

Currency and Financial Crises in Turkey 2000 –2001: Bad Fundamentals or Bad Luck?

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Abstract

This paper attempts to explore the underlying causes of twin crises experienced by Turkey in November 2000 and February 2001. We study an extensive set of leading indicators of crises that are drawn from the existing literature. Our results identify three sets of vulnerabilities in the Turkish economy in triggering the financial crisis and bringing about the collapse of the Turkish lira. These are: first, the weak external position caused by excessive debt burden combined with the loss of competitiveness; second, the weak fiscal position resulting from the record levels of interest payments on domestic borrowing; and most importantly, third, weaknesses in the financial and banking sector. Given these observations, we argue that the success of financial sector reform is instrumental not only for putting the economy on a sustainable recovery path but also for reducing the likelihood of similar crises in the future. The general lesson to be drawn from this experience is that a sound financial system is a pre-condition for the successful operation of a fixed exchange rate regime.

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