

ABSTRACT

Stabilization programs are usually implemented in developing countries that face high inflation, high external debt, unsustainable public sector budget deficits and balance of payments problems. The fundamental objective of a stabilization program is to balance aggregate supply and demand in the economy. The scope and methods of stabilization programs have gradually evolved and changed over time. *Orthodox programs* are those that rely on tight fiscal and monetary policies to discipline the economy and to reduce inflation. *Heterodox programs* consist of temporary use of price and wage controls in order to bring inflation down. Stabilization programs that aim at stopping inflation by controlling any of prices (exchange rates, wages, money or prices) are also classified according to the chosen *nominal anchor*. The programs which use exchange rates are called “*exchange-rate based stabilization*” and the programs which control money supply are called “*money-based stabilization*”. In cases where one anchor itself may not be sufficient to control nominal variables at the same time, multiple nominal anchors are used during the stabilization process. Stabilization programs that use the exchange rates as the main nominal anchor are often associated with a business cycle that begins with a boom and ends with a recession. Stabilization programs that use money supply as the main nominal anchor results with an immediate recession after the program is implemented. This is called “*boom-now-versus-recession-later*” hypothesis.

Since the economic, political and cultural characteristics of countries which implement stabilization programs during their high inflation period are different, the results of programs vary among countries. Most Latin American countries have been using such programs since 1970s. Some of them became successful and achieved low inflation target. Chile, Mexico and Israel were high chronic inflation countries during the 1980s. Now, they have moderate (or low) inflation. Argentina, on the other hand, experienced hyper-inflation in the beginning of 1990s. After an ambitious stabilization effort in 1991, Argentina also reduced its inflation to very low levels. Thus, the stabilization experiences of such countries may be useful for Turkey.

In 1994, Turkish economy found itself in a very severe financial crisis. The underlying cause of the 1994 crisis was an unsustainable fiscal position. The lira rapidly depreciated, official international reserves sharply declined and the inflation rate jumped to three digit levels. Following this, the Turkish government announced a stabilization program and structural reform measures on the 5th of April 1994. The immediate target of the program was to restore stability in the foreign exchange market, reduce PSBR, reduce inflation and improve the external balance. The 1994 stabilization program produced some noteworthy results during the second and third quarter of 1994. But, it failed to sustain the fiscal discipline and reduce inflation. This is due in large part to the unsustainable fiscal and monetary discipline, the persistence of high inflationary expectations, and slow implementation of structural reforms.

The aim of this study is to analyze the 1994 crisis of Turkey and 5 April Stabilization Program in detail in the context of stabilization theory, with the help of stabilization experiences of some countries that implemented similar programs during their high-inflation episodes. Under the subject of nominal anchors, the possibility of inflation stabilization through the control of exchange rates, of money supply and of wages are examined *with a vector error correction (VEC) model*. The *impulse response* analysis indicates that attempts to establish nominal anchors are likely to fail as a medium term strategy for inflation stability, unless the underlying fundamentals have been sufficiently strengthened. Exchange rate anchors have played an important role in disinflation episodes of the Latin American countries, but they have only been successful in reducing inflation once structural measures have been taken. The *variance decomposition* analysis indicates that there is an inflationary inertia in Turkey. A high degree of inertia implies that the inflation has a life of its own and cannot be easily reduced by only controlling nominal anchors. A sustainable and substantial adjustment in the fundamentals -particularly the fiscal deficit and fundamental structural reforms of the public sector are essential for the success of any stabilization program. Beyond this, before a comprehensive stabilization program took place, a strong political environment and a consensus among members of society are necessary conditions for sustainable success.