

# PERIPHERAL DEVELOPMENT UNDER FINANCIAL LIBERALIZATION: THE TURKISH EXPERIENCE

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## *I. Introduction*

Integration of the developing national economies into the evolving world financial system has been achieved by a series of policies aimed at liberalizing their financial sectors. The motive behind liberalization was to restore growth and stability by raising saving and improving economic efficiency. A major consequence, however, has been the exposure of these economies to short term capital movements (hot money) which have increased financial instability and have resulted in a series of financial crises in the developing countries.

Against this background, the UNCTAD (1997) Report presents the following stylized facts of development and income (in)-equality over the post-1970 evolution of the global world economy (p.65):

- (1) taken as a whole, the world economy is growing too slowly to alleviate poverty;
- (2) finance has been gaining over industry, and rentiers over investors. Similarly, capital has gained in comparison to labor, and share of profits has risen within the functional distribution of income;
- (3) the middle class has been under significant pressure as labor markets have become marginalized and the existing wage inequalities between skilled and un-skilled labor have intensified.

While the factors behind these trends constitute a topic of active debate,<sup>1</sup> conceptually they are acknowledged to be part of a broader set of developments in the world economy, loosely referred to as the process of *globalization*. This process, even though known to be an integral part of the world capitalism since its very conception, has accelerated during the 1970s with advent of the technological innovations in electronics and telecommunications industries. From the point of view of pure economic relations, we observe the process of globalization to entail two related phenomena: (i) liberalization of the commodity and financial markets at the national scale (the so-called structural adjustment); and (ii) elimination of all the administrative and regulatory statutes hindering the free movement of international capital flows. The terms, “globalization” and “-regulation” do, in fact, reflect the ideological underpinnings of these overall processes.

It is the purpose of this paper to identify and study the main stylized facts and

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<sup>1</sup> See for e.g., the recent contributions by Milanovic (1999), Barro (1999), Rodrik (1997, 1998), Adelman and Yeldan (2000), and Stiglitz and Bhattacharya (2000).

processes characterizing the dynamic macroeconomic adjustments of Turkey since inception of its reforms towards global integration –viz. post-1980's. Turkey's post-1980 history of macroeconomic and political developments under the neo-liberal model is observed to suffer persistent difficulties and wide fluctuations in national income, with conflicting policy adjustments. This observation pertains despite the overall thematic continuity with the ambitious programme of economic liberalization and market-led adjustments put into full force during the early 1980s led by the military government and its civilian successors. At the turn of the 3<sup>rd</sup> millenium, the most striking aspects of the current Turkish political economy context are the persistence of price inflation under conditions of a crisis-prone economic structure; persistent and rapidly expanding fiscal deficits; marginalization of the labor force along with the dramatic deterioration of the economic conditions of the poor; and the severe erosion of moral values with increased public corruption.<sup>2</sup>

## ***II. Financial Liberalization in Turkey***

Turkish attempts towards liberalizing its financial system began along with the structural adjustment reform program initiated in 1980. Prior to that time, the system revealed all attributes of "financial repression" with negative real interest rates, high tax burden on financial earnings, and high liquidity and reserve requirement ratios. Given the underdeveloped and fragmented nature of the capital and stock exchange markets, corporations had to over rely on banking credits rather than issuing stocks in order to finance their working capital balances (OECD, 1988). The fiscal deficits were mostly financed by direct monetization through the Central Bank.

A structural adjustment programme was introduced in January, 1980 under the auspices of the international centers such as the World Bank and the IMF. The period 1981-87 was marked with commodity trade liberalization and export promotion along with a price reform aimed at reducing the state's role in the economic affairs.<sup>3</sup> During the decade, export revenues increased at an annual rate of 15%, and gross domestic product rose at annual rate of 4.2% in 1981-82, and 6.5% between 1983-87. The period was also characterized by severe erosion of wage incomes via hostile measures against organized labor. The suppression of wages was instrumental both in lowering production costs and in squeezing of the domestic absorption capacity. Through this manner, an exportable support could have been generated which found its way to the newly growing Middle

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2 See Yeldan (1995) and (1998) for a discussion on the characteristics of the post-1989 Turkish macro adjustments in terms of creation and absorption of the economic surplus, and provide a quantitative analysis on the strategic role played by the state apparatus. Cizre-Sakallioğlu and Yeldan (2000), Boratav, Türel and Yeldan (1996), Ekinçi (1998), Balkan and Yeldan (1998), and Boratav, Yeldan, and Kose (2000) provide similar analyses based on the effects of international speculative financial capital flows on the Turkish economy.

3 See Boratav and Türel (1993), Çenses (1994), Celasun and Rodrik (1989), Uygur (1993), and Celasun (1994) for a thorough overview of the post-1980 Turkish structural adjustment reforms. For a quantitative assessment of the export subsidization programme, see Milanovic (1986) and Togan (1993).

Eastern markets with heavy use of export subsidies. In retrospect, it can be stated that the mode and the pace of financial reforms have progressed in leaps and bounds, mostly following pragmatic, on-site solutions to the emerging problems. The foreign exchange regime was liberalized early in 1984. Banks were allowed to accept foreign currency deposits from citizens and to engage in foreign transactions. In the credit market, the Central Bank's control over commercial banks was simplified with a revision of the liquidity and reserve requirement system. An interbank money market for short term borrowing facilities was enacted in 1986. In 1987, the Central Bank diversified its monetary instruments by starting open market operations. In order to regulate and supervise the capital market, a *Capital Market Board* was established, and it initiated the re-opening of the Istanbul Stock Exchange in 1986.

With full liberalization of the capital account and the recognition of full convertibility of the *Lira* in 1989, however, there has been a massive inflow of short term capital into the domestic economy. Even though there was no officially stated exchange rate management policy during this period, the government seemed to use the exchange rate as the nominal anchor in trying to control the inflationary expectations. However, as also witnessed under the Southern Cone experience, such use of the exchange rate to attain the inflationary targets led to significant fluctuations in the real economy and was severely deflationary ( see, Dornbush, 1982, Diaz-Alejandro, 1985, and Fanelli and Frenkel, 1993).

The adjustment experience of the real sector to financial liberalization had been one of boom-and-bust cycles. As documented in Table 1, the post-1988 performance of gross domestic product revealed intensified short-term business cycles with rates of annual growth ranging between %8 (1993) and %-5.5 (1994). Following the production cycle, both consumption and investment demand fluctuated sharply over the same period. Similarly the external economy was in turbulence with the balance on current account suffering from severe fluctuations between \$-6.4 billions in 1993 and \$2.6 billions in 1994, and again \$-2.3 billions in 1995. Domestic rate of inflation reached the plateau of %70-80 per annum and displayed strong resistance at this threshold.

<Insert Table 1 here>

Given the Turkish experience, one can easily trace out the drastic impacts of unregulated financial opening on the domestic financial markets and the ongoing trend towards financial deepening. Contrary to expectations, however, public sector's share in financial markets remained high. The financing behavior of corporations did not show significant change, and credit financing from the banking sector and inter-firm borrowing continued. Furthermore the share of private sector securities in total financial assets fell. Thus, the observed upward trend of the proportion of direct securities to GNP originated from the direct new issues of public sector securities and Treasury bills. Since the commercial banking system has been the major customer of such securities, however, the share of aggregate security instruments fell in private portfolios. In fact, with the implementation of positive interest rates, and the new possibility of foreign exchange accounts, the

-1990 Turkish experience shows the serious problems confronting a developing economy which decides to move into full external and internal deregulation in the financial system under conditions of high inflation. The specter of capital flight becomes the dominant motive in policy-making and creates commitment to high interest rates and expectations for cheap foreign exchange. The links of these two policy variables with the real sphere of the economy, *i.e.* investment on physical capital and the current account balance of payments, are deeply severed. Instability in the rates of foreign exchange and

interest rates creates feedbacks which lead the economy into further instability.”

This prolonged instability reached its climax during the fourth quarter of 1993, when the currency appreciation and the consequent current account deficits rose to unprecedented levels. With the sudden drainage of short-term funds in the beginning of January 1994, production capacity contracted, followed by continued fall in industrial output throughout that year. Together with this contraction, the post-1994 crisis management gave rise to significant shifts in income distribution, and to an intensification of the ongoing processes of transfer of the economic surplus from the wage-labor in particular, and the industrial/real sectors in general, towards the financial sectors. Likewise dollar-denominated wage costs decreased substantially and enabled export earnings to rise. In Table 3, we document the extent of the deterioration of wage incomes by using private manufacturing industry quarterly data. Real wages are observed to fall rapidly by 25% in 1994. The contraction of wages were concomitant with the rise in exports. In this manner, Turkey has, once again, switched back to a mode of surplus extraction whereby export performance of industrial sectors depended on savings on wage costs. In fact, the disequilibrium could have only been accommodated by the massive (downward) flexibility displayed by real remunerations of wage-labor (Yeldan ,1998; Kose and Yeldan, 1998).

<Insert table 3 here>

### **III. The Analytics of Adjustment**

No doubt, the macroeconomic environment of the period was based on a series of unsustainable adjustments which necessitated abrupt shifts of equilibria in both the commodity and the labor markets. Notably, a key feature of the post-1989 dynamics of the Turkish economy is that the level of economic activity is no longer constrained by its external gap. Since foreign capital inflows can in principle be channeled to the domestic markets as long as a sufficiently high risk premium is attached, they can be used in the alleviation of the supply side constraints.

The analytics of this adjustment is narrated in Figure 1 where we portray an analytical three quadrant graph of the foreign account, production, and labor markets. Labor market duality is depicted in the south-east quadrant by introducing marginalized labor as an indispensable complementary component. In the north-west quadrant we have two processes between output (accumulation) and the current account balance. The dependence of growth and accumulation on imports give rise to the standard upward sloping schedule DD. The post-liberalization vicious circle narrated in Boratav, Turel and Yeldan (1995, above) generates an equilibrium with increased current account deficits and high real interest rates with a consequent negative effect on accumulation. The end result is negative relationship between accumulation and the current account deficit along the rr-schedule: higher CA deficits necessitate higher real rates of interest to attract foreign capital, which results in contraction of investments. The equilibrium is given by the intersection of all these processes summarized by the DD and rr schedules.

<Figure 1 here>

The deregulation of the capital account leads to an appreciation of the real exchange rate, and leads to a structural increase of the real interest rate. We follow the post capital account liberalization (1989-93) by shifting the  $rr$ -schedule out. Stimulated by inflows of short term capital, the domestic economy experiences an expansionary swing together with a rise of the current account deficit. The delicate balance upon which this fragile growth path rests is broken by the built up of confidence crisis and the sudden reversal of the “hot money” flows beginning the end-of-1993. We portray the 1994 crisis as an abrupt shift of the capital account-schedule back to  $r''r''$ . Furthermore, the aggregate demand schedule shifts downward indicating the decline of the absorption capacity of the domestic economy.

The 1994 crisis is a constrained equilibrium with lower investment demand, higher real interest rates, and a severe contraction of the production capacity. In the labor market, the post-liberalization response of private capital is revealed through shedding formal labor and increased marginalization. As also conceptualized in Amadeo (1996) at a greater extent, this has the effect of tilting the formal labor employment schedule inwards to  $L^F$ . Increased marginalization of the labor market, higher real rates of interest, and increased volatility of accumulation patterns become characteristics of the domestic economy under financial deregulation.

#### ***IV. Deterioration of the Fiscal Balances of the State***

The post-1980 period witnessed rapid deterioration of the fiscal position of the state. As Table 4 documents, the major breakdown has occurred in the flow of factor revenues generated by the state economic enterprise system, and in the rapid rise of the transfer expenditures. Factor revenues declined by 4.6 trillions TL in *real 1987 values* in a period of 4 years from 1988 to 1992. Even though there had been modest improvements in tax revenues, the surge in transfer expenditures overran such gains. Likewise, the capacity of the public sector to generate savings eroded severely and turned negative after 1992. The aggregate disposable income of the public sector fell by 30% in real terms between 1988-95, and the saving-investment gap widened by nearly fourfold.

<Table 4 here>

A significant constraint on the state's capability in financing its gap was its limited options in borrowings from abroad. Given the fragile asset position of the public sector, government net foreign borrowing was minimal, and at most instances was negative. With the advent of full-fledged financial liberalization after 1989, however, the governments had the opportunity of by passing much of the liquidity constraints on its operations. The financing of the PSBR relied exclusively on issues of government debt instruments (GDIs) to the internal market –especially to the banking sector.

The stock of securitized domestic debt grew rapidly over the 1990s. The stock of GDIs, was only 6% of the GNP in 1989, the year when the capital account liberalization was completed. By the end of 1996 this ratio reached to 22%. Interest costs on domestic debt grew to 10.6% of the GNP in the same year, increasing almost 10-folds in real terms over the decade (Table 4). As a further comparison, interest costs on servicing the debt reached to 1,010% of public investments, and to 481% of the transfers accruing to social security institutions in 1998. In this regard, the central budget in Turkey is observed to lose its instrumental role of social infrastructure development and long term growth, but rather became a tool of finance capital.

Thus, an important mode of finance for the state's fiscal operations has been the opening up the domestic financial sector to speculative short-term foreign capital flows. We investigate the consequences of this maneuver in the next section.

### ***V. Short Term Capital Flows and Their Effects on the Domestic Economy***

Turkey has completed the liberalization of its capital account in 1989 by de-regulating all its capital movements in its balance of payments transactions. Since then, such flows have effectively displayed very high sensitivity to the net differential between the domestic and foreign interest rate, and the rate of currency depreciation. In this situation, the Central Bank has lost its overall control over these two instruments; they practically turned into exogenous variables controlled by the external financial markets. As discussed above, liberalization of the capital account necessitated a higher rate of return on domestic assets as compared to foreign currency (as given by the rate of nominal depreciation). As this commitment stimulates more direct portfolio investments, domestic currency appreciates, inviting an even higher level of hot money inflows to the domestic economy.

The elements of this process are displayed in Table 5. We report the net return on "hot money" in column 1. This return is calculated as the rate of difference between the highest (nominal) interest offered in the domestic economy and the rate of (nominal) depreciation of the TL. It yields the net return to a foreign portfolio investment, which switches into TL, captures the interest income offered in the domestic economy and switches back to the foreign currency at the end-of-period exchange rate. The difference between interest earned and the loss due to currency depreciation is the net earnings appropriated by the investor.

<Table 5 here>

The inflows show high sensitivity to whether or not the domestic rate of return is positive. Except for 1990 values, the net flows are observed to be of the expected sign. Net flows fluctuated widely, especially between 1993 and 1995, and caused drastic business cycles with 1994 being the worst economic crisis of the post-War Republic

history.

It has to be noted, however, that one has to be aware of the *gross* magnitudes of such flows rather than *net* amounts. For that is where the de-stabilizing consequences of speculative short term capital movements prevail. In columns 2 and 3 of Table 5 we report the gross in- and outflows of hot money to the domestic financial markets for the post-1991 period. For our purposes, we distinguish “hot money” as the FX credits brought by the banking system; and the net errors and emissions form the balance of payments statistics (mostly to account for the so-called “unrecorded” transactions).

We witness that the gross inflows grew rapidly from \$50 billion in 1991 to reach \$120 billions in 1995. After a brief deceleration during 1996 and 1998, they again reached to 108.6 billions in 1999. This magnitude is almost 2/3 of the size of the overall Turkish GNP! Clearly, the domestic financial system is under a severe pressure of the international speculative centers and is no longer in a position to generate an independent monetary and foreign exchange policy. Furthermore, those centers constituted the major reason for the short-termism and volatility of the real business cycles, led to increased fragility of the financial and the external position of the domestic economy, and resulted in worsening the distribution of income. (Balkan and Yeldan, 1998; Yentürk, 1999). We now study these issues in more detail.

#### *V-1. Short Term Capital Flows Restricts the Independence of the Central Bank*

With the opening up of the domestic economy to the speculative foreign transactions, the monetary authority is bound to a passive role. Two of the most important tools of the Central Bank, the rates of interest and of foreign exchange, fall under the exclusive directives of the external centers, and consequently, the domestic economy is trapped into the vicious cycle of high real interest rates together with an overvalued domestic currency. In order to accommodate to this process, the central bank is pushed into a passive role of foreign reserve administration and is forced to hold significant foreign exchange. Indeed, one of the most direct consequences of the hot money inflows was the massive build up of international reserves of the Central Bank. This build up is clearly visible from data displayed in Table 5. Thus, rather than financing productive investments in the real sector, short-term capital inflows lead to a rapid build up of the reserves of the monetary authority. This reflects a serious contrast to the orthodox expectations, prognosticating a complementarity between financial liberalization and the expansion of investment funds in the domestic economy. In this setting, the only proper role that is remained for the monetary authority becomes that of monetary sterilization so that the surge in the M2Y value of money supply is checked by restricting the *domestic* component, with a consequent rise in the domestic interest rates, and a re-commencement of the cycle.

#### *V-2. Short Term Capital Flows Disassociate the Financial and the Real Sectors and*

### *Create Bubbles in the Stock Exchange Market*

Another direct consequence of the speculative hot money flows pertains to the links between the real and the financial spheres of the domestic economy. Speculative flows, given their sheer size and volatility, lead to artificial bubbles in the stock markets with no real foundation and end up inflating the stock prices. In theory, stock prices have to depend on the productive performance of the corporations. In principle a well-functioning stock market should help the economic development process through (a) growth of savings, (b) efficient allocation of investment resources, and a better utilization of existing resources, through the pricing process (Singh, 1992). Nevertheless, with the in-and-outflows of speculative capital that are almost the size of the national product, all financial returns are inflated and an artificial burst on nominal values is created. The evolution of the bubble is clearly visible starting from 1993, where the ISE Index accelerates along with the intensification of hot money flows. Such bubble-burst-bubble performance of the stock market is clearly disassociated from the real production capacity of the economy. Rather than enhancing the aggregate credit volume, it reveals itself as the major cause of the economic crisis.

### *V-3. Short Term Capital Flows Increase External Fragility and Lowers Creditworthiness*

Another consequence of hot money flows concerns the creditworthiness of the recipient country. Despite the fact that the composition of external borrowing has changed dramatically relative to the period of debt crisis, by looking at several creditworthiness indicators we can conclude that there has been a continuous lowering of the creditworthiness of Turkey by the foreign investors. This is associated with the unstable economic environment caused by continuous speculative capital flows. Creditworthiness is mainly associated with balance of payments problems, the likelihood of devaluation, economic and political stability. All of these indicators have been extremely volatile in the 1990s.

In the words of the UNCTAD's 1998 *Trade and Development Report*, "the ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. (...) In particular, financial deregulation and capital account liberalization appear to be the best predictor of crises in developing countries" (pp. v and 55). Almost all recent episodes of financial-cum-currency instability disclose that the observed sharp swings in capital flows are mostly a reflection of large divergences in domestic financial conditions relative to those of the rest of the world. Reversals of capital flows are often associated with deterioration of the macroeconomic fundamentals in the recipient country. However, "such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies". (*ibid*, p. 56).

Looking at total debt outstanding as a percentage of export earnings, it is clear that this

indicator has been extremely high for Turkey during the period 1988-1995. Just to make a comparison, at the height of the debt crisis, in 1982, Mexico's debt outstanding/exports was around %236. During the same period Turkey's outstanding debt/exports was around %200. In 1993 this ratio for Turkey was %431. The volatility in the current account balance is another indicator of creditworthiness and fragility. By looking at Table 1 the current account balance for 1993 was \$-6,433 million, for 1994 \$2,631 million and for 1995 it stood at \$-2,339. Another interesting indicator is the ratio of short-term debt to total debt. In 1993 short-term debt was around %28 of total debt. In the following year it fell to %17 and then increased again to %27 in 1995. These fluctuations were exclusively the result of short-term capital flows, which led to intensify financial instability in the domestic economy.

Turkish fragility indicators are further displayed in Table 6

<Table 6 here>

## ***VI. Conclusions***

The integration of the Turkish economy into the global financial system through financial liberalization and privatization has been a mixed blessing. Even though the main motive behind financial liberalization was to restore growth and maintain stability through increased efficiency and savings, it created financial instability. The inflows of short term capital were not used to create new and productive investments, but instead simply created new dollar obligations for which there is no clear source of repayment. It has also intensified the already existing problems such as budget deficits, monetary instability and market distortions.

The post-1989 experience shows the serious problems confronting a developing economy that moves into full external and internal deregulation of its financial system under conditions of high inflation. The spectre of capital flight became the dominant motive in policymaking and created unsustainable commitment to high real interest rates and expectations for cheap foreign exchange. Meanwhile the links between the financial sector and the real sector have been severed. Instability in the rates of interest and foreign exchange created feedbacks which led the economy further into instability.

During the same period, fiscal position of the state rapidly deteriorated as factor revenues declined. Likewise, the capacity of the public sector to generate savings eroded. The state has resorted to a massive operation of domestic debt financing by issuing new debt instruments. As a result, the stock of domestic debt has grown very rapidly. The interest payments on domestic debt also reached high levels during the same period and constituted an important mechanism of income transfer within the domestic economy.

The overall Turkish experience also showed the limits and the problems of financial liberalization by relying on the exchange rate as a nominal anchor and riding on short

term capital inflows to finance deficits. Such a stabilization program is often attractive for governments because it avoids politically unpopular, painful measures. Its changes of success are also high in the short run because financial markets tend to be short sighted. The issue is not whether capital flows are good or bad but rather the challenge they pose to the state's ability to make sound and credible macro and micro policy that would ensure such capital flows are directioned toward the promotion of long term growth, economic development and social equity.

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