Turkey experienced a severe banking crisis in 2001 that resulted in huge social and fiscal costs since most defaulting banks had already been compulsorily transferred to a publicly-held fund (the deposit insurance fund). Basing ourselves on estimations by Burnside et al. [2003, NBER Working Paper], we further investigate the links between these fiscal costs and the subsequent debt deflation that occurred in Turkey after the crisis. Our analysis also draws extensively on the Fiscal Theory of the Price Level (FTPL) and on the empirical methodology originally proposed by Canzoneri et al. [2001, American Economic Review]. Our main results are twofold. First, the fiscal costs attributable to the banking crisis can be given a FTPL interpretation and debt deflation appears as a deliberate policy. Second, the FTPL interpretation is not reliable over a time span excluding the most recent years, and the public management of the banking crisis can be considered as an “exceptional circumstance”. The policy implications are then that without a substantial improvement in the management of banks, a dramatic economic episode like the 2001 crisis could again occur and the Turkish disinflation efforts could be wasted and lost for a long period. Hence, converging towards the EU standards in terms of deregulation seems a reasonable condition for avoiding long years of high deficits and inflation.

JEL Classifications: F31, E62, E63