A downgrading of Turkey’s credit rating by both Standard & Poor’s and Moody’s Investors Services in 1994 triggered high volatility in Turkey’s currency market, which subsequently led to a considerable devaluation of the Turkish lira and a chaotic financing environment. Before this critical downgrading decision, the Turkish economy was in a state of disequilibrium, struggling with persistent imbalances in both goods and money markets. The budget and current account deficits were at unsustainable levels, and excessive reliance on debt financing to meet the record high public-sector borrowing requirement had resulted in high levels of capital infl ow, domestic debt stock, and interest rate payments. At the time, the government seemed reluctant to introduce a much-needed stabilization plan to correct the situation. Because of a highly turbulent political environment and the populist tendencies that the forthcoming March 1994 local elections had led to, it made more sense, at least from the politicians’ perspectives, to leave the stabilization issue to a more politically favorable date. So instead, in an effort to lower interest rates, the government tried to keep domestic borrowing at a minimum and turned to monetization, extending its short-term advance facility and borrowing heavily from the Central Bank. As markets were adapting to this deceivingly stable but in fact highly fragile and uncertain policy environment, the first warning came from the international rating agencies. On January 14, 1994, both Standard & Poor’s and Moody’s Investment Services downgraded Turkey’s credit rating from investment grade to speculative grade, and that alone prompted intense volatility in both the foreign-exchange and loanable-funds markets.¹

Subsequent to the downgrading decision, the Turkish lira depreciated sharply against major currencies: the U.S. dollar rose by 13 percent against the Turkish lira, and with no Central Bank intervention in sight, it peaked at 42 percent at one point and closed at 20 percent higher than

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¹ Standard & Poor’s reduced Turkey’s rating from BBB to BBB-, and Moody’s reduced it from BAA3 to BA1.
its pre-crisis levels. On January 20, the Central Bank finally intervened; it raised overnight interest rates, and the Turkish lira began to stabilize against the U.S. dollar at about 8 percent lower than its January 15 value. But despite the Central Bank intervention, both overnight rates and the value of the U.S. dollar continued to surge. On January 27, the Turkish lira was devalued by 13.5 percent (see figure 4.1).

After the devaluation of the lira, the Central Bank continued to monitor the money markets and the value of the Turkish lira by making frequent changes in overnight interest rates (see figure 4.2). During the following weeks, overnight interest rates fluctuated from about 95 percent to 700 percent, and the interest rate on commercial credit at one point rose to 500 percent. However, despite these highly reflexive daily interest rate adjustments, both interest rates and the value of the U.S. dollar against the Turkish lira continued to rise.

There were several other factors that may have raised the intensity of such volatility. These were: (1) heavy purchases of dollars by the state employees who were on a biweekly payroll, (2) short covering by the commercial banks anticipating devaluation, (3) movement of funds from the stock market to the currency market; and (4) the Central Bank’s shrinking reserves and indecisiveness regarding intervention.