reducing short- and long-term currency mismatches, the Government should:

(i) hedge Turkey's foreign currency liabilities, short-term as well as long-term, using its reserves. This would imply an increase in yen-denominated reserves held by the Central Bank in its investment portfolio, in order to match the growing yen-denominated debt service payments;

(ii) consider increasing the share of US dollar-denominated short-term borrowings; currently 52 percent of short-term borrowings are in dollars, which is not sufficient to correct the overall imbalance; and

(iii) consider futures, forward arrangements, and options -- these transactions can be used as short-term instruments to hedge or