

## **POLITICAL ECONOMIC ANALYSIS OF TURKISH ECONOMY: STRUCTURAL PROBLEMS AND THE ROLE OF THE STATE<sup>1</sup>**

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### **ABSTRACT**

The objective of this essay is to survey some of the structural problems and their connection with the government policies and the bureaucracy. This essay emphasizes the fundamentals of the social, cultural and political dynamics and their associations with the current structural problems in Turkey. Our focus on these social, cultural, and political accounts will be analyzed in line with the historical developments while particular attention is given to last three decades.

**Keywords:** Turkish economy, financial crisis, institutional problems

## **POLİTİK-İKTİSAT BAKIŞ AÇISINDAN TÜRKİYE EKONOMİSİ: YAPISAL SORUNLARI VE DEVLETİN ROLÜ**

### **ÖZET**

Bu çalışmanın amacı Türkiye ekonomisindeki yapısal sorunları ve bu sorunların devlet politikaları ve bürokratik yapı ile olan ilişkisi üzerine analitik bir gözlem yapmaktır. Türkiye'nin sosyal, kültürel ve politik dinamiklerinin ülkedeki yapısal sorunlar ile olan ilişkisi ve devletin bu dinamikler ile etkileşimi ortaya konulmaya çalışılacaktır. Bu çalışmada ülkenin belirtilen sorunları tarihsel bir çerçevede incelenecek olmakla birlikte, yakın tarihe daha büyük bir önem verilecektir.

**Anahtar Kelimeler :** Türkiye ekonomisi, finansal krizler, kurumsal sorunları.

### **1. INTRODUCTION**

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The region of Anatolia, generally considered synonymous with Asia Minor, has been under Turkish rule since the 11<sup>th</sup> century. The Seljuk Turks, invading from the East, defeated the Byzantine Empire in 1071 at the Battle of Manzikert (Malazgirt in Turkish). The rule of the Anatolian territory by the Great Seljuk State was followed by the Ottoman State, which existed from the beginning of the 14<sup>th</sup> century to the end of WWI. Through more than six hundred years of rule, the Ottoman Empire extended its borders from the Crimea in the North to Yemen and Sudan in the South, and from Iran and the Caspian Sea in the East to Vienna in the Northwest and Spain in the Southwest.

Starting in the 17<sup>th</sup> century, the Ottoman Empire began to lose its economic, technological, and military superiority vis-à-vis Europe and Russia. Throughout the 19<sup>th</sup> century, successive military defeats and nationalist movements accelerated the Ottoman Empire's process of dissolution. After WWI the Empire was forced to accept the heavy stipulations of the 1918 Moudhros Armistice and the 1920 Sevres Treaty.

In response to the unacceptable conditions of the Sevres Treaty, the Turkish nationalist movement started under the leadership of Mustafa Kemal Atatürk.

The defiant nationalist movement turned into a full-scale war against the WWI victors resulting in the signing of the Lausanne Treaty and the formation of an independent Turkish Republic to replace the Ottoman State.

The new Turkish Republic inherited many social, economic, and institutional impediments from the Ottoman State. Although the preliminary ideals of the nation were to immediately follow the modernization route, Western democracy and its economic prosperity, the geo-strategic location, risky neighborhood, and overall world conjuncture did not offer much opportunity to attain those goals. Its location in a volatile region neighboring on such authoritarian regimes as the former Soviet Union, Iran, Iraq and Syria and the ongoing problems with Greece justified the maintenance of Turkey's vast army and large defense budgets. Moreover, high rank army officers, the founding elite of the Turkish Republic, have always seen themselves as guardians of the state and claimed the right to exercise influence on domestic and international issues. Turkish military coups ousted civilian governments in 1960, 1971 and 1980. Most recently the Republic's first Islamist government was removed by a velvety coup in 1997. In spite of this history of military intervention, the nation has experienced a parliamentary democracy for several decades.

This essay will emphasize the fundamentals of the social, cultural and political dynamics and their associations with the current structural problems in Turkey. Our focus on these social, cultural, and political accounts will be analyzed in line with the historical developments while particular attention is given to last three decades.

## **2. THE FRAGILITY IN POLITICS, THE ROLE OF THE MILITARY, COALITION GOVERNMENTS, AND POPULISM**

Founded by military elite, the Republic of Turkey has never attained Western democratic standards throughout its history. During its multiparty periods of the 1950's and later, the Turkish democracy was interrupted by four military coups in 1960, 1971, 1980, and 1997.

The founding fathers of the Republic, Ataturk, and the military elite have strongly desired a perfectly westernized and modernized Turkey, but in order to attain this goal the creation of a new Turkish identity was necessary. Although the identity has been tried to be implemented above by the State, Herslag (1988) argues that the problem has not solved yet. Herslag defines this identity problem as: "Kemalism has been an ideology largely imposed by the elite and hardly understood or shared by the rural and even urban masses, despite many efforts at indoctrination" (1988, p. 10). The complete creation of this model has yet to be accomplished; however, the seeds of long-lasting animosities in the layers of society and strong political tensions have remained at the center of Turkish politics and also provided fertile ground for the military coups. These factors have not created a healthy environment for democratic institutions to flourish in Turkey. In his 1970 model of the "transition to democracy," Rustow concluded that Turkey's authoritarian tendencies were related to its lack of struggle and/or overt conflict among social strata. He argued that:

The Turkish commitment to democracy was made in the absence of prior overt conflict between major social groups or their leading elites. In 1950 there was the first change of government as the result of a new electoral majority, but in the next decade there was a drift back into authoritarian practices on the part of this newly elected party, and in 1960-1961 the democratic experiment was interrupted by a military coup. These developments are not unconnected: Turkey paid the price in 1960 for having received its first democratic regime as a free gift from the hands of a dictator (1970, p.360).

Political instability has been the most important factor behind the failure of Turkish governments to conduct structural reforms. Önis and Riedel (1993) argued that there were several structural causes of the macroeconomic crises, which were also strongly related to the major features of the Turkish political economy. The most prominent structural features of Turkish political economy may be defined as its influential Etatist tradition accountable for most of the inefficiencies in the national economy, and the dispersion of political power within the context of the electoral system<sup>2</sup>. The electoral system has produced several coalition governments, which aimed at a high rate of economic growth in order to stay in power. Önis and Riedel (1993) maintained that unsustainable populist macroeconomic policies

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<sup>2</sup> See Okyar (1965) and Boratav et.al. (1981) for the details of Turkish Etatism.

unavoidably brought about economic crises. Tutar and Tansel in their empirical study which covered a period from 1960 to 2001, argued that

The analyses show that a separate Treasury from the Ministry of Finance and the State Planning Organization under the existence of coalition governments adversely affected the consolidated budget deficits in Turkey. As annual and quarterly results indicate, this adverse effect stems from the fact that coalitions are causing increases in interest rates on government debt and therefore the interest payments from the budget (2001, p.22).

In Turkey, every ruling party has been blamed for populist economy policies since the beginning of the multi-party period in 1950. Under the protection of the military junta and the absence of the political competition, the first two governments of the 1980's liberalization period were able to carry out structural reforms and launch successful initiatives in the economic field. However, following the commencement of the political competition, the incumbent elected governments resorted to populist economic policies which proved fiscally damaging in the long run. Amidst multi-party politics and the competitive electoral environment, all of the governments without exception were simply not bold enough to implement the necessary reforms that the Turkish economy needed. The international institutions, namely the IMF and the World Bank, at the beginning of each stand-by agreement, addressed the weaknesses of the Turkish economy and proposed necessary structural reforms; actually, those advices were not something novel to the Turkish bureaucrats or politicians. But the event inevitably took the populist route as, with the first signal of economic recovery, the governments tended to forget the recipes and started to say and do whatever the voters wanted.

The most influential group of Turkey's voters has historically come from the rural communities. As of 2000, the agricultural sector accounted for roughly 15 percent of GDP and 42 percent of the population. It has been a tradition to set higher support prices for agricultural products relative to the world market. The reason for this generosity from the government has been mostly populist-oriented vote calculations; on the other hand, the likelihood of unprepared and massive migration of rural populations to big cities has also been taken into consideration. The reformist ANAP government suffered its first defeat in the local elections of 1989. The result of the election made incumbents reconsider the distributional demands, the critiques of the main opposition party, and other political pressure groups (mainly on the left of the political spectrum) which frequently defended the redistribution of the national income in pursuit of populist ends (Boratav et al., 2000; Önis, 1998).

In addition to agricultural restructuring, the government policy agenda included pension reform, fiscal management and transparency, tax policy and administration, privatization, and improving the banking system. The 1999 IMF-Turkey standby agreement emphasized the same issues (Aruoba, 2001).

In December 1999, Turkey sent its Letter of Intent to the IMF in order to get a additional financial aid. In the letter, which was signed by the Minister of State

for Economic Affairs and the Governor of the Central Bank, Turkish authorities stated the necessary structural reforms for Turkey under the headline of Structural reform as: the recent agricultural support policies (which accounted for 3 percent of GNP, were not cost-effective, and tended to benefit rich farmers) were to be replaced by direct income support system; the pension system would be remodeled in regard to the minimum retirement age, administrative reorganization to improve coverage, compliance and efficiency; fiscal management and transparency were to be enhanced by eliminating inefficient budgetary and non-budgetary funds and avoiding duty losses of the state owned banks. Taxation was to be improved through better collection with an emphasis on equitability. The government pledged to accelerate privatization in order to increase efficiency and shrink public debt, strengthen the banking system and its regulation by founding a new supervision agency, ameliorate the legal framework and improving law enforcement.

### **3. WEAK FINANCIAL SYSTEM, INFLATION, EXCHANGE RATES, AND INTEREST RATES**

Prior to the liberalization era of 1980, the Turkish financial system demonstrated classic characteristics of the financial repression (Yeldan, 2001). The Central Bank's resources had been frequently used to finance government deficits. This was in turn feeding inflation. In those times, it was the Central Bank that directly set interest rates. During the very high inflation periods of the late 1950's and second half of the 1970's, the real rate of return from time deposits was generally negative (Denizer, 1997). This vicious circle of the budget deficit, increasing money supply, inflation, and distorted interest rates created an unproductive and stagnant economy before the liberalization program of 1980.

Since the inception of the 1980 liberalization program, the financial institutions and banking system of Turkey have changed dramatically, although Turkey could not adjust its institutions and organizations as thoroughly and as rapidly as needed. The so-called adjustment problems were the main causes of the Turkey's financial difficulties. After 1980 the country suffered at least four crises. The first crisis of the liberalization period came in 1982<sup>3</sup>. As it was theoretically introduced by Diamond and Dybvig (1983), the absence of a deposit insurance system in the early 1980's led to an economic collapse as people panicked and withdrew their deposits from the banks. This sudden loss of public confidence put the banking system in jeopardy sinking many of the banks into bankruptcy.

In the early 1980's, the total assets of the banking system amounted to less than 30 percent of GNP. After two decades of liberalization practice, by 1999 bank assets had increased to 70 percent of the GDP. In addition to increasing the assets, credit volume, the use of information technology and integration into the world

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<sup>3</sup> See Yülek (1998), Uygur (1993), Senses (1988), Rodrik (1991), Ozatay (1994) and Onis et.al (2000) Turkish liberalization experience.

banking system, the banking sector has been able to attract well-educated graduates from the best universities in Turkey (Ersel, 1994). Yet, despite these positive aspects, the banking system still remained vulnerable. One of the most important criticisms was that the banking system has turned into a “*semi-treasury*” for the government. From 1980 to the early 2000s, the banking system has intractably operated under the maturity risk i.e., *maturity mismatch*. Moreover, the majority of assets in the balance sheet of the banks were comprised of the TRL denominated assets while they were borrowing from the international market with foreign currency denominated liabilities until the 2001 crisis. Simply stated, Turkish banks were borrowing from the international market in foreign currencies in the short term and these foreign resources were being converted into the TRL to buy government bonds. In the event of any fluctuation in the government bond market or FX market, banks were entering into short positions. Briefly, the Turkish banking system, until very recent times, had operated under the maturity and exchange risks in order to benefit from high real TRL interest rates. The government did not discourage the practice because it continued borrowing money from these banks to cover its expenses.

According to the survey-based report by the Istanbul Chambers of Commerce in 1997, 50percentof the gross profits of Turkey’s top 500 industrial companies came from interest earnings (Istanbul Sanayi Odasi, 1998: p. 86). It was evident that during liberalization periods high real interest rates were a more attractive source of profit than production and capital investment.

International financial institutions interpreted recent Turkish financial crises (that is, 2000-2001) as comparable to the experiences of other developing countries<sup>4</sup>. One of the JP Morgan analysts (2001, p.32) stated:

Cross-country comparisons suggest that the causes of the Turkish crisis are not systematically different from those underlying financial crises elsewhere, at least in theory. Poor banking practices – inadequate capital, poor assessment of credit risks, lending to connected enterprises or insiders and excessive maturity or currency mismatches – are some of the common themes for any country experiencing problems in the financial sector.

The relationship between the banking sector developments and macroeconomic instabilities is seen as a bi-directional phenomenon. Three major decisive traits of the Turkish banking sector are believed to cause banking system failures and, in turn, macroeconomic instability. These are the negative effects of the public banks' duty losses that assumed special significance after the crisis and the associated stabilization program of 1994; the granting of new bank licenses on the basis of political criteria and the resultant negative outcomes; and the limited number of foreign banks in the Turkish banking sector (Alper and Önis, 2002, p.4).

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<sup>4</sup> See TOBB (2001) and Yeldan (2001) for the recent financia crisis in Turkey.

In addition to distortions created by budget deficits, another aberration was due to significant currency substitution. In a volatile economy it is common to see frequent economic crises, recessions, fluctuations in growth, high and instable inflation rates, numerous failed stabilization attempts, large public sector deficits, and political uncertainties. Under these conditions, any economic agents, the Turkish people being no exception, tend to keep their savings in relatively stable currencies, generally the US Dollar. Due to the unpredictability of money demand that stemmed from currency substitution, the Central Bank's ability to implement a solid monetary program remained limited. In addition to the technical aspect in relation to the administration of the money supply, large volumes of currency substitution in the economy have been a very significant indicator of people's distrust of the economy. Although the statistics have shown that throughout the post-1980 liberalization period, in the long run, the TRL denominated deposits brought higher interests in real terms relative to foreign currency savings, the foreign currency holdings and foreign currency denominated deposits in the banking system have gradually increased. In economics, this phenomenon is known as hysteresis effect; even in the case that a relatively stable economic pattern comes about, it takes some time for economic agents to develop confidence.

Turkey has experienced two digit inflation rates in the last three decades. The main cause of inflation has been a mixture of cost-oriented and demand-oriented factors. Hershlag argued that "demand inflation was further aggravated by the emergence of relatively strong unions defending, in 1978 and 1979, fixed wages exceeding inflation and efficiency, vis-à-vis a net of public and even private monopolies" (1988, p.110). We can extend its interpretations for the post-liberalization period of 1980 and after. Scholars have found five main sources of the Turkey's inflation problem. These were the public sector, monetary aggregate, exchange rate, inflation inertia, and external factors (Pongsaparn, 2002, p.7). More specifically, in the Turkish economy, dependence on imported raw materials, high budget deficits, increasing money supply, and fluctuating exchange rates were seen as the most vital causes of inflation. Tutar & Tansel's work suggested a strong positive relationship between the coalition governments and budget deficits as well as a link between the latter and inflation.

#### **4. THE WEAKNESSES IN THE PUBLIC ADMINISTRATION, BUREAUCRACY, AND INSTITUTIONS**

It was mainly due to the powerful Ottoman legacy that Turkey has adopted a highly centralized public administration that has persisted in the economy. The existence of too many ministries in the executive body has added complexity to liberalization and resolution of its side effects. Elected politicians have been in conflict with the bureaucracy ever since the beginning of the multi-party era. Politicians and bureaucrats have always held contrasting economic opinions. However, in general the elected officials and the bureaucratic establishment have

equally contributed to slowing down the economic reform. Finally, until recently the necessary regulatory economic institutions and the legal framework have been deficient or totally absent.

Tutar & Tansel suggested that the unification of the Treasury and the Ministry of Finance would lessen the negative effects of the dispersion of political power; in addition, all off-budget expenditures should be abolished (2001, p.22).

#### **5. Budget Deficits, Public Debt, Fiscal Discipline and Privatization**

During the liberalization period of 1980 and after, the escalating foreign debts have been another outstanding factor in the evolution of the Turkish economy. As of 2004, Turkish debt stock reached 136.1 billion USD; this meant that Turkey placed 7<sup>th</sup> among 130 developing nations in the world in regard to debt stock according to the Global Development Finance Report by the World Bank.

Servicing the foreign debt, i.e., sum of the interest and principal payments, had increased threefold from 1989 to 2001. The total payments amounted to 7.2 billions USD in 1989; however, they increased up to 21 billions USD in 2001. The former figure was 5 percent of that year's GNP; on the other hand, the latter was slightly more than 10 percent of respective year's GNP. Another striking data suggests that public investment dropped from 9.5 percent of GDP in 1980-83 to 5.3 percent of GDP in 1993-97; on the other hand, gross tax revenue has increased from 16.6 percent of GDP in 1980-83 to 19.5 percent of GDP in 1993-97 (Aybar & Lapavitsas, 2001, p.301). These figures and Turkey's increasing foreign debt reflect the state's inability to finance itself and Turkey's continuing problem of roll-over debts and interests.

The data indicates that Turkey's foreign debt has increased to such an extent that the deficits in the current account do not account this magnitude alone (Esen, 2000, Yeldan, 2001). For example, in 1984 the total foreign debt stock was around USD 20.6 billion; on the other hand, it jumped to USD 115 billion in 2001 which means a net increase of USD 94.4 billion. In the same period, the cumulative current account deficit totaled USD 22 billion; the amount of reserve increase in the CBRT balance sheet plus the net error and omissions in the official "balance of payments" account totaled USD 13 billion. In other words, a net difference of USD 59.4 billion occurred in different accounts. With regard to this large difference between the two official statistical data, Esen (2000) argues that, among many official data, stock variables are more reliable since the data for stock variables are subject to auditing and disclosure requirements. Finally, it can be concluded that researchers should take into account the odds of misleading data and the importance of being selective to ascertain qualified data.

Prior to the 1994 economic crisis, the fundamental indicators, e.g. current account deficit, were alarming. This crisis was a very appropriate example illustrating the first generation crisis model advanced by Krugman (1979). Before the crisis, it had been routine for the government to finance the budget deficits through the central bank's sources when the CBRT was not yet independent.



Consequently, the CBRT, aimed to control the exchange rate in order reach its primary goal of reduction of the inflation. It was dependent on its foreign currency reserves to reach this goal, although this was not the best means for the purpose. In late 1993 and early 1994, the government attempted to fix the interest rates in order to reduce borrowing costs; the result was catastrophic because foreign investors and banks attacked the foreign currency. During the crisis, large amount of foreign currency left Turkey resulting in a significant and sporadic devaluation of the domestic currency. From the end of 1993 to the end of 1994, the domestic currency depreciated by 168 percent vis-à-vis foreign currencies. On the upside, the current account surplus reached USD 2.6 billion in 1994.

The story of 1994 economic crisis serves as an important case study to describe and summarize the Turkish economy's structural deficiencies, and the cultural and socio-political environment within which the economy was functioning. It was not surprising to observe that, immediately following the crisis, the incumbent governments were behaving as though nothing had happened. Neither the majority party nor the opposition seemed to learn any lessons from the crisis in order to take adequate long-term measures to reduce the likelihood of another crisis in the future. It was apparently understandable to even an average person that the public deficit was the number one problem of the liberalization process in Turkey and that budget discipline was the best method by which to solve problem. Large public deficits and other structural reforms have long remained on hold until the next government came into office. The aftermath of the 1994 crisis again displayed overvalued foreign exchange on the 10-15 percent band until the 2000-2001 twin crises came. On the other hand, the current account deficits sustained around USD 1-2 billion each year. In 2000, the current account deficit reached USD 9.8 billion, an unprecedented amount. It was apparent that the Turkish economy was headed for a severe crisis in the near future. The so-called twin crises struck the Turkish economy in November 2000 and February 2001 respectively.

The first step toward the liberalization of the capital account was shifting from the fixed exchange rate regime to the crawling peg exchange regime in the early 1980s. The exchange rate was being set according to inflation differentials between Turkey and its main trading partners. In the second step, limited reforms were introduced during 1984-1986 that anticipated the engagement of banks and foreign trade companies in foreign credit contracts. In addition to this, banks were allowed to accept foreign currency denominated deposits. After this reform movement in the exchange regime, a significant amount of currency substitution took place. Finally, in 1989, full convertibility of TRL was achieved and all restriction on capital movements and borrowing by residents from international markets were lifted.

During 1980-2002 periods, the annual Foreign Direct Investment (FDI) figures were revolved around USD 1 billion, which was a satisfactory level for Turkey. Other world cases have shown that FDI boomed in other newly

industrialized [liberalized] countries such as China and Mexico. Other kinds of capital account tools, the portfolio investment and the net credit, were also below Turkey's expected level as well as their volatility (Celasun et al, 1999). This lack of foreign capital has been strongly related to the instability of Turkish democracy and its deficient political and economic structure.

### 5. CONCLUSION

The Turkish Republic was built upon the remnants of the Ottoman State. The founding father of the republic, Mustafa Kemal Atatürk, an ex-Ottoman army officer, dreamed of a fully westernized, industrialized, and modernized state. This dream necessitated the building of new state institutions, a new social order, a new culture, and ultimately a new identity for the Turkish nation.

In the economic sphere, during the single-party and multi-party periods Turkey's political and economic strategies revolved around the major world developments and, to a relatively lesser degree, domestic dynamics.

September 12, 1980 marked a crucial turning point in the history of Turkey and its political economy. Backed by the military junta, the Turkish functionaries, particularly Turgut Ozal, prepared the first consequential program of economic liberalization.

International institutions have been very influential in the promotion of Turkey's modernization process. Turkey's progress toward EU membership, the relationship between the IMF and World Bank, and the western worlds' view of Turkey have had a serious impact on the formation of domestic policy, particularly in the economic domain.

Due to several factors, the liberal efforts in the Turkish economy experienced sporadic setbacks in 1982, 1988, 1994, 1997, 1998, 2000, and 2001. Public deficits, inflation, a weak financial system, populist policies, and increasing public debt are among the central themes used in explaining economic trends and causal relationships in the economy.

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