The Recent History of Financial Crises in Turkey

Ali Arı[a1] and Raif Cergibozan[a]

[a]Department of Economics, Kırklareli University, Kırklareli – Turkey

Abstract

The Turkish economy encountered several financial and economic crises since its foundation in 1923. However, the frequency of these crises has sharply increased in the aftermath of the liberalization policies implemented through 1980s as illustrated by the 1994, 1998-99, 2000-01, 2006, 2008-09 financial crises. In this paper, we aim to assess the causes and consequences of these crises from a comparative perspective. According to our descriptive analysis, the financial crises occurred in 1990s mostly result from domestic macroeconomic imbalances and banking sector weaknesses that are exacerbated by volatile capital in- and outflows; while the financial crises through 2000s are mostly related to external economic and financial problems.

Keywords: Financial crises, Financial liberalization, Turkey

Article History: Received 15 January 2014; Received in revised form 28 February 2014; Accepted 3 March 2014

1. Introduction

The Republic of Turkey encountered several financial and economic crises since its foundation on October 29th 1923. These crises led to important negative economic, financial, social, and political consequences. Moreover, every crisis episode led to radical transformation of applied economic policies. Following the Great Depression of 1929, Turkish authorities abandoned liberal economic post-war rebuilding policies by adopting protectionist trade measures and implementing a state-led, inward-looking growth strategy, like many other developing and advanced economies. Subsequent decreases in GDP growth rate, by an annual average of 6.6% during the first half of the 1940s (Nas, 2008), caused first an important devaluation of the Turkish lira (TL) against the US dollar in September 1946, and led then to removal of some barriers on foreign trade. However, increasing trade deficits and in parallel rising foreign debt stock accompanied by slowing GDP growth rates, particularly during the second half of the 1950s, triggered again the TL devaluation in August 1958. Following the military coup in 1960, Turkish authorities re-

[1] Corresponding author, E-mail: ali.ari@klu.edu.tr

adopted protectionist measures by deepening import substitution policy in a planned economy (Boratav, 2009).

The 1977-79 balance of payments and debt crises caused again the reorientation of Turkey's development strategy in order to restore macroeconomic balances by implementing free-market reforms (in particular, trade and financial liberalization), and promoting export revenues (Arı, 2012). However, after a short-lived stability during the 1980s, the Turkish economy entered in a long period of financial turbulences from the beginning of the 1990s to 2002. We can clearly observe that the occurrence of financial crises accelerated following the financial liberalization process, as illustrated by the 1994, 1998-99, 2000-01 financial crises, due to a combination of domestic imbalances and external shocks. Although some remarkable improvements were recorded in terms of inflation and economic growth from 2002 to 2013, the Turkish economy still remains vulnerable to external shocks as the 2006, 2008 and 2013 episodes confirmed.

In this paper, we aim to examine causes of the Turkish crises occurred in the aftermath of financial liberalization process from a comparative perspective. We also analyze socio-economic consequences of these crises, and assess measures and policies taken to face them.

The annual data used in this descriptive study are gathered from the International Monetary Fund (IMF) International Financial Statistics, and the Central Bank of the Republic of Turkey (CBRT).

The paper is organized as follows. Section 2 treats liberalization policies implemented during the 1980s. Section 3 assesses the causes and consequences of these crises. Section 4 concludes.

2. Structural Reforms: Trade and Financial Liberalization

Unsustainable domestic economic policies (inefficient and costly import-substituting industrialization, mostly due to supply-side shocks of the 1973-74 and 1977-78 oil crises), deteriorated macroeconomic aggregates (increasing short-term foreign borrowing to finance current and fiscal deficits, thus continuously growing foreign debt stock, increasing inflation rates, and low growth rates), increasing political instability (rising violence between right and left political sides, subsequent early political elections and short-lived coalition governments), and important external shocks (i.e. the collapse of the Bretton Woods system in 1971, oil crises in 1973-74 and 1977-78) through the 1970s led to a severe currency and debt crisis in Turkey during the 1977-79 period.

Following the crisis, Turkish authorities reoriented their development strategy by adopting a radical structural adjustment program in January 1980.[2] This program, largely supported by the IMF and the World Bank, aimed to implement an outward-looking and free-market-based mode of regulation in order to restore economic growth by improving economic and financial efficiency, increasing domestic savings and attracting foreign capitals. In the framework of this program, Turkey also took neoliberal austerity measures, i.e. a combination of tight fiscal and monetary policies that intended to reduce real income, thus lowering domestic demand and consequently lowering inflation rate.

The early phase of the program (1980-1984) was mostly characterized by the trade liberalization which consisted of export promotion and import liberalization (Rodrik, 1990; Boratav and Yeldan, 2006). As for the second phase (1985-1989), it was characterized by the financial liberalization which mainly consisted of interest-rate liberalization and the liberalization of capital flows.

In this sense, exchange-rate adjustments (devaluation of the TL) were implemented in order to promote exports, and in parallel to balance current account deficits. Import quotas and tariffs were also gradually removed. Moreover, removal of price controls, privatization of several state-owned enterprises (SOEs), and ending interest rate controls were envisaged. Furthermore, Turkey abandoned the fixed exchange rate regime used since the 1920s by adopting the managed float regime. On the other hand, the Turkish authorities facilitated the entry of new banks to the banking system in order to increase competitiveness in the sector. They also established some key institutions such as Capital Markets Board and Interbank, and they inaugurated Istanbul Stock Exchange (BIST, recently called Borsa Istanbul) in 1986. Finally, the full liberalization of capital movements along with the convertibility of TL was done with the Decree 32 of 1989.

This large structural reform program obtained an initial success by reducing the triple-digit inflation rates to 30% on average, increasing export earnings by an annual average of 10%, and ensuring an average economic growth rate of 5.5% in the period 1982-1989. However, this early success was first shadowed by bankruptcies of several unregulated brokerage firms (*bankerler krizi*) in 1982, and then by the occurrence of severe financial crises in 1994, 1998-99, 2000-01, and 2008-09. These crises led to severe economic consequences in terms of increasing interest rates, large reserves losses, high currency depreciations, large capital outflows, collapse of the BIST index, excessive output losses, and failure and/or nationalization of more than twenty domestic banks (see Figure 1).

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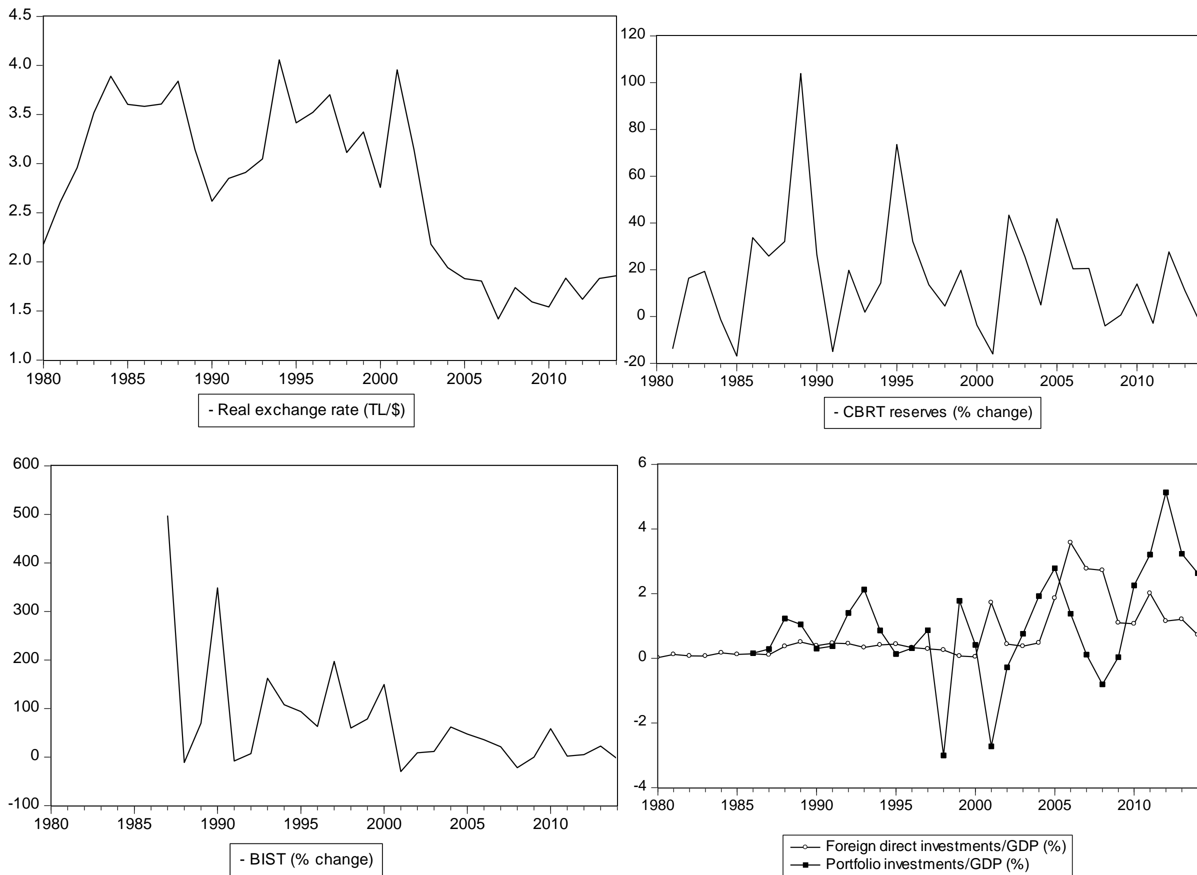
[2] As stated by Summers and Pritchett (1993), this neoliberal structural adjustment programs consist of stabilization, liberalization, deregulation, and privatization.

Figure 1. Results of financial crises in Turkey



Source: Authors' calculations according the data gathered from the IMF and the CBRT.

3. Turkish Financial Crises

As underlined by many economists (Akyüz and Boratav, 2003; Özatay and Sak, 2002; Öniş and Rubin, 2003), the 1990s had been a lost decade for Turkey. A continuous deterioration of macroeconomic fundamentals, a highly vulnerable banking sector, a very unstable and fractional political environment, and contagion effects of financial crises occurred in emerging economies in the second half of the 1990s created all the ingredients of a crisis-prone economic structure, like in late 1970s.

Fiscal discipline was never achieved in the Turkish economy over the 1980s and 1990s, except for some short-lived improvements in 1995 and 1998. These large budget deficits were primarily caused by an expansionary fiscal policy mainly related to infrastructure investments, populist wage policy,[3] large subventions granted to exporting firms,[4] an

[3] Populist wage policies were particularly observed with the return to parliamentary democracy in 1987.
[4] Since the growth strategy was based on export revenues, the public authorities did the most to encourage exporting firms via tax reductions, TL devaluations, and real wage reductions.

inefficient tax system, important informal economy,[5] off-budget expenditures of the central government, high fluctuations in economic growth rate, and increasing interest payments on the public debt.[6] The persistent deficits (on average 8% of GDP over the 1990s) led in parallel to an increase in public sector borrowing requirement (12% of GDP in 2001) and public debt stock (superior to 100% of GDP).

Moreover, inflation rates followed an increasing trend from 1980s (around 40%) to the 1990s (on average 65%). Large budget deficits, steady real devaluation of the TL, inflationary expectations of economic agents, and institutional factors, i.e. politically dependent Central Bank, and political instability,[7] are seen as the main reasons of the chronic Turkish inflation from 1975 to 2004.[8] This unstable and uncertain economic framework consequently caused high real domestic interest rates, low private investments, and low economic growth rates.

The liberalization of capital movements in 1989 was another factor of vulnerability for the domestic economy, since excessive short-term capital inflows due to high real interest rates led to overvaluation of the domestic currency that lowered the competitiveness of exporting firms.[9] This was a big problem for the country of which growth strategy was based on export revenues. This situation naturally deteriorated the current account balance. In order to offset these current deficits (nearly 5% of GDP before the occurrence of 1994 and 2000-01 crises), the country needed more capital inflows that constantly increased the ratio of short-term foreign debt stock over international reserves. This unsurprisingly augmented the vulnerability of the country to external shocks.

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[5] The informal economy in Turkey may reach from 30% to 40% of GDP. See Us (2004) for further discussion on this issue in Turkey.

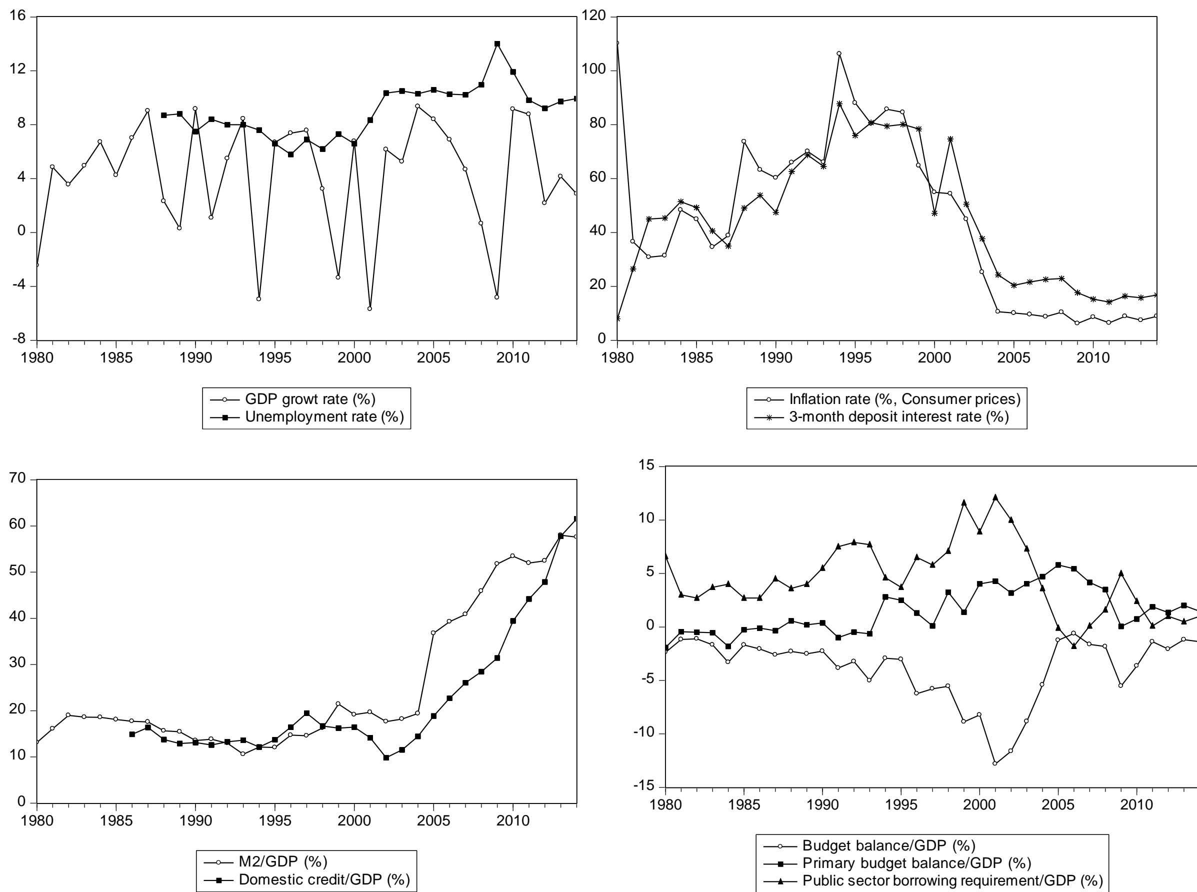
[6] Note that increasing military interventions against the PKK during the 1990s also created heavy burden for the budget balance.

[7] The relationship between political instability and inflation in Turkey is examined by Kibritçioğlu (2001). In a descriptive and comparative analysis, he shows that political cycles (measured by government changes following general elections) have significant effect over the high and chronic Turkish inflation rates.

[8] See Yılmaz and Arı (2013) for further discussion on inflation dynamics in the Turkish economy.

[9] See Rodrik (1990), Aşıkoğlu and Ersel (1993), Sak (1995), and Nas (2008) for further discussion on financial liberalization and its consequences in the Turkish economy.

Figure 2. Domestic macroeconomic indicators



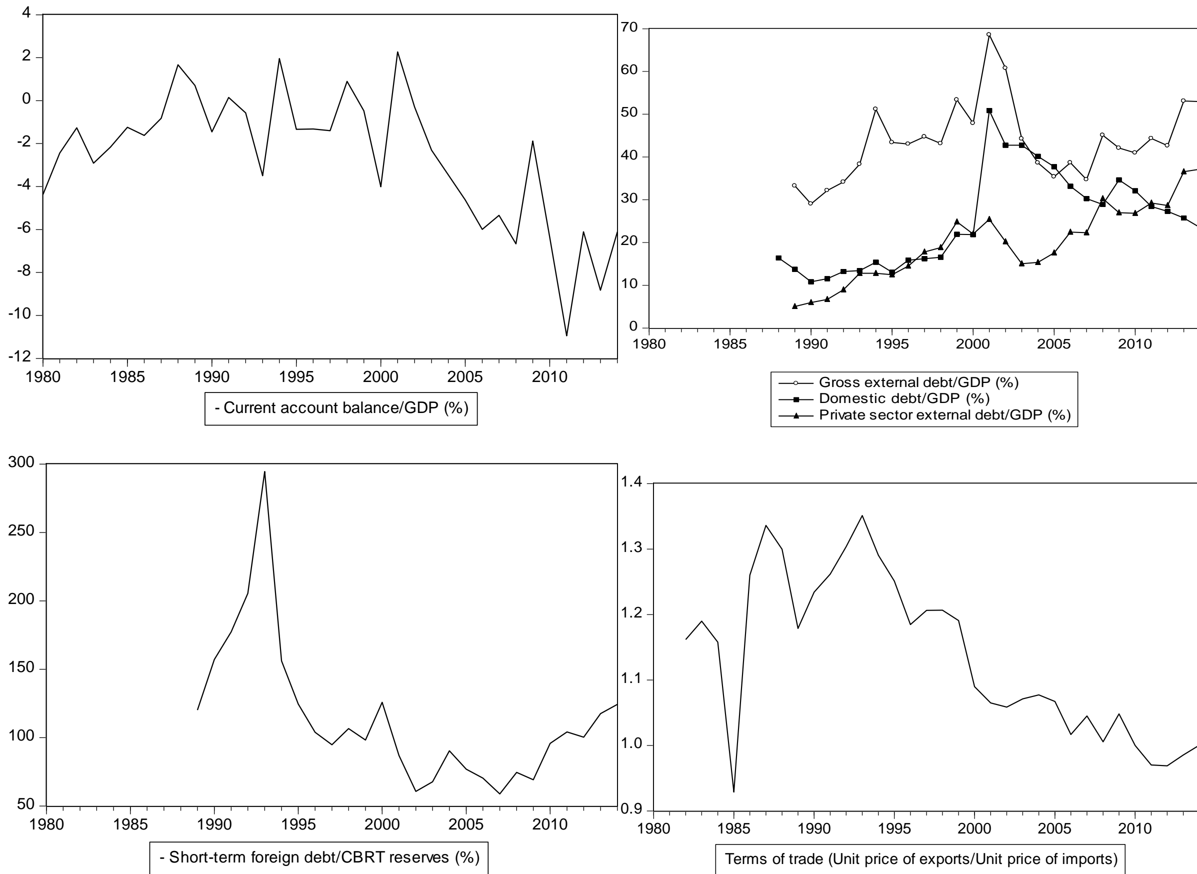
Source: Authors' calculations according the data gathered from the IMF and the CBRT.

On the other hand, capital account liberalization amplified the banking sector's weaknesses as the banks had much more opportunity to borrow in international capital markets. Since the unstable economic environment increased the credit risk for banks, they preferred to finance public deficits instead of granting credits to the private sector (the ratio of bank loans to central government over bank total loans was around 40% between 1993 and 2002). In this context, banks borrowed in foreign currency in international markets in order to invest in public sector securities in domestic currency, which generated a strong growth of their open positions.

Moreover, the great part of state-owned banks in the sector created negative effects on the entire system. Interventions of political authorities in their management and the use of their assets to finance public deficits deteriorated their balance sheets, thus increased their borrowing requirements. This led to high domestic interest rates that raised the instability of the whole banking system.

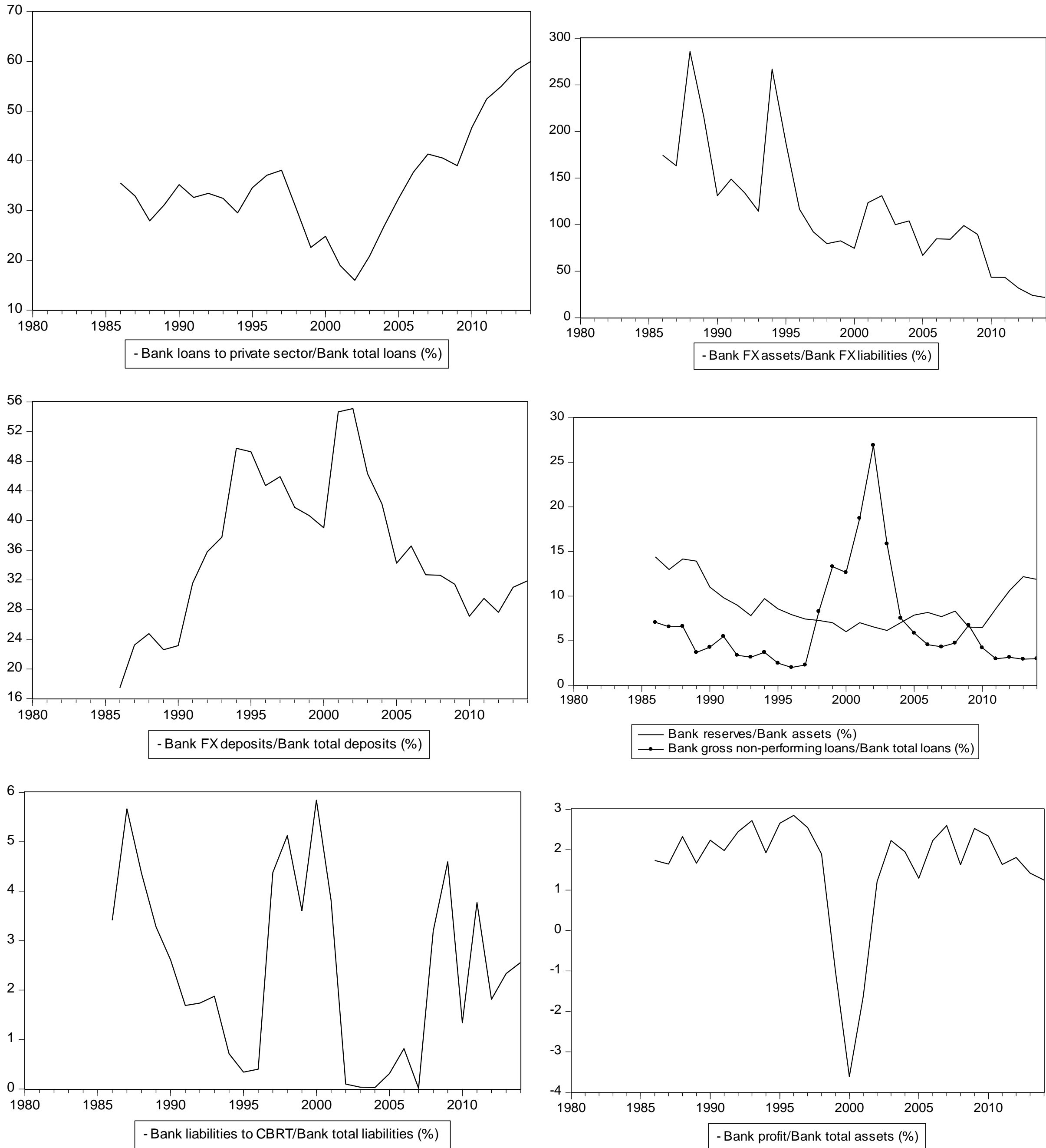
Furthermore, the full deposit insurance implemented after the 1994 crisis in order to restore confidence in the banking system created moral hazard problems. This structure encouraged banks and their depositors to take on excessive risks in order to get higher profits. Poor supervision and regulation of the system accompanied by the close connections between bank conglomerates and political authorities unquestionably fostered this excessive risk-taking setting.

Figure 3. External balance indicators



Source: Authors' calculations according the data gathered from the IMF and the CBRT.

Figure 4. Banking sector variables



Source: Authors' calculations according the data gathered from the IMF and the CBRT.

The 1994, 1998-99 and 2000-01 financial crises occurred in a similar highly deteriorated economic and financial environment. However, their triggering factors were different.

A sharp downgrading in Turkey's credit rating in the beginning of 1994 by Standard & Poor's and Moody's, mainly due to increasing short-term advances from the CBRT to offset

budget deficits, played a triggering role in the occurrence of a severe currency crisis (Celasun, 1998; Özatay, 2000). The TL depreciated more than 100% on the yearly basis despite the intervention of the CBRT in money and currency markets: overnight interest rates increased to 700% and more than the half of the foreign reserves stock was mobilized.

In the following weeks, the currency crisis first spread to the banking sector, largely exposed to currency and liquidity risks, as the Saving Deposit Insurance Fund (SDIF) took control over three small-scale banks (Marmarabank, TYT Bank et Impexbank), then to the real sector: economic growth slumped by more than 5%; inflation rates reached record levels (125%); external debt stock increased by nearly 40%. This twin crisis à la Kaminsky and Reinhart (1999) could be controlled with the announcement of a stand-by agreement with the IMF on April 5, 1994. In the framework of this orthodox austerity program, tightening monetary and fiscal policies were carried out to correct the fiscal fundamentals (Ertuğrul and Selçuk, 2001). Moreover, full deposit insurance was put into operation in order to restore confidence in the banking system.

During the period 1995-97, the program brought a short-lived improvement in terms of inflation, fiscal balance, and economic growth in the Turkish economy. But the generalized deficiency of financial markets towards emerging economies (flight to quality) following the 1997-98 Asian and the 1998 Russian financial crises caused large capital outflows from Turkey (USD 10.5 billion). This deteriorated once more the country's macroeconomic and financial fundamentals.[10] On the other hand, the devastating earthquake of the 17th August 1999 also played an important role in deterioration of economic fundamentals. Following the economic recession and financial instabilities, eight other banks were transferred to the SDIF from late 1998 to the end of 1999.

In order to restore the economic stability, the three-party coalition government launched another IMF-supported disinflation program in January 2000. This exchange-rate based stabilization program was accompanied by tight fiscal and monetary policies, heterodox income policy, and structural reforms.

Within this crawling peg regime where exchange-rate adjustments are declared in advance, the inflation rate is indexed to the exchange rate from 2000 to 2002 to minimize inflation uncertainty and in parallel to break out the inflation inertia. The government also

[10] The Russian crisis created much more problems than the Asian crisis for the Turkish economy, as Russia was Turkey's one of the main trade partners. Since the Russian economy was in a deep crisis, Turkish exports to Russia significantly declined, contributing to economic recession in Turkey. See Binay and Salman (1998) and Akçay and Zenginobuz (2001) for an amplified analysis on contagion effects of the Asian and Russian crises over the Turkish economy.

limited by law wage and rent increases in line with future inflation rate in order to lower and manage inflation expectations.

Monetary policy was designed to be tight, but rather passive (Nas, 2008). Including no-sterilization rule, the liquidity in the economy was to be managed by the domestic interest rates that were determined through market dynamics. Moreover, the money supply could only change with variations in the foreign exchange reserves, while net domestic asset level of the monetary base was kept constant. This gave a "Currency Board" character to the program.

Another aspect of the program was the implementation of important structural reforms in particular in banking and social security systems along with privatizations of SOEs. With this policy, the government aimed to improve fiscal and economic efficiency.[11]

The program found a positive echo among economic agents: capital inflows accelerated (USD 15 billion in 2000), interest rates strongly decreased (from more than 80% to about 40%), and private consumption sharply increased in particular with low cost bank credits. However, sharp increases in private consumption mainly met by imports, led to overvaluation of the TL (about 15%) compared to the preannounced parity of the fixed exchange rate which deteriorated in turn the trade balance (deficit of USD 27 billion at the end of 2000).

Besides, the rise of the short-term debt associated to the failure to achieve the privatization goals increased the tensions in the Turkish money market and created doubts on the sustainability of the program. International investors became then increasingly reluctant in renewing their credits. Furthermore, the strong exposure of the banking system to currency mismatches and to credit and default risks enhanced these doubts. As a consequence, domestic interest rates sharply rose. This led to the failure of of two small-scale banks (Etibank and Bank Kapital) in October 2000, and the failure of Demirbank (the fifth biggest bank in the Turkish banking system) in December. In order to avoid a systemic banking crisis, the CBRT suspended its "Currency Board" commitment and bailed out the illiquid banks. However, economic agents were reassured only on December 6th, with the IMF's Supplemental Reserve Facility[12] of USD 7.5 billion.

[11] The program actually had some basic problems. First, the reserves stock of the CBRT was not enough to support the fixed exchange rate regime. Second, the exchange rate was not enough competitive when the program was implemented. Finally, the no-sterilization rule was the weak link of the program.
Moreover, as stated by Calvo and Vegh (1999), exchange rate-based stabilization programs lead to boom-bust cycle in emerging economies.

[12] IMF's Supplemental Reserve Facility is a sort of short-term credit granted to the countries which suffer balance of payments problems and/or currency crises.

Table 1. List of Turkish domestic banks transferred to the SDIF

Name of Bank	Date of Transfer
Marmara Bank	April 1994
TYT Bank	April 1994
Impexbank	April 1994
Türkbank	November 1997
Bank Ekspres	December 1998
Interbank	January 1999
Egebank	December 1999
Yurtbank	December 1999
Yaşarbank	December 1999
Esbank	December 1999
Sümerbank	December 1999
Kıbrıs Kredi Bankası	September 2000
Etibank	October 2000
Bank Kapital	October 2000
Demirbank	December 2000
Ulusal Bank	February 2001
İktisat Bankası	March 2001
Bayındırbank	July 2001
Kentbank	July 2001
EGS Bank	July 2001
Sitebank	July 2001
Tarişbank	July 2001
Toprakbank	November 2001
Pamukbank	June 2002
İmar Bankası	July 2003

Source: Arı (2010).

Nevertheless, the deterioration of the financial structure of the public banks and the SDIF banks and their massive requirements for short-term credits increased again interest rates in January 2001. This context led investors to question the sustainability of the fixed exchange system. The program that aimed at decreasing the inflation rate to single digits by the end of 2002 collapsed then in February 2001, following the public disclosure of a political disagreement between the Prime Minister and the President of the Republic on February 19, 2001. The monetary authorities defended the fixed exchange rate by mobilizing reserve stocks (US$5 billion in three days) and increasing the short-term

interest rates to 4000%. However, following the investors' generalized distrust, the authorities were forced to let the currency float on February 22. The crisis led to devastating economic and social consequences: economic growth slumped by more than 5%; unemployment rate increased to %10; inflation rate went back to its 1999 level (about 70%); budget deficits and public sector borrowing requirement reached record levels (about 12% of GDP); domestic and foreign debt nearly doubled; banks recorded massive losses and more other commercial banks were transferred to the SDIF.

Another stabilization program, "Transition to the Strong Economy", was announced on May 15, 2001. The program, backed by USD 19 billion IMF stand-by credits, finally restored a relative economic stability by restructuring the banking sector (which cost over USD 50 billion) and fulfilling many structural reforms in several areas and sectors of the economy and the financial system. Remarkable improvements were recorded in terms of inflation (from over 70% in 2001 to 8% in 2013), budget deficits (from 12% of GDP in 2001 to 4% in 2013), economic growth (on average 5% of GDP from 2002 to 2013), and dollarization (bank foreign deposits over bank total deposits fell down from 55% to 25%).

Tight fiscal policies (primary budget surpluses to GDP over 4% on average from 2002 to 2013), high economic growth, lowered real wages, appreciation of the TL mainly due to large capital inflows, the independent Central Bank focusing only on price stability were key issues behind the successful inflation targeting regime implemented since 2002. The interesting point here is the inflation rates fell down to single digits, while the ratios money supply to GDP and domestic credit to GDP were following an increasing trend.

High and steady growth rates were also achieved by ensuring fiscal discipline. The restructuring of the banking sector and large capital inflows (both foreign direct and portfolio investments) also played an important role in economic growth as the bank loans to private sector tripled after the 2001 crisis. Moreover, political stability was also a key determinant of economic stability since the Justice and Development Party (AKP) came into single-party-government in November 2002.

However, these achievements cannot hide Turkey's vulnerabilities (Rodrik, 2012). Sharp increases in current account deficits (more than 6% of GDP on average from 2002 to 2013), high unemployment rates (on average superior to 10% from 2002 to 2013), a highly indebted private sector (private sector short-term external debt over USD 70 billion and overall foreign debt superior to USD 200 billion in 2013), and difficulties to attract foreign direct investment (FDI) are the highly notable ones. The economic growth strategy, which is closely related to export earnings and short-term capital inflows, seems indeed to be the

main reason behind the vulnerability of the country to external shocks, as the May 2006, October 2008, May 2013, and December 2013 episodes illustrated.

The fluctuations in the exchange rate in 2006 were mainly caused by international economic developments: increasing global imbalances, rising commodity and oil prices and increasing speculative bubbles in the US mortgage market. Contrary to the 2006 episode, which only led to large fluctuations in the Turkish financial markets, the 2008-09 crisis heavily affected the real economy as the country recorded an economic recession of nearly 5% of GDP, slumping export revenues (more than USD 30 billion) and rising unemployment rates to 14% in 2009. It may be argued that Turkey was affected by the global financial crisis mainly through trade and financial channels. Sharp reversals in capital inflows to developing countries (sudden stop) accompanied by a significant slowdown of economic activity in developed countries and a parallel collapse in their export demand clearly explain the emergence of the 2008-09 financial crisis and the following economic contraction in Turkey.

The Turkish economy had a quick recovery as in 2010 and 2011 the GDP growth rate exceeded 9% level and the unemployment rate started to lower again (10% in 2013). However, this high growth rate led to current deficits to reach record levels in 2012 (8% of GDP). This situation increased risks of external shocks for Turkey in a period where global risks increased following the unsolved European debt crisis and the announcement of decreasing bond buy-outs by the US authorities in the period 2012-2013.

Note that economic integration between the European Union (EU) and Turkey has deepened significantly over the years. Foreign trade volume between both markets reached up to 110 billion euros in 2011. The EU is Turkey's number one trading partner and leading export market. During the period 2008-2011, 3/4 of FDIs were of EU origin. Turkey takes part in the production and logistics chain of EU companies with its increasing investment opportunities. Turkey is also a candidate country undergoing accession negotiations with the EU. With such deep economic ties in terms of trade, capital flows, and investment, it was impossible for Turkey to completely isolate itself from the on-going crisis in the EU.

Moreover, domestic and external political risks also increased in 2013 because of corruption investigations and 'Gezi' manifestations across the country and the Russia-Ukraine conflict. The increasing vulnerability of the Turkish economy led then to high depreciation of the domestic currency (more than 20% and 25% in May and December 2013, respectively), increasing interest rates and slowing growth rates (about 3% in 2013).

4. Conclusion

According to our descriptive study, there appear to exist two distinct periods in the Turkish economy: before and after the 2001 financial crisis. During the pre-2001 crisis period, Turkey presented important macroeconomic imbalances (excessive budget deficits, high money supply growths, high and chronic inflation, significant dollarization, sharp rises in short-term external debt), significant banking sector weaknesses (high non-performing loans, important currency mismatches, low own equity and reserves), and it also underwent some external shocks mostly related to the 1997-98 Asian and 1998 Russian crises. This is why we can affirm that the 1994, 1997-98 and 2000-01 crises mostly result from domestic problems.

However, these domestic problems are not only related to domestic factors, but also to volatile capital flows. Of course, the highly unstable and fractional political context, excessive public deficits and public borrowing requirements, excessive risk-taking domestic banks in the poorly supervised and corrupted banking system all created a crisis-prone economy. But significant capital inflows and outflows following the financial liberalization in 1989 worsened all these domestic problems. This is consistent with the recent literature which shows the fact that the sustainability of financial opening necessitates a deep fiscal restructuring before its implementation (Aizenman, 2004).

In the post-2001 crisis period, Turkey reached to restore a relative economic and financial stability with a radical structural economic program in the relatively stable political framework. However, the country suffered a severe financial crisis in 2008-09, and high fluctuations in its money and currency markets in 2006 and 2013. These crises and/or fluctuations are mostly related to external economic and financial problems. The economic growth strategy, which is heavily dependent on export earnings and short-term capital inflows, is the main reason behind this external vulnerability.

In that regard, reducing the dependence on foreign capital requires an increase in public and private savings that may finance a dynamic and sustainable economic growth. This transformation would also break the parallelism between economic growth and widening current account deficits which are a source of vulnerability for the domestic economy. But this is hard to achieve in the current international and domestic framework: the on-going crisis and recession in the EU and Russia which are Turkey's main trade partners, degrading domestic and international political environment (Syria and refugee problems, increasing tensions with the PKK).

Another important policy should be reviving the unfinished industrialization in Turkey. Despite some efforts during 1930s and 1960s, the Turkish economy passed directly from

agricultural to service economy in the post-liberalization period. In order to achieve a sustainable growth and development, Turkey needs to heavily invest in high-technology industries that may present a possible exit from the so-called middle-income trap. For doing so, the Turkish authorities should orientate public and private capitals towards these sectors, grant significant subventions to the firms producing high-tech goods, and even take some protectionist measures in some target sectors à la Chang (2002).

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