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### **III. Banking system restructuring in the context of macroeconomic stabilisation**

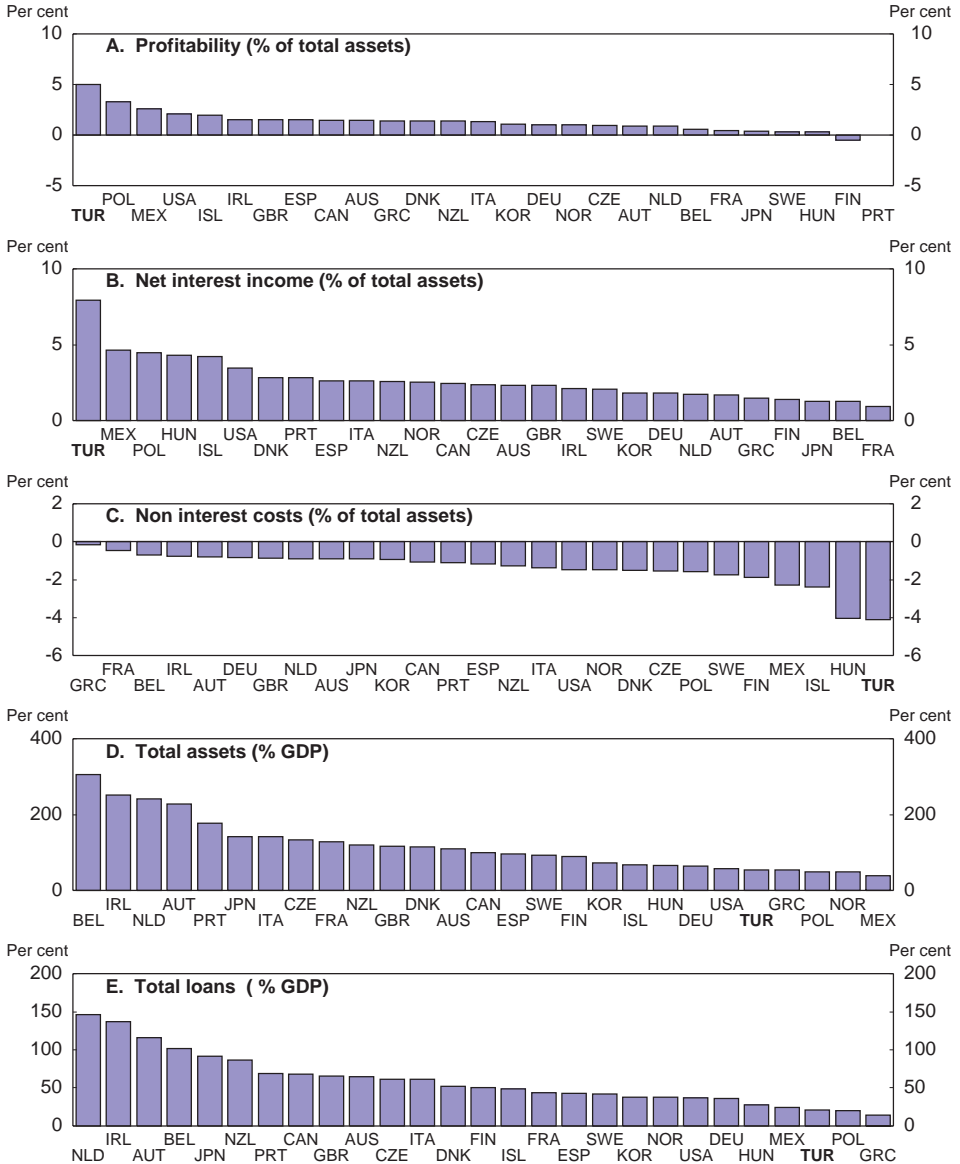
A weak banking system was a root cause of the crisis that ended the December 1999 stabilisation programme and led to a new series of IMF packages. The quasi-currency board rules supporting the exchange rate-based disinflation attempt exacerbated problems of currency and maturity mismatch in the banking system, leaving it highly vulnerable to the shifts in international investor sentiment that occurred after mid-2000. The success of the new programme and sustained recovery are unlikely without significant reform of the banking system, difficult though that may be in a crisis. Central Bank inflation targeting cannot work well if a risk-exposed, fragile banking system constrains interest rate policy adjustments in either direction. Conversely, a healthy banking system requires macro stability, as high inflation and a large public debt currently distort banking incentives. Achieving durably low inflation would moreover allow Turkish agents to issue more debt denominated in their own currency and at longer maturities, greatly enhancing stability of the financial system. Disinflation and banking reform thus go hand in hand, an important strength of the current programme.

The chapter examines the main policy issues involved in systemic bank restructuring and it is organised as follows. The first section gives an overview of structural distortions in the banking sector, and the second examines their roots in policy. The third section turns to the banking reform programme, assessing what has been accomplished so far but also what remains to be done. The last section looks at challenges for the medium term and summarises.

#### **Overview of structural problems in the Turkish banking system**

The Turkish banking system remains characterised by weak competition and limited development despite a high rate of domestic and foreign entry, reduced concentration, and diversification of banking activities resulting from the process of financial liberalisation (Annex IV). Thus, banking sector credits as a share of GDP, at around 20 per cent, have remained small by international comparison (Figure 5). This in turn could have been one of the factors holding back economic development, given considerable cross-country evidence that bank development

Figure 5. **Banking structural indicators: some international comparisons**  
Average of 1990's<sup>1</sup>



1. From 1994 for Poland, Hungary and Czech Republic and from 1995 for Ireland.  
Source: OECD, *Bank Profitability – Financial Statements of Banks*, 2001.

exerts a positive impact on economic growth.<sup>29</sup> Also striking is the low importance in practice of foreign banks despite their large number – fully one-quarter of the banks in Turkey are foreign owned, but their share in total banking sector assets is only 5 per cent (Table 15 and Figure 6). This compares with more than 50 per cent asset shares of foreign banks in the accession countries of Eastern Europe, and implies limited contestability of the financial market despite an absence of barriers to entry in Turkey.<sup>30</sup> Conversely, state banks occupy a prominent place in the system despite their declining share in total assets, and the largest deposit-taking bank is a public bank (Ziraat). As state banks have operated under a soft budget constraint, this also weakened sectoral competition and development.

Limited competition is furthermore suggested by high net interest margins alongside high operating costs (Figure 5). Turkish banks have been among the most profitable in the world despite low efficiency. Part of the profitability phenomenon derives from high inflation itself. Besides income from international arbitrage activities to capture the domestic inflation risk premium, banks earn float income and seigniorage revenues, and benefit from a high demand for bank services due to strong liquidity preference.<sup>31</sup> High intermediation spreads are likely to have reflected not only high inflation but also uncompetitive pricing in the context of tacit collusion by banks (see Annex IV). Low competitive pressure from foreign banks is also typically associated with high profitability for domestic banks. Inefficiencies are masked by such “easy” profits, and moreover reflect non-optimal banking size: banks tend to enter at sizes that are either small or large, but with insufficient dynamism there is a dearth of mid-sized banks to exploit scale economies.<sup>32</sup> In sum, excess profits have attracted a high number of entries into the sector, but there is little subsequent competition to drive them down to levels that would make more conventional banking activities or optimal banking size attractive or necessary.

As in many emerging markets, the financial system is bank-dominated, and with the banking system itself underdeveloped, opportunities for external enterprise finance are limited and the cost of capital high. Banks through their affiliates supply the bulk of capital market services, but with few other players and poorly developed instruments, capital markets (and investment portfolios) remain illiquid and undiversified. The stock of bank deposits exceeds that of total private securities by a factor of 10 (Table 16), and the use of non-bank savings vehicles lags far behind the rest of the OECD (Figure 7). Banks intermediate most of the securities issued by government, holding in their portfolio 70 per cent of the total stock outstanding, and are typically unwilling to lend to companies except at short term and against substantial collateral, or within industrial groups. Only the largest firms can borrow directly abroad, and many firms are reluctant to enter the stock market because of disclosure requirements. Crowding out pressures are exacerbated by the high ratio of the public debt to M2, a proxy for financial market depth (Table 17), and by the fact that only five major bank players dominate the market for government auctions.<sup>33</sup>

Table 15. **Banking system structural indicators**  
(end of period)

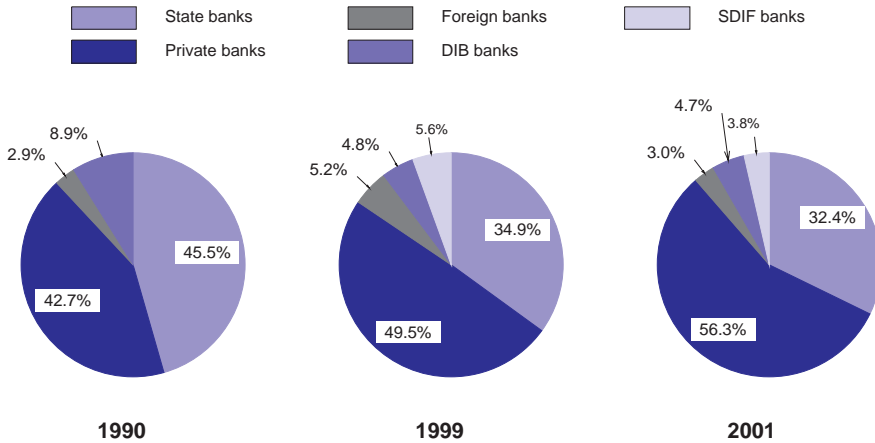
	Number of banks			Number of branches			Personnel employed			Employees per \$ million of bank assets			Bank assets in % GNP		
	1999	2000	2002 <sup>1</sup>	1999	2000	2002 <sup>1</sup>	1999	2000	2001	1999	2000	2001	1999	2000	2001
<b>Investment and development banks</b>															
State banks	3	3	3	10	10	4	4 336	4 456	4 322	0.94	0.87	1.00	3.18	2.74	3.49
Private banks	13	12	8	16	16	12	1 027	1 021	822	0.87	0.76	0.88	0.82	0.72	0.76
Foreign banks	3	3	3	3	3	3	67	79	77	0.12	0.19	0.64	0.40	0.23	0.10
<b>Deposit money banks</b>															
State banks	4	4	3	2 865	2 834	2 040	72 007	70 191	56 108	1.54	1.32	1.51	32.17	28.43	29.99
Private banks	31	28	20	3 960	3 783	3 520	76 386	70 954	64 380	1.16	0.96	0.99	50.70	39.36	52.19
Foreign banks	19	18	15	121	117	204	4 185	3 805	5 395	0.60	0.45	1.54	4.87	4.49	2.82
SDIF banks	8	11	3	714	1 073	244	15 980	19 895	6 391	2.13	1.51	1.53	..	7.06	3.36
<b>Total</b>	81	79	55	7 691	7 838	6 026	173 988	170 401	137 495	1.30	1.10	1.20	92.13	83.03	92.71

1. As of October.

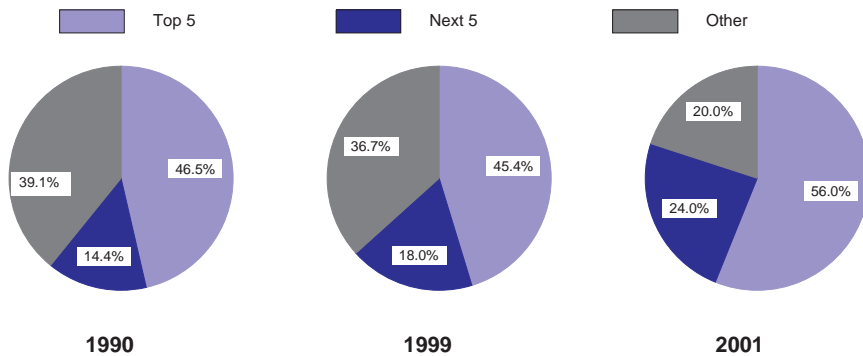
Source: The Banks' Association of Turkey.

Figure 6. **Banking system structure**  
Shares in total assets

**A. By ownership**



**B. By size**



*Note:* State owned, domestic private and foreign banks are commercial banks. DIB banks refer to development and investment banks including state owned, domestic private and foreign DIB banks. SDIF banks are the failed private banks under the administration of the Saving Deposit and Insurance Fund.

*Source:* The Banks Association of Turkey.

Table 16. **Stocks of financial assets**  
(As percentage of GNP)

	1993	1994	1998	2000	2001
<b>Currency</b>	3.2	3.1	2.3	3.0	3.0
<b>Deposits</b>	21.8	29.4	35.4	44.0	56.9
<b>Total securities</b>	19.1	18.7	25.6	34.8	74.4
Total private securities	5.6	3.4	3.5	5.5	5.9
Private debt instruments	2.0	0.6	0.0	0.0	0.0
Shares	3.6	2.8	3.5	5.5	5.9
Total public securities	13.5	15.4	22.0	29.3	68.5
Government bonds	9.5	6.0	10.8	27.4	56.9
Treasury bills	3.2	7.8	10.9	1.6	11.2
Other <sup>1</sup>	0.8	1.6	0.3	0.3	0.4
<b>Total</b>	44.1	51.2	63.3	81.7	134.2

1. Includes revenue sharing certificates, privatisation bonds, FX linked bonds.

Source: Capital Markets Board and Central Bank of Turkey.

There is consequently a high dependence on capital inflows for bank liquidity, government funding capacity, and economic growth, and given their predominantly short-term nature, such flows dry up or even reverse in a crisis situation, *e.g.* when the credibility of the overall policy stance is in question. Major banking-currency crises occurred in 1994 and 2000-2001, each episode being followed by widespread bank losses and real sector value destruction. Turkey was, in fact, a prime candidate for financial crisis on several grounds. First, much as in the case of the 1997 crisis-hit countries of east Asia, it followed the wrong sequencing of reforms. Financial liberalisation took place against the background of weak institutional arrangements for bank oversight and governance, hence the flow of resources into the banking system released by liberalisation outstripped banks' capacities to manage market risks properly and to process information about credit quality (Figure 8).<sup>34</sup> Second, the authorities were unable to eliminate high inflation despite a series of IMF programmes, and in this Turkey resembles some Latin American debtor countries in the past that were hit by crises. Given the history of high inflation, debt contracts in Turkey were heavily denominated in foreign currency and overwhelmingly of short duration, making balance sheets highly exposed to risks of currency depreciation and interest rate increases, and prone to self-fulfilling runs. It is suggestive that the ratio of short-term foreign debt to Central Bank reserves, considered to be a key leading indicator of crisis when it rises above a threshold value of around 60 per cent,<sup>35</sup> has in Turkey's case been closer to 100 per cent since capital account liberalisation in 1989 (Table 17).

### Policy incentives and resource allocation

It emerges that banking incentives and resource allocation by the financial system have been profoundly distorted by a set of policy and institutional

Table 17. **Basic characteristics of the financial system**

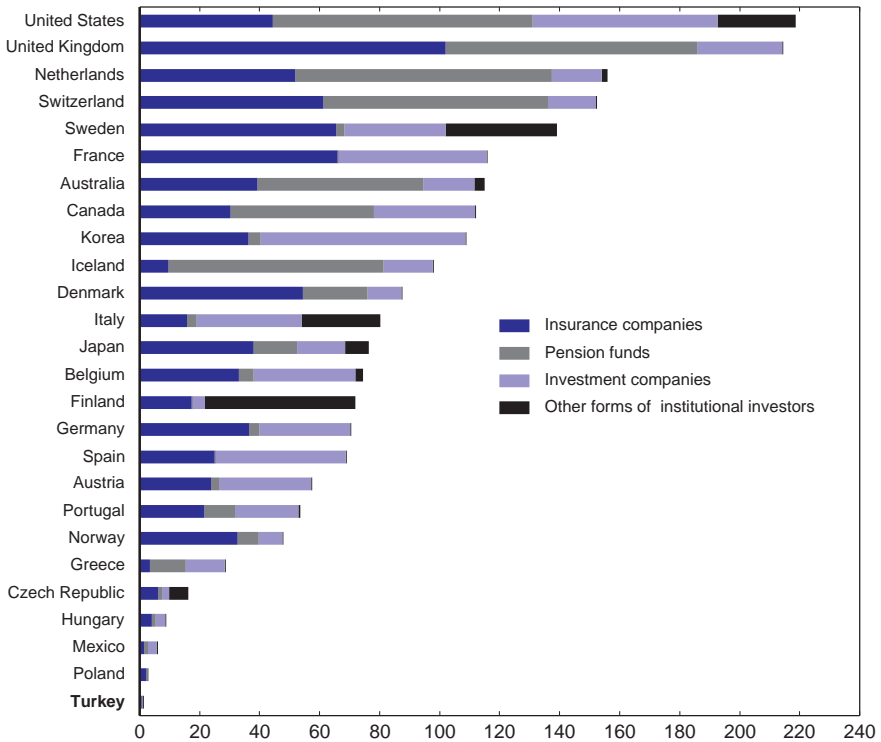
	Total assets of banking sector/GNP	Banking sector short-term foreign liabilities (US \$ million)		Net short-term capital flow (US \$ million)	Total foreign debt/GNP	Short-term debt/Central Bank reserves	Currency substitution <sup>1</sup>	Public domestic debt/M2
		Inflow	Outflow					
1995	52.2	76 427	75 626	3 635	42.6	126.7	51.7	107.1
1996	59.8	8 824	8 055	2 665	42.9	104.9	48.4	107.7
1997	65.9	19 110	18 386	-7	43.3	96.1	50.4	111.0
1998	68.8	19 288	19 225	1 313	46.8	105.3	44.6	101.7
1999	92.1	122 673	120 603	1 024	54.4	98.9	45.9	104.2
2000	83.0	209 432	204 691	4 200	58.9	127.6	45.3	117.1
2001	94.6	110 270	117 322	-11 321	78.3	86.5	56.7	260.0

1. Rate of dollarisation: Ratio of foreign exchange deposits to total deposits of residents.

Source: Central Bank of Turkey.



Figure 7. **Vehicles for savings**<sup>1</sup>  
Per cent of GDP



1. Financial assets of institutional investors in 1998; 1996 for Switzerland and Greece; 1997 for Belgium, the Czech Republic, Poland, Portugal, Sweden and Turkey.

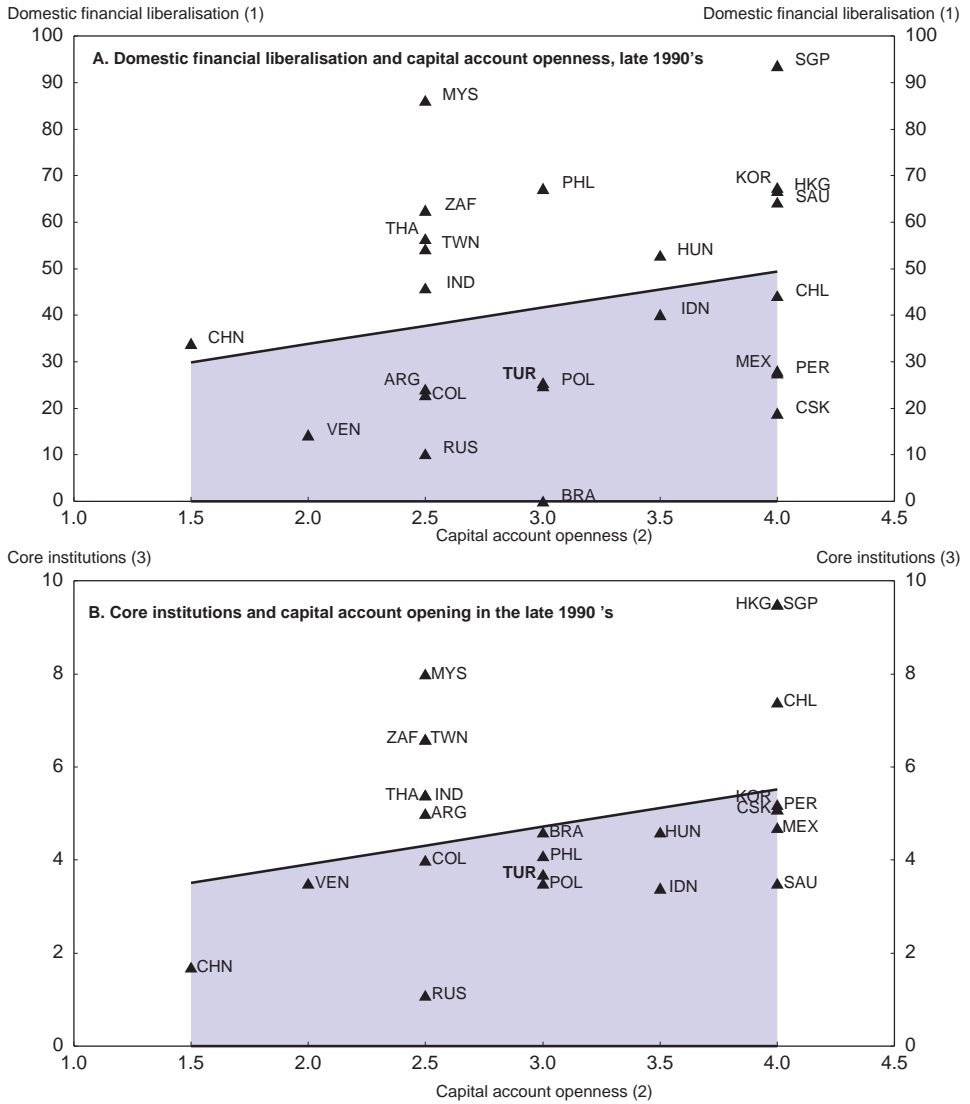
Source: OECD, *Institutional Investors, Statistical Yearbook*, 2000 Edition.

failures. These failures were exacerbated in the 1990s by “myopic policy bias” arising from weak and short-lived coalition governments. The present section explains the main policy distortions leading up to the recent crisis, laying the groundwork for the subsequent evaluation of the reform programme to correct such distortions and make the banking system more robust.

### ***Macroeconomic instability and balance sheet fragility***

Turkish banks have had to operate in possibly the most unstable macroeconomic environment facing an OECD country, and they adapted accordingly.

Figure 8. Institutional determinants of crisis



Note: Shaded areas represent crisis zones.

1. *DFL*: effective measure attempting to capture the degree of interest rate liberalisation, based on timing and sustainability of positive real interest rates (negative rates characterising suppressed financial systems).
2. *KAO*: rule-based indicator proxying the intensity of exchange restrictions on capital account transactions, with a higher number indicating fewer restrictions.
3. *Core institutions*: unweighted average of indicators of rule of law, creditor rights, shareholder rights, accountancy standards, quality of bank management, and quality of bank balance sheets.

Monetary policy was continually subordinated to the needs of public debt financing, resulting in high and volatile inflation and real interest rates along with steadily appreciating or stable real exchange rates in the past – albeit subject to periodic massive devaluations resulting in economic collapse (Box 5). High real interest rates coupled with relative predictability of the exchange rate in turn attracted capital inflows which helped to ease the financing constraint of fiscal policy, thus boosting growth *ceteris paribus*, and such inflows were largely intermediated by banks.

Private and foreign banks increasingly turned to uncovered arbitrage for their profits (Table 18), *i.e.*, raising cheaper foreign funds, converting them to TL, and investing in high-yielding government securities, which later would be converted back to FX to repay the liability. If the real exchange rate appreciated in the meantime, the bank gained even more. If there was a risk of devaluation, the likelihood that all banks would act in unison to shed assets, making their capital

#### Box 5. **Fiscal dominance**

Prior to the 1994 crisis, a combination of loose fiscal policy and relatively tight monetary policy resulted in high real interest rates which attracted capital inflows, decreased money demand, and appreciated the real exchange rate. The 1994 crisis was provoked by policy mistakes in trying to reduce high interest rates, and the exchange rate plunged by 100 per cent. After the crisis, the Central Bank turned to stabilisation of domestic liquidity conditions, in order to ensure smooth placement of the government debt, rather than to inflation reduction as its main objective, so that monetary policy became accommodating. A key element of this policy was a *de facto* real exchange rate targeting rule, whereby the Central Bank maintained a rate of nominal exchange rate decline in line with past inflation. This encouraged renewed capital inflow, thereby easing public debt funding while also allowing a build-up of Central Bank reserves. But the policy also validated high inflation, in turn boosting real interest rates *via* the channel of unsustainable debt dynamics. Inflation, real interest rates, and the PSBR all jumped in the second half of the 1990s. Only at end-1999 was a strategy of concerted fiscal and monetary stabilisation adopted, but the new commitment to a nominal exchange rate anchor only reinforced the perceived predictability of the exchange rate, which prompted large capital inflows and interest rate undershooting, while tying the Central Bank's hands in dealing with the consequent overheating. This led to renewed crisis and exchange rate collapse in 2001 (Annex VII). All in all, the Central Bank was in a no-win situation. If it did not sterilise the capital inflow, a build-up of net foreign assets increased money supply and inflation. To the extent that it did sterilise, it bid up interest rates and incurred quasi-fiscal costs which were as high as 30-60 per cent of reserve money, and also inflationary (see Altinkemer, 1998).

Table 18. **Commercial banks' income statement**  
(in per cent of total banking sector assets, end of period)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>Net interest income</b>	6.5	6.3	7.7	8.3	5.9	7.2	7.3	9.0	6.2	4.0	7.3
<b>Net non-interest income</b>	-3.9	-3.6	-4.3	-5.4	-2.4	-3.6	-3.7	-4.9	-3.8	-5.2	-6.3
Non-interest income	1.8	2.1	0.9	-0.5	1.9	1.3	0.1	0.0	1.4	1.2	-2.1
Non-interest expenses	5.8	5.7	5.1	5.0	4.4	4.9	3.8	4.9	5.2	6.4	4.1
Staff costs	2.9	2.9	2.5	2.2	2.0	1.9	1.9	2.1	2.0	2.0	1.5
Property costs	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.3
Taxes	0.5	0.5	0.5	0.6	0.3	0.3	0.3	0.3	0.3	0.8	0.5
Other <sup>1</sup>	2.1	2.1	1.8	1.9	1.7	2.4	1.4	2.1	2.6	3.2	1.9
<b>Net income</b>	2.5	2.7	3.4	2.8	3.5	3.6	3.6	4.1	2.4	-1.2	1.0
<b>Provisions on loans</b>	0.6	0.3	0.3	0.5	0.3	0.3	0.3	0.9	1.6	1.4	3.8
<b>Profits before tax</b>	2.0	2.4	3.1	2.3	3.2	3.3	3.3	3.1	0.8	-2.6	-2.8

1. Equal to other provisions plus other expenses.

Source: The Banks' Association of Turkey.

realisation value near worthless as they were the only actors in the market, implied the expectation of a bailout in the worst case. In any event, the Central Bank was trusted to provide stability in the real exchange rate, and even a steady appreciation under the 2000 disinflation attempt. Since the mid-1990s, there was an increasing portfolio concentration in securities, while almost three-quarters of private banks' liabilities came to be in FX terms (Table 19). A high proportion of assets was also in FX-denominated securities, limiting exchange risk, albeit with longer maturities. Off-balance sheet transactions provided further exchange rate cover, but their quality was dubious because of the lack of credible (non-bank) market counterparties, implying large *de facto* net open positions and exchange risk exposure on the eve of the crisis (Table 20).

High and volatile inflation encouraged large portfolio shifts by all economic actors towards greater liquidity, and growing use of foreign exchange as an inflation hedge (dollarisation). Hence, the maturity of banks' funding sources shortened considerably while the share that was denominated in foreign exchange increased sharply. Savers were induced to hold larger volumes of short term deposits, more than half of which were in foreign exchange, and to purchase overnight repos which were held off balance sheet by banks. A large volume of savings never made it into the banking system, despite high real deposit and repo rates, and was kept "under the mattress" in the form of FX holdings and gold, or invested in real estate.<sup>36</sup> The structure of lending by foreigners to domestic banks also shifted after the 1994 crisis: trade credits became much more important than purpose credits, and maturity declined sharply. On the banks' asset side, most TL lending was short-term finance for working capital and household consumption to

Table 19. Consolidated balance sheet of the banking system

	In per cent of GNP					In per cent of total				
	1991	1995	1999	2000	2001	1991	1995	1999	2000	2001
<b>Assets</b>	46.5	52.2	92.1	82.9	97.3	100.0	100.0	100.0	100.0	100.0
TL	..	..	57.1	53.6	50.5	71.3	56.6	61.9	64.7	51.9
FX	..	..	35.1	29.2	46.8	28.7	43.4	38.1	35.3	48.1
Due from banks	5.4	7.7	9.8	10.7	9.9	11.7	14.7	10.6	12.9	10.1
Reserve requirements	2.6	3.2	3.9	3.1	4.5	5.6	6.1	4.3	3.8	4.7
Securities portfolio	5.5	5.5	15.8	9.5	9.9	11.8	10.6	17.2	11.5	10.2
Loans	20.4	22.2	27.7	27.2	27.0	43.9	42.5	30.1	32.9	27.7
Non performing loans (net)	0.4	0.3	1.1	1.2	2.5	0.8	0.5	1.2	1.4	2.6
Equity participation	1.3	0.8	0.6	1.5	1.1	2.8	1.5	0.6	1.8	1.2
Affiliated companies	0.0	0.0	4.1	7.0	26.8	0.0	0.0	4.5	8.4	27.5
Fixed assets	2.3	2.9	2.8	2.6	2.2	4.9	5.6	3.0	3.1	2.3
Other assets	5.6	6.8	22.7	16.7	8.3	12.1	13.0	24.7	20.2	8.5
<b>Liabilities</b>	46.5	52.2	92.1	82.9	97.3	100.0	100.0	100.0	100.0	100.0
TL	..	..	47.9	44.4	41.3	68.2	52.1	52.0	53.5	42.5
FX	..	..	44.2	38.5	56.0	31.8	47.9	48.0	46.5	57.5
Deposits	26.2	33.9	61.7	54.5	68.5	56.3	65.0	66.9	65.8	70.4
Non deposit Funds	8.5	7.4	15.8	11.8	10.4	18.3	14.1	17.2	14.3	10.7
Due to domestic	1.8	2.1	1.8	1.8	1.5	3.9	3.9	2.0	2.2	1.6
Due to foreign banks	3.1	2.4	8.3	8.7	7.1	6.7	4.6	9.0	10.5	7.3
Other liabilities	7.4	6.3	9.2	6.9	6.3	15.8	12.0	10.0	8.3	6.4
Shareholders equity	3.3	3.2	2.5	4.0	5.7	7.2	6.1	2.7	4.8	5.8
Net income	1.1	1.5	2.9	1.7	1.3	2.4	2.8	3.1	2.1	1.3
<i>Memorandum items:</i>										
Repos and reverse repos	..	5.2	12.7	11.8	6.5	..	10.7	22.3	27.9	10.6
Other off-balance sheet contracts	..	1.4	5.9	4.2	4.1	..	2.8	10.3	9.8	7.5

Note: Banks Association of Turkey data does not include the results of the BRSA triple audit and inflation adjustments for the domestic private banks.

Source: The Banks' Association of Turkey, BRSA.

Table 20. **Indicators of bank risk exposures**  
(end of period)

	Banking system <sup>1</sup>		Private deposit banks <sup>1</sup>		Public deposit banks		SDIF banks		Foreign banks	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
<b>Capital ratio</b>										
(Shareholders' equity + net income) / Total assets	6.9	7.2	13.7	5.6	3.1	8.5	-27.1	-7.4	9.6	20.0
Net Working Capital <sup>2</sup> /Total assets	-1.7	-0.8	2.7	-4.9	-3.3	3.8	-36.7	-13.1	6.4	16.6
<b>Assets quality</b>										
Loans/Total assets	32.9	24.6	37.7	26.7	25.8	16.4	25.6	8.4	17.1	26.8
Non performing loans / (Loans + Non performing loans)	10.3	18.9	5.8	15.1	11.1	28.9	41.4	66.6	2.8	5.1
Provision for loan losses / Non performing loans	36.9	70.0	59.2	58.7	18.4	64.9	34.1	135.9	50.1	39.9
<b>Liquidity</b>										
Liquid assets/Total assets	32.2	33.3	36.5	38.0	18.3	21.6	51.6	72.9	63.7	45.5
of which securities	11.5	10.2	10.5	10.8	6.2	5.6	43.1	55.5	12.9	7.9
TL liquid assets / TL liquid liabilities <sup>3</sup>	52.2	65.6	97.7	87.0	16.5	39.6	40.1	57.8	178.1	211.6
FX liquid assets / FX liquid liabilities <sup>3</sup>	62.8	55.3	60.8	51.2	69.4	58.5	26.5	17.0	49.9	63.5
<b>FX open position<sup>4</sup></b>										
Excluding forward positions (US \$ millions)	-14 553	-1 932	-8 377	110	-144	116	-3 984	-449	-1 803	85
Including forward positions (US \$ millions)	-5 445	-695	-1 182	1 597	-90	117	-4 030	-449	-36	17
Excluding forward positions (% of bank capital)	-128.0	-18.8	-82.9	3.0	-8.8	4.2	113.7	145.5	-222.6	13.7
Including forward positions (% of bank capital)	-47.9	-6.7	-11.7	44.0	-5.5	4.3	115.1	145.5	-4.4	2.7

Note: Banks Association of Turkey data does not include the results of the BRSA triple audit and inflation adjustments for the domestic private banks.

1. Includes investment and development banks.

2. Post-audit including inflation accountings; excluding SDIF and foreign banks.

3. Net working capital is equal to shareholders' equity plus income (current + previous) minus permanent assets.

4. For maturities less than 3 months.

5. End September for banking system, public deposit banks and foreign banks.

Source: The Banks' Association of Turkey.

the detriment of real-sector investments that would have required longer maturities. On the other hand, the average maturity on the growing volume of government securities was around 15 months. Such “maturity mismatch” exposed banks to significant interest rate risks.<sup>37</sup>

Finally, easy profits from uncovered bond arbitrage diminished incentives for banks to engage in core activities, or to be efficient in doing so. At the same time, macro policies stimulated capital inflows and fast economic growth between crisis episodes, expanding resources at the disposal of banks. Thus, even though the allocation of resources to the real sector declined strongly in counterpart to the rising share of government securities, there was nevertheless a sharp rise in the ratio of credits to GDP over the second half of the 1990s (Table 19). Rapid credit growth *per se* does not augur well for loan quality, as there is no time to do careful credit risk assessments or to develop corresponding bank skills. Furthermore, bank lending in foreign currency terms, along with bank guarantees of non-bank foreign borrowing, may have protected borrowers against the high domestic inflation risk premium but was subject to currency risk insofar as the borrower did not have a corresponding cash flow in foreign currency. This caused widespread loss of corporate net worth and loan defaults in the case of devaluation. The short term nature of lending also exposed firms to interest rate risk, which similarly meant derived credit risk for banks. Hence, high credit risk became another determining feature of bank balance sheets, materialising in a systemic manner in the aftermath of the asset price shocks that accompanied banking crises. Default risk on government securities was also implicit in the abnormally high real yields that these instruments enjoyed.

### **Tax, governance, and accounting distortions**

Tax policies and accounting procedures reinforced the channelling of resources to government, while prevailing corporate governance practices underpinned distortions in the allocation of private sector credit. The following were the main channels of operation:

- Differential tax rates, withholding rules, and reserve requirements favoured repos, FX borrowing and deposits, and government securities to the detriment of traditional bank contracts, namely TL deposits and private credits.<sup>38</sup> A financial transactions tax was levied on banks to partly compensate in revenue terms for these loopholes, but it disadvantaged banks in foreign competition and contributed to market illiquidity (see Chapter II).<sup>39</sup>
- Business groups belonging to wealthy families were controlling stockholders in most private banks, with profits from open positions used to cross-subsidise connected lending back to the group owners (tunneling). As connected lending typically involves neither loan evaluation nor

monitoring, it increased credit concentration and risk in banks and inefficiency in the use of funds by borrowers. Lending to related parties accounted for the bulk of non-performing credits, especially in downturns when the true state of the borrowers was revealed.<sup>40</sup>

- Poor accounting standards in the past – in particular incomplete coverage of group and off-balance sheet exposures and lack of consolidated accounts – created an environment where connected lending and open positions were easily sustained, while prudential limits were generous in relation to international standards.<sup>41</sup> Turkish banks set up branches and subsidiaries in foreign countries outside the regulatory net,<sup>42</sup> or utilised non-bank domestic subsidiaries, to park open positions and re-route group credits.<sup>43</sup>
- Inadequate loan loss classification rules made it easy to cover up non-performing credits by extending new loans at the time of repayment (ever greening), being based on the number of days that a loan was past due for principal repayments and the type of collateral provided by the borrower. Loans at risk whose interest payments are falling behind were not given consideration as under international best practice standards.<sup>44</sup> Less than full provisioning requirements further weakened asset quality. State banks did not adequately classify problem loans nor provision for them, because of the implicit government guarantee.
- Inflation accounting was not allowed for tax purposes, which overstated profits and bank capital. This in turn gave an incentive to limit reported profits by paying high salaries and incurring other large non-interest costs (Table 18). The lack of inflation accounting for (non-listed) companies also made it difficult to get an accurate picture of corporate clients for reasonable loan analysis, reinforcing the decline in traditional intermediation services.

### ***Regulatory forbearance and moral hazard***

Deficiencies in internal control and risk management in banks were compounded by weakness in the supervisory and regulatory framework. Until recently, Treasury, the Central Bank and the Capital Markets Board were the major regulatory and supervisory bodies in the financial sector. Conflicting objectives and suboptimal co-ordination decreased efficiency in tracking the soundness of the banking sector.<sup>45</sup> In particular, Treasury faced weakened incentives to regulate undercapitalised banks with excessive holdings of government securities, as this eased deficit finance and roll-over of maturing debt, while the use of public funds for possible rehabilitation of banks, in particular the state banks, may have conflicted with objectives of budgetary equilibrium.<sup>46</sup> The weakness and uncertainty of regulation also acted as a barrier to foreign banks to participate on any meaningful scale.<sup>47</sup>



Bank entry and exit was highly politicised. The granting of bank licences was based primarily on political criteria during the 1990s.<sup>48</sup> The decision to intervene in banks rested with the Minister for Economic Affairs, who was more exposed than Treasury to the influence of bank lobbies and political pressures to maximise short-term growth or protect employment. Non-transparency of the process critically added to its non-accountability (*e.g.*, being placed under Treasury surveillance was secret and involved advantages such as lower reserve requirements). Such regulatory forbearance raised moral hazard incentives by insolvent but still operating institutions to take excessive risks and deteriorate further, also sending signals to banks that there were no sanctions for misbehaviour. An ineffective bankruptcy law and court system also were not conducive to quick restructuring efforts (it took 8 years to liquidate the banks taken over after the 1994 crisis). The Savings Deposit Insurance Fund (SDIF) was created in 1983 to administer deposit insurance and its functions were enlarged in 1994 to resolve failed banks, but its effectiveness was highly constrained *inter alia* by an inefficient asset recovery process. The creation of an independent regulatory agency with full licensing authority under the 1999 banking reform was a major step forward, but it became operational too late to prevent banking crisis from erupting in late 2000 (see below).

Weak regulation was further evidenced in the failure to limit moral hazard problems arising from full deposit insurance imposed after the 1994 crisis. Although this was meant to be a temporary measure to help calm down the situation, politicians subsequently lacked any incentives to remove it. Excessive risk-taking in the banking system resulted, in the absence of credible policies to extract maximum liability from managers and shareholders, as depositors and foreign lenders had diminished incentives to choose banks carefully or to monitor them in the expectation of a government bail-out.<sup>49</sup> With the end-1999 IMF stand-by agreement, the government committed itself to gradually reducing deposit insurance to EU norms, and a first step reduction was made. However, with renewed crisis at the end of the year, a blanket guarantee of all banks' liabilities was announced and is to be maintained until further notice.

### ***Soft budget constraints in state banks***

Public banks have created major distortions in the sector because of their large size and their abuse for political rent distribution purposes (Box 6). Credit selection has tended to reflect political preferences and access to subsidised loans for agricultural or small business investments has tended to be neither transparent nor fair. Moreover, the large public sector borrowing requirement induced public banks to participate in public financing, either explicitly or implicitly, crowding out credits available to the private sector. While public banks accounted for 40 per cent of total banking sector deposits, they represented only 27 per cent of the loans by end 2000.<sup>50</sup> Public banks' losses, incurred from their

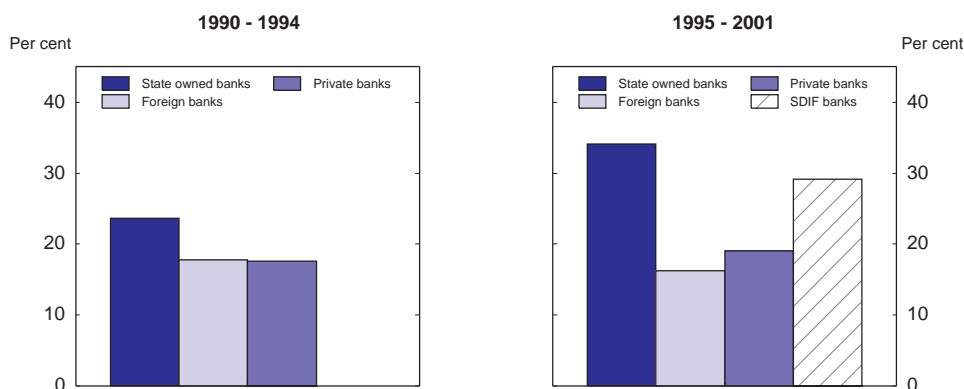
**Box 6. Public banks**

Public banks often pursue objectives with respect to regional or sectoral development. They establish branches in areas where private banks are unlikely to invest. The private banking sector has no interest in maintaining branches in developing countries that have poor and remote regions, although banking activities can be considered as quite essential in terms of regional development. Public banks also extend credits to agents who are unlikely to obtain them from market sources. Most countries have supported credit to sectors that are socially and politically desirable but unable to get enough credit from the market. Even in the United States, there are credit institutions that are owned or sponsored by government to provide credits to the sectors such as housing, agriculture, and small business (Corrigan, 1998). Against this, credit allocation is often not based on careful analysis of the borrower, and after getting credits, borrowers have incentives to use them in more profitable areas than the intended sectors. Also, public banks tend to direct deposits into public debt finance rather than productive credits, and they can be misused by political parties to direct credits to favoured support groups. In short, public banks need to be regulated properly.

In Turkey, public banks were founded for development and supportive purposes. As in other countries, they complemented the market by providing credits to small agricultural units and small and medium size entrepreneurs, and by establishing an extensive network of branches in remote areas. Each public bank has targeted a specific group in its supportive duties: Ziraat Bank was specialised in agricultural credits and development; Halk Bank in small and medium sized entrepreneurs and artisans; and Emlak Bank in the construction sector. However, public banks became the main vehicle for “distributive politics” following reform of the state economic enterprises in the early 1990’s (see OECD, 2002b), thus falling into above-described traps.

“duty” of lending at below-market interest rates, were by law supposed to be covered by Treasury subsidies from the budget. However, Treasury withheld such funding and instead occasionally issued “non-cash” government securities to clear its liabilities with the banks. In the interim, Treasury receivables (“other assets”) would accumulate – these two asset items squeezed out credits. When real interest rates reached 20-30 per cent levels, the capitalised value of such receivables quickly exploded. In the absence of proper incentives, inefficient management contributed to the rapid deterioration in the financial health of the public banks.

The duty losses, together with unrecorded NPLs, transmitted pressures to the whole banking system. The public banks were forced to fund their losses through short term financing. They offered deposit interest rates well in excess of those in the private banks (Figure 9),<sup>51</sup> and they had huge overnight borrowing

Figure 9. Deposit interest rates<sup>1</sup>

Note: See note to Figure 6.

1. Deposit interest rates are defined as interest payments on deposits over total deposits. In the state banks, private depositors would have received even higher deposit rates than shown because, until recently, public sector depositors received zero rates of return.

Source: The Banks' Association of Turkey.

requirements. The stock of duty losses thus exerted upward pressure on market interest rates just as surely as explicit government debt would have, and maybe even more so because of the non-transparent nature of the mechanism. The unwillingness or inability to resolve failed private banks that were brought under the administration of the SDIF prior to the crisis caused them to exert growing upward pressure on overnight and deposit interest rates as well, although the combined size of these banks was at that time relatively limited. Such interest rate pressures in turn adversely affected the private banks who themselves had large maturity mismatches linked to open positions.

## Conclusion

Mainly as a result of the above policy distortions, over the 1990s the Turkish banking system became increasingly subject to the following structural weaknesses:<sup>52</sup>

- Small and fragmented banking structure, superficial involvement of foreign banks, and dominance by loss-ridden state banks;
- Weak asset quality (concentrated credits, group banking, mismatch between loans and provisions) and inadequate capital base;

- Extreme fragility with respect to market risk (maturity mismatch and open FX positions);
- Inadequate internal control mechanisms, risk management, and corporate governance.

These structural problems made the system highly vulnerable to domestic and foreign shocks. A few banks failed after the 1994 crisis, but the system rapidly recovered up until the East Asian and Russian crises of 1997-98, which indirectly led to a number of new bank failures while causing a sharp increase in the public debt-to-GDP ratio *via* contagion effects. Finally, the 2000 disinflation programme created conditions for sharp increases in market risk exposures of private banks, while growing state bank losses reinforced systemic imbalances. The syndrome culminated in the end 2000-early 2001 crisis (Annex VII).

### **Banking system restructuring programme**

Following the 2000-2001 crisis, the government put into effect a programme to “eliminate distortions in the financial sector and adopt regulations to promote an efficient, globally competitive and sound banking sector.”<sup>53</sup> Financial and operational restructuring measures received equal emphasis. The latter aspect is especially important to ensure that the reforms are internalised by bank management, that problems do not recur and that large public monies spent for the financial restructuring are not wasted. The systemic non-performing loan problem further necessitated mechanisms to rehabilitate the corporate sector, a part of which was also technically insolvent, in order to fundamentally strengthen the banking system. The bank restructuring programme has been supported in a significant way by financial and technical assistance from the World Bank (see Annex VI).<sup>54</sup>

### ***Institutional and regulatory changes***

#### *Bank supervision*

The first actions of the new independent regulator, the Banking Regulation and Supervision Authority (BRSA) (Box 7), were relatively gradual and lacked prompt corrective interventions. At the same time the SDIF, newly transferred to the BRSA, failed to resolve the banks it took over. An inadequate regulatory framework tied their hands. Moreover, the delay in the nomination of the BRSA Board until nine months into the stabilisation programme, during which bank risk positions were dangerously growing out of hand, was the result of protracted political infighting over selections. After the February 2001 crisis, the cabinet changed the governing board, citing the need for a more “professional” board, while Parliament had to pass a special law to overturn their 6-year tenure. Apart from the question of whether the first board was professional or not, the abrupt lifting of the tenure

### Box 7. The BRSA and SDIF

The Banking Regulation and Supervision Agency (BRSA) regulates and supervises all the banks in Turkey. The BRSA was founded in June 1999 with banking law No. 4389 and started its operations at end-August 2000. It became the sole authorised agency in banking sector regulation and supervision. The governing board of BRSA is independent from political powers by law. The members of the governing board should be composed of professionals, with qualifications defined strictly in the Banks Act, and are appointed by the Council of Ministers, upon the proposal of the Minister of State responsible for Economic Affairs, for a 6-year term. The main mechanisms to ensure independence are that board members cannot be removed from their duties easily and they are prohibited from working in the banking industry for two years after retirement from the board. The BRSA is supported by bank contributions up to 3/10000 of their balance sheet amounts. Its main power is the threat of intervention and prompt corrective action. A banking law amendment in May 2001, law No. 4672, strengthened the independence and authority of the BRSA, notably by providing staff members immunity from prosecution for actions resulting from their duties. Accountability is to be promoted by regular performance assessment by the public (*via* surveys, etc.) and by the pursuit of transparency on the part of the BRSA (full public disclosure of BRSA operations and their results).

The Savings Deposit Insurance Fund (SDIF) is the deposit insurance fund and agency responsible for liquidating the insolvent banks. It was founded in 1983 under the management of the Central Bank, and later transferred to the newly founded BRSA. The financial sources of the SDIF are the insurance premium on deposits, claims and entrust that pass the time limit, entrance fee to the banking system (10 per cent of capital), penalties, etc. The SDIF board has been responsible for the management and disposal of all banks it has taken over. Law No. 4672 enhanced the authority of the SDIF in collection of receivables, especially rapid collection of funds misused by majority shareholders and directors of the bank. Law No. 4743 further strengthened the powers of the SDIF to: extract losses from shareholders; participate in Financial Restructuring Framework Agreements tied to restructuring plans of debtors of the Fund banks; and file lawsuits against former auditors and board members of Fund banks while immunising the Fund from penalties arising from lawsuits brought against it. In addition, the Collection Department was formed to deal with the collection of non-performing loans, and later the Real Estate and Subsidiaries divisions were created to downsize and reorganise banks prior to their privatisation. Substantial steps were also taken to strengthen the institutional structure of the SDIF, especially *via* internal and external auditing procedures.

There is an ongoing discussion about whether the regulatory agency should be connected to the liquidating agency or not. While integration of these two entities increases efficiency in terms of information flow, it may prevent prompt action in some cases if regulatory staff do not want to give the signal that supervision is inefficient when they intervene banks. Turkey is just at the beginning of the banking sector stabilisation and restructuring plan, and this may be less of a threat

**Box 7. The BRSA and SDIF (cont.)**

since the regulation, supervision and interference are all managed together. After the stabilisation phase is completed, the judgement of both the SDIF and the BRSA could be called into question in the event of an SDIF intervention, in that the BRSA should see the problems before they get out of control and lead to bank insolvency. On the other hand, under non-crisis conditions bank failures are one of the means by which markets weed out weaker performers so that scarce supervisory resources should not be expended on averting bank failures at any cost (OECD, 2002a).

(the main safeguard of political independence) exacerbated concerns about the rule of law, political influence, and outside influence.<sup>55</sup> The legal and institutional structure of the BRSA and SDIF were then strengthened, however, *e.g.* protecting BRSA staff from lawsuits over their actions and expanding the SDIF's powers in asset recovery, laying the groundwork for the intensive banking restructuring plan.

Given the history of politicised bank regulation in Turkey, the establishment of an independent bank regulator is perhaps the single most important element of the banking reform. It is vital that the BRSA be perceived by banks and the public as acting with knowledge, independence, fairness, transparency, and authority, so that confidence in the system can be restored. The building up of credibility is a process that will take time and consistency, requiring the BRSA to resist political pressures to compromise sound banking principles for the sake of other objectives, which could be achieved by other means. IMF conditionality has thus far strengthened the hand of the BRSA (as indeed of all reformers), and an important goal will be to maintain its independence *vis-à-vis* domestic interests in the future. Sufficient resources at the disposal of the BRSA will at once make its actions more credible and independent of government, while salaries that are competitive with those in the private sector will at once protect the integrity and assure the technical expertise of BRSA staff. At the same time, strict implementation of current provisions sanctioning unethical behaviour and taking jobs in recently supervised banks will be important to maintain necessary independence from the industry.

Under the ongoing bank restructuring (see below), the BRSA has indeed taken clear and swift actions, for example obliging banks to switch over to full provisioning for bad loans this year instead of over four years as they had insisted, and taking on powerful political and corporate interests in the take-over of Pamukbank. Its *modus operandi* has also become more open: in the initial phase of the pro-

gramme, the BRSA was criticised for being too secretive regarding the bank letters outlining recapitalisation plans. Even if individual bank data could not be released for understandable reasons, aggregate data for the banks whose plans were accepted, for example, or reasons for transfer of the banks with unacceptable plans to the SDIF, might have increased trust in the BRSA and in the whole banking sector operation. However, the next phase of the programme, featuring the bank audits, was marked by a higher level of transparency in BRSA communication policy. Notably, regular publication of details about the audits and capital needs of banks, at least at the aggregate level, has enhanced democratic accountability of the BRSA. However, publication of more disaggregated bank information by the BRSA could better help markets to monitor the banks.

Once the stabilisation part of the programme is completed and confidence in the banking system has been restored, the government intends to impose a limit on deposit insurance in line with EU norms. The lifting of the blanket guarantee on bank liabilities is critical to correcting bank incentives and should be done as soon as possible. Indeed, failure to do so might itself send a signal that the banking system is not yet healthy. However, this will not be sufficient to eliminate moral hazards from the system (see Annex V). It is equally important that a clear policy of manager, shareholder, and uninsured creditor liability in the case of bank closure be maintained, and that accounting and reporting transparency be rigorously enforced (see below).

The government has also indicated that the administrative status of the SDIF might be eventually reviewed. Although joint administration of the BRSA and SDIF has so far been working effectively, there could be conflict of interest problems in the longer term, when single-minded pursuit of prompt corrective actions by the BRSA will be needed to maintain good practices in the banking system (Box 7). In the past, regulatory forbearance (the opposite of prompt corrective actions) had disastrous results on bank incentives. Hence, the review would be appropriate, and should take place on a timely basis.

### *Regulatory and tax measures*

International experience has shown that addressing weaknesses in the regulatory, supervisory, and accounting framework is a matter of priority in bank crisis resolution (OECD, 2002a). To improve both the BRSA's information set and bank incentives, and to fulfil the intentions already laid out in the 1999 Banking Act, important legal changes to the banking law have been made since the last crisis in Turkey. Prudential and accounting rules have been brought more closely into line with international best practice, in particular EU directives, while tax changes have sought to remove current distortions and facilitate bank restructuring. Major changes are listed in Box 8.

**Box 8. Post-crisis regulatory reforms in banking**

The rules on *connected lending* were tightened: the concept of “risk group” set consolidated lending limits within the whole group of related parties; the limit on loans to “a group of related parties” was reduced from the previous 75 per cent of capital to 25 per cent, with the adjustment to be completed by 2007; investments in non-financial subsidiaries are limited to 15 per cent of total net worth and the total sum of lending to all subsidiaries is limited to 60 per cent of net worth in a transition period to 2009; and the definition of credit for regulation of lending limits was broadened to include off-balance sheet derivatives.

*Accounting* was made more transparent as repo transactions were brought on-balance sheet as of 1 February 2002; full adoption of the International Accounting Standards Board accounting system, including inflation accounting, was realised by banks in July 2002. The establishment and operation principle of the *independent auditing firms* has been revised; as a result, the licence of one independent firm was cancelled. *Offshore banks* owned by Turkish entities are to be supervised in co-operation with the host country supervisory agency, and Turkish banks' foreign branches will be subject to on-site supervision based on agreements between home and host countries. The deductibility of *loan loss provisioning* in the calculation of corporate income tax was clarified, to encourage compliance with the new 100 per cent provisioning rule by end-2002 (an earlier 4-year transition rule was rescinded in January 2002), while loan classification rules were updated.

An important measure for strengthened prudential limits was passage to a *risk adjusted capital adequacy ratio* in February 2002. A standardised market risk measurement procedure has been announced, but banks are permitted to develop their own models which will be evaluated and closely monitored. Banks are required to develop *internal control and risk management systems*; the BRSA will monitor these for their efficient functioning and provide technical advice, and banks will have to provide monthly reports on their performance. Open positions and capital adequacy ratios will be monitored on a daily basis by the BRSA, and though the data are not public, the BRSA informs the market by its banking sector reports. To improve the hedging mechanisms for FX risks, the Capital Markets Board of Turkey opened a foreign exchange futures market in early 2002.

Tax advantages were extended (as defined in the 1999 banking law) to *facilitate mergers and acquisitions* of banks and their subsidiaries. In addition, regulations on M&A procedures were simplified: those involving up to a 20 per cent market share limit of the combined entity were not made subject to the scrutiny of the Competition Authority. To encourage a better composition of balance sheets, differential *withholding tax rates and reserve requirements* on repo, TL and FX deposits were narrowed, and will be eventually eliminated in 2002, while lower rates for longer maturity deposits were allowed; also remuneration of required reserves on TL deposits was introduced. The withholding tax on income from government securities was reinstated, although in order to induce households and institutional investors to hold government securities directly rather than *via* the banks, the tax exemption on government bond earnings has been raised from \$3750 to \$38500. The *bank and insurance transactions* tax on interbank foreign exchange sales was removed.



The many regulatory changes that have been passed in a short period of time strengthen both accounting standards and disclosure requirements – and are critical to improving the information by which both the BRSA and the markets can monitor excessive risk-taking. The loopholes in the definition of consolidated accounts for purposes of regulating connected lending and open positions are being removed, while regulatory limits have been tightened and co-operation with off-shore supervisory authorities should extend the scope of the regulatory net. However, it remains to be seen how the new rules are applied in practice, given problems of implementation in the past.<sup>56</sup> Also, the transition period for connected credits appears long (7 years), though banks already in excess of the 25 per cent limit cannot extend further lending to the same risk group in the meantime. The tax and regulatory changes already led to a number of mergers among smaller banks during 2001.<sup>57</sup> Other tax changes should establish neutrality between different component of bank balance sheets by end-2002, ending distortions that favoured bank holding of government debt over other assets. However, a sharply higher tax exemption for government bond earnings has been introduced to encourage direct holdings of government securities outside banks, which means that the tax base will shrink and real sector earnings are once again disadvantaged in relative terms. Therefore, this application should be limited to the transition period until the public sector borrowing requirement is reduced to reasonable levels. Finally, the elimination of one of the major financial transactions taxes should significantly help to reduce their earlier distortionary impacts.

For purposes of capital adequacy regulation, Turkey has chosen to keep the Basle minimum standard of 8 per cent. Specific conditions of countries may require higher percentages, however.<sup>58</sup> Even though capital is hard to measure, capital adequacy is an important concept because it puts the banks' own money at risk, establishing incentives to avoid excessive risk-taking on the part of bank managers. The BRSA insists that the minimum chosen is adequate as it applies to a risk-weighted asset aggregate and a capital requirement measured for the market risk.<sup>59</sup> However, the adopted weights (which come from developed countries) may not reflect adequately conditions in Turkey. For example, Treasury securities are given a zero credit risk weight.<sup>60</sup> This gives a perverse result. Apart from connected lending, Turkish banks' risky behaviour has been focused in excessive exposures to government securities, funded by very short term liabilities and open positions. But by further shifting portfolio allocations into securities and away from credits, banks' capital adequacy ratios are actually enhanced. Furthermore, the risk of default on these instruments is non-negligible, as reflected in the sovereign risk premium underlying their very high real yields – which is in turn what crowds out private credits. The risk weights should be revisited and the national requirement determined higher than the Basle standard if necessary. In any case, the Basle standards themselves are under review.

The new regulations have mandated the introduction of internal control and risk management systems. The BRSA's authority to monitor them should be fully used in order to deter excessive risk-taking, especially as underlying incentives to such risk-taking (macro instability and full deposit insurance) remain in place. In the area of credit risk management, rigorous application of forward looking loan loss classification and full provisioning rules should be monitored closely to allow a realistic assessment of NPLs. It is especially important to stop the practice of evergreening in a high inflation environment such as Turkey's, where a large share of interest payments is effectively principal repayment. Even so, there will be loopholes. For example, banks have an incentive to overestimate the value of collateral in order to reduce provisioning charges, but the authorities may not have the resources to do an accurate assessment. It is thus vital that new mechanisms for accounting transparency and outside auditing be effective. Recent research has found that regulatory and supervisory practices that force accurate information disclosure and empower private sector monitoring of banks work best to promote bank performance and stability, and may actually be more important than regulatory powers and capital adequacy regulations.<sup>61</sup>

### ***Restructuring of state and SDIF banks***

#### *Financial restructuring*

In order to eliminate the existing stock of duty losses of the public banks and to strengthen the financial position of the SDIF banks, which were suffering from large non-performing loans and FX losses (Table 20), in May 2001 the Treasury securitised all the losses and bad assets. In exchange for their receivables from Treasury, long-term securities at market rates were provided to the state and SDIF banks (Table 21). Cash was also injected in order to strengthen their capital base. As a result of the operations, the process of recapitalising the public banks, which had begun in 1999, was completed. By end 2001, the three large state banks, Ziraat, Halk, and Emlak (later absorbed by Ziraat), reported capital adequacy ratios (CAR) of 36 per cent, far above the 8 per cent regulatory minimum. This reflected not only the capital injections themselves, but also the huge increase in government securities holdings – from 6 to 58 per cent of total assets – having a zero credit risk weight in the new calculation of the CAR (by comparison, the ratio of shareholder equity to unweighted total assets was 9 per cent). The Turkish authorities believe that this should provide an adequate cushion against any future operational and loan losses, as well as off-balance sheet risk which may not have yet been fully reflected in the banks' balance sheets.<sup>62</sup> The SDIF banks also reported a positive net worth. In addition, the large overnight position of the state-owned and SDIF banks was eliminated,<sup>63</sup> as banks used these securities to obtain liquidity by repo from the CBRT directly. The latter then absorbed the resulting excess liquidity in the market by reverse repo operations and FX sales, avoiding monetisation of the losses (Chapter II).

Table 21. **Public resources for State and SDIF banks restructuring**  
(as of 31 December 2001)

	TL trillions	% of GNP
<b>State banks<sup>1</sup></b>		
Ziraat	15 251	8.5
Halk	12 627	7.0
Total	27 878	15.5
<b>SDIF banks</b>		
Securities <sup>2</sup>	21 581	12.0
SDIF own resources <sup>3</sup>	27	1.5
Total	24 196	13.5
<b>Total</b>	<b>52 074</b>	<b>29.0</b>

1. Securities plus subordinated debt and cash injections issued to State banks.

2. Securities issued to SDIF.

3. Capital and deposit support from SDIF sources as of 4 July 2002.

Source: JBDST and Treasury, BRSA.

The benefits of the operation were clear. Pressure on overnight rates stemming from these banks' borrowing requirements was eliminated, and duty losses were removed as a lump sum transfer and covered under the public debt, increasing the transparency of both public bank management and government. But it implied a high cost to the public. The recapitalisation programme was funded by issuance of Treasury securities totalling around 30 per cent of GNP (part of which prior to 2001). It is significant that the Central Bank lender of last resort facilities were not used extensively, and that it mainly stood by to provide emergency liquidity support to viable banks, a feature of most successful operations.<sup>64</sup> The bank-clean up was, however, among the most costly in international terms: countries have rarely had fiscal costs larger than 20 per cent of GNP (Table 22).<sup>65</sup> This mainly reflected the long delay in taking action. Indeed, research based on cross-country comparisons suggests that permitting impaired institutions to continue to operate for extended periods of time, as Turkey did with the SDIF and state banks, can significantly raise the fiscal costs of resolving crises and points to the danger of forbearance as a resolution technique (OECD, 2002a).

The jump in the public debt and the fact that it was mainly in floating rate terms aggravated the public debt rollover requirement at a time when interest rates were very high and tax receipts depressed on account of the economic crisis. After the securitisation, servicing of the debt burden in 2001 looked to be far above the resources coming from the primary surplus and international institutions. In such an environment, Treasury engaged in debt operations *vis-à-vis* the state banks that helped to both meet banks' needs and ease the public debt rollover and service burdens (Chapter II). It announced that it would make early

Table 22. **Restructuring during past banking crises**

	Crisis period	Peak NPL as % total loans	Cost of restructuring as % of GDP
Chile	1981-1985	116	19-41
Colombia	1982-1987	25	5-6
Finland	1991-1993	9	8-10
Indonesia	1987-1998	40+	20+
Korea	1997-1999	25-30	20+
Malaysia	1997-1998	20	5
Malaysia	1985-1988	33	18
Mexico	1995-1997	13	14
Norway	1988-1992	9	4
Sri Lanka	1989-1993	31	9
Sweden	1991-1993	11	4-5
Thailand	1983-1987	15	1
Thailand	1997-1998	35-40	34
<b>Turkey</b>	<b>2001-2002</b>	<b>25<sup>1</sup></b>	<b>31<sup>2</sup></b>
United States	1984-1991	4	5-7
<b>Median</b>		<b>20.7</b>	<b>7.7</b>

1. 25 audited private banks only, as of 31 December 2001.

2. Estimated as of mid 2002 (28.5 public, 2.5 private).

Source: IMF, BIS, OECD.

redemptions to public banks in order to further improve their liquidity position and thus ease pressure on the short-term borrowing markets, and to participate in Treasury auctions with the excess liquidity remaining after paying their short-term obligations. Subsequently, the pre-existing government securities with their accumulated interest held by the state banks were replaced by newly-issued longer-dated securities indexed to the auction rate. This suggested that Treasury still has considerable say in the portfolio management of public banks.

After eliminating the existing losses, the next step was to prevent the generation of new losses. In line with this objective, around 100 previous decrees regarding subsidised state bank lending *via* duty losses were abolished and henceforth any support that is financed through public banks is required to have an appropriation within the budget. This significantly increases the transparency of support policies and improves the future financial structure of the public banks. A second step was to set an upper limit on deposit rates offered by the public and SDIF banks. Deposit rates are now to be uniformly determined on a daily basis below market interest rates for Treasury securities in order to ensure their profitability.<sup>66</sup> The “unfair competition” formerly exerted by these banks in the market for deposits, and highly resented by the private banks, has thus been eliminated. Nevertheless, the public banks did not see a reduction in their share of total banking sector deposits, being considered safe havens during times of crisis. In parallel, deposit rates for public sector depositors have risen to market levels: in

the past, public sector deposits earned zero interest (subsidising above-market rates paid to private sector depositors).

Besides recapitalisation, several further steps were taken to make balance sheets stronger and more transparent. *First*, state banks have become far more prudent about identifying and provisioning for problem loans, causing their net loan portfolio to shrink by 60 per cent in real terms by May 2002 (Table 23). The minimum maturity on repo transactions of state banks was extended to a week or longer in order to mitigate maturity mismatch and liquidity risk associated with the larger securities portfolio. Likewise, maturity issues of the securities were staggered so as to provide banks with a monthly cash flow. *Second*, the large open positions of the SDIF banks were closed in part by the transfer of FX liabilities to Ziraat bank, which was in turn matched by Treasury issue of FX-linked securities to Ziraat (in this way the FX risk was ultimately transferred to Treasury).<sup>67</sup> Also, a large part of the SDIF banks' FX and TL deposits were sold to other private banks *via* an auction mechanism, reducing their balance sheets.<sup>68</sup>

#### *Operational restructuring of state-owned banks*

Subsequent to the securitisation operation, the banking license of Emlak Bank was revoked,<sup>69</sup> and its assets and remaining liabilities were transferred to

Table 23. **Consolidated balance sheet of state banks**

	TL trillions		Percentage change		Percentage share	
	December 2000	May 2002	nominal	real	December 2000	May 2002
<b>Assets</b>						
Cash and claims on banks	2 555	4 475	75.1	-6.6	8.3	9.2
Securities portfolio	1 759	31 027	1 663.9	840.3	5.7	64.1
Loans	6 525	4 926	-24.5	-59.8	21.2	10.2
Past due loans (net)	722	1 075	48.9	-20.6	2.3	2.2
Past due loans (gross)	1 017	3 680	261.8	92.9	3.3	7.6
Loan loss reserve (-)	296	2 650	795.3	377.2	1.0	5.4
Duty losses	15 196	..	..	..	49.3	..
Other Assets	4 061	6 883	69.5	-9.7	13.2	14.2
<b>Liabilities</b>						
Deposits	20 234	33 151	63.8	-12.7	65.7	68.5
Borrowings from banks	4 612	3 369	-27.0	-61.1	15.0	7.0
Other liabilities	5 258	7 415	41.0	-24.8	17.1	15.3
Shareholder's equity	712	4 451	525.1	233.2	2.3	9.2
<b>Balance Sheet Total</b>	<b>30 817</b>	<b>48 386</b>	<b>57.0</b>	<b>-16.3</b>	<b>100.0</b>	<b>100.0</b>

1. Consolidated balance sheets of Ziraat, Halk and Emlak Banks.

Source: BRSA, JBDST.

Ziraat Bank. As part of the transition to long-term plans, the long-delayed privatisation of Vakif Bank was also started, but it has not yet been successful. The next step was appointment of a joint and politically independent management board consisting of professional managers for the two remaining large public banks, Ziraat and Halk.<sup>70</sup> This board is responsible for applying commercial criteria to ensure profitability and formulate plans for privatisation. Its first task has been to implement a strategic plan and detailed institutional restructuring programmes which involved downsizing of inefficient branches and elimination of overstaffing, though downsizing is to be consistent with the branch distribution in the remote areas. A staff cut of almost 40 per cent was already realised by May 2002, while the number of branches were reduced by almost 30 per cent.<sup>71</sup> Besides rationalisation, a programme has been set up to monitor profit and loss accounts, liquidity position and interest rate spreads of the state banks, and an independent auditor will assess their conditions. Internal control and risk management units have also been set up within the banks. The profit picture of the state banks has, consequently, been on an improving trend.<sup>72</sup>

Personnel reductions (which are voluntary) have been encouraged by retirement incentives in the form of an additional 20 per cent (formerly 30 per cent) retirement pension lump-sum transfer to persons eligible for retirement. Those who did not wish to retire were given the choice of accepting private sector (performance-based) contracts or being transferred to the pool of the state personnel department. The ones who accepted to sign private contracts were given considerably higher salaries than they earned previously. A main difficulty is that the education level of the personnel in the public banks has traditionally been much lower than that in private banks.<sup>73</sup> In the retirement process, the priority should thus be given to underqualified personnel. However, there is a drawback. The under-qualified persons are the least likely to find a new job in the case of early retirement. In that case, the bonus may not be enough to convince them to retire, and it may be the most qualified staff who accept the severance package. Indeed, this kind of voluntary departure package has in many cases in the OECD countries' experience proved to be expensive and counter-productive.

### *Ownership restructuring*

No concrete plans have yet been put forward for the privatisation of Ziraat and Halk banks. The privatisation process and design is extremely important. Other countries' experiences show that a badly managed privatisation is more costly, and potentially more distorting, than keeping the banks public. Purchasers should be screened to rule out large industrial groups, to avoid aggravating the problem of connected lending, or more generally those likely to have poor banking skills. The experience of Mexico in 1995, when the banking system was brought to the brink of collapse, shows that the exclusion of foreign participants at the

time of bank privatisation several years sowed the seeds of future crisis by preventing the transfer of badly needed management expertise. Requiring purchasers to put up sufficient capital would also avoid the incentive by new owners to engage in risk activity at taxpayers' expense. In Turkey's case, since the public banks have already been fully recapitalised, the purchase price should reflect the cost of this capital injection as well as franchise value of the state banks. As well, solutions to "market failures" that were ostensibly met by the public banks should be developed before the privatisation can be credible or acceptable politically. There are as yet no measures to deal with the developmental objectives that are currently used to justify state intervention. Insofar as state banks have provided financial activities to rural areas that are not commercially viable but that are held necessary for development and/or social reasons, privatisation will have to be supplemented appropriately. There may be branches specific to remote areas as in the case of Brazilian banking stations or specific credit institutions that can be run under certain guidelines.

Timely implementation of the privatisation plans will be critical: the current programme with the World Bank calls for privatising Vakif Bank by end-June 2003, Halk Bank in 2003, and Ziraat by 2006.<sup>74</sup> The transition process of the public banks is another important point. The external audits of the public banks are publicly available, and the transparency thereby provided should be the major disciplining mechanism for public banks, increasing their credibility and value before the privatisation process begins. The main impediment may be the organic connection between the board and the government (the board reports its activities to Treasury, the owner of the public banks). And as already noted, Treasury is still the main authority deciding the size and profitability of the securities portfolio. Hence, as long as the borrowing requirement of the Treasury remains at high levels, independence of the governing board and balance sheet reduction remain limited. This may impede the transition process. It also would seem to contradict a fundamental objective of the banking reform to correct the unhealthy situation where banks finance public debt rather than extending credits. It will thus be important that the public banks remain fully accountable to the BRSA, with the latter given adequate powers to intervene the state banks and to audit them effectively.

In conclusion, the following facts emerge. The public banks have been brought to financial health *via* a virtual doubling of the gross public debt. However, public banks' asset structures and cash flow are distorted by the overwhelming weight of government securities. As a general principle, bank recapitalisations should avoid aggravating maturity or currency mismatches (Honohan, 2001). Only when the government bonds are redeemed can balance sheets shrink, allowing migration of deposits back to the private banks and a more efficient public bank structure prior to privatisation, in line with stated objectives. The same could happen when confidence in the private banks is restored and services there may be

considered to be better than in the state banks, putting competitive pressure on the latter. In either case, it is important that the market interest rate policy and hard budget constraints for public banks be rigorously maintained, while continuing to introduce appropriate levels of expertise into state banks and to enhance market and BRSA oversight of their performance.

#### *Resolution of SDIF banks*

Since the crisis, the SDIF has been active in intervening unsound banks and has done an efficient job in restructuring and preparing them for the sale within a short period of time (Box 9), but it was only pushed to action after the February 2001 crisis. The balance sheet cleaning was quick and transparent in the sense that details about procedures and data have been published on the BRSA's website. According to law, SDIF monthly balance sheets are now published, along with independent external audits of the SDIF. The design of the bank resolution followed international best practice standards, for example, by breaking out the bad assets from the rest of the bank to allow a focus on core activities prior to restructuring and sale. The efforts and expanded powers of SDIF to improve its loan collection infrastructure are commendable (Box 7), and this will be important in order to recover some of the costs to taxpayers of the bail-out, but faster loan recovery depends mainly on bankruptcy reform (see below).

Nevertheless, bank ownership structure needs further attention. It is important to make sure that the new owners of the unsound banks have the means and incentives to provide efficient bank management; otherwise the old patterns of high risk and connected lending might be perpetuated. These sales should be an opportunity to start the change in ownership structure of the banking sector. In particular, a shift away from excessive ownership by the big industrial groups would be desirable, notably *via* foreign entry. Indeed, there are no barriers to foreign entry, other than "fit and proper" criteria. Although the domestic sales were to large industrial groups, the HSBC and Novabank purchases are a good indicator that SDIF banks are also attractive for foreign banks.<sup>75</sup> Other foreign banks will be looking closely at *ex post* performance of these acquisitions, and may also wait for the stabilisation programme to succeed, before entering.

A second concern is that of sharing the loss. The social unrest stemming from the huge resource transfer to the mismanaged banks was reinforced by the high lay-offs, especially as in the current economic climate, new job availability is limited. The above principles of extracting maximum liability from owners and managers of the mismanaged banks must be respected. Otherwise, the burden completely falls on the unemployed workers and taxpayers. And if the blanket guarantee is lifted, as it should be, in future cases of bank resolution depositors and other creditors could be asked to accept losses as well.<sup>76</sup>



### Box 9. SDIF bank resolution

Since the crisis, increased supervision and control over banks was evidenced in the number of banks that were taken over. Out of 20 banks intervened by the SDIF since its creation in 1983, 3 were at end-2000 and 8 in 2001, and 1 (so far) in 2002. By March 2001, the share of non-performing credits in total credits of the intervened banks was 145 per cent and losses were running at \$10.6 billion. Open positions were running at over 300 per cent of bank capital. The SDIF actions covered the transfer of bad assets of the banks to the collection department, sale of recapitalised and structurally adjusted banks and in the case of no offer, liquidation of the unsold banks. Some banks were liquidated before any financial restructuring was attempted. In order to make their management easier and sale attractive, eight of the intervened banks were merged under two transition banks (Table 24). The number of lawsuits filed both by and against the SDIF has risen sharply (now numbering over 800 in total). By end-June 2002, the number of branches and personnel of SDIF banks were each cut by more than half (from 1815 to 873, and from 33 to 18 thousand, respectively), and many of their subsidiaries, tangible and intangible assets were sold. In other OECD countries, likewise, the solution of liquidation has been seldom chosen where problems were widespread, as this would have shut down a large part of the system and incurred costs up front – mergers were a far more common technique, combined with capital injections and increased government control (see OECD, 2002a).

After the transfer of non-performing loans to the collection department, recapitalisation, and operational restructuring, the sale process was started.<sup>1</sup> Bank Ekspres was sold to Tekfen Holding, a local big industrial group. Almost one-third of the balance sheet of Sumerbank will be transferred to Oyak Group, another large group that is controlled by the military. All FX deposits and equities of Sumerbank which were not sold were transferred to Kentbank and Etibank. This sort of acquisition of a part of a bank is not uncommon in other countries.<sup>2</sup> In the meantime, HSBC, a UK bank, won the bid for Demirbank, while Novabank S.A., a Greek bank, was selected as buyer of Sitebank, leaving two banks (Toprakbank and Bayindirbank) of the original 19 taken over under SDIF administration to be sold. Pamukbank was taken over in June 2002. The SDIF transferred almost \$2 billion to restructure Pamukbank, and the selling process of the bank has started.

1. As of end-June 2002, a total of 128 thousand bad loan files with a book value of TL 52 quadrillion was transferred, out of which TL 1.1 quadrillion was recovered by the Fund banks and the Collection Department, including a portion collected from ex-owners. In addition, SDIF is arranging debt workout schemes by ex-owners (including the Ceylan group, owners of Bank Kapital), as well as restructuring of claims (new payment scheme) for about \$1.7 billion of 48 debtors.
2. For example, in Brazil ABN Amro acquired 40 per cent of Real; Santander/BGC got 50 per cent of Noroeste; and Santander again acquired 51 per cent of B. Geral do Comércio in Brazil (Baer and Nazmi, 2000). Similarly, in Argentina acquisitions cover different percentages of asset and liability transfers.

Table 24. List of banks transferred to the SDIF

Banks	Date of Transfer to SDIF	Current Situation
<b>Sold Banks</b>		
Sümerbank	22 December 1999	Merged Sümerbank was sold to the OYAK Group on 10 August 2001. Merger of Sümerbank and Oyakbank was approved as of 11 January 2002.
Egebank	22 December 1999	Merged into Sümerbank on 26 January 2001.
Yurtbank	22 December 1999	Merged into Sümerbank on 26 January 2001.
Yasarbank	22 December 1999	Merged into Sümerbank on 26 January 2001.
Bank Kapital	22 October 2000	Merged into Sümerbank on 26 January 2001.
Ulusal Bank	22 February 2001	Merged into Sümerbank on 26 January 2001.
Bank Ekspres	22 December 1998	Sold to the Tekfen Holding on 30 June 2001. Transfer was completed on 10 October 2001 and operating as Tekfenbank A.S.
Demirbank	6 December 2000	Sold to HSBC on 10 September 2001. Transfer was completed on 30 October 2001.
Sitebank	9 July 2001	Sold to Novabank on 11 January 2002. Transfer was completed on 16 January 2002.
<b>License withdrawals</b>		
Etibank <sup>1</sup>	27 October 2000	Banking and deposit taking license was revoked as of 28 December 2001.
Interbank	7 January 1999	Merged into Etibank on 15 June 2001.
Esbank	22 December 1999	Merged into Etibank on 15 June 2001.
Iktisat Bank <sup>1</sup>	15 March 2001	Banking and deposit taking license was revoked as of 7 December 2001
Kentbank <sup>1</sup>	9 July 2001	Banking and deposit taking license was revoked as of 28 December 2001.
<b>Banks that remain under SDIF</b>		
T. Ticaret Bank		Banking and deposit taking license was revoked as of 1 July 2001. The decision by the State Council that accepted the objection for the liquidation has been rejected.
Tarisbank		Sale process started in 30 <sup>th</sup> May 2002. However the investors interested have not been considered sufficient financially
Bayindirbank	9 July 2001	To be structured as a bridge bank that will focus on asset management.
EGS Bank	9 July 2001	Banking and deposit taking license was revoked as of 18 January 2002. Merged into Bayindirbank.
Toprakbank	30 November 2001	Sale process started on 31 January 2002. The proposals of foreign and domestic investors have been considered insufficient. Sale process started again on 13 May 2002. The offer made by one of the investors is still under examination.
Pamukbank	19 June 2002	Sale process started in 29 June 2002. The deadline for applications was 19 July 2002. The deadline for the offers is 4 October 2002.

1. Have been decided to be merged into Bayindirbank as of 4 April 2002.

Source: BRSA.

## **Strengthening of private banks**

### *Voluntary debt swap operation*

Around the time of the public bank securitisation operation, Treasury arranged for a voluntary swap operation with the private banks, whereby short-dated TL-denominated government bond holdings were exchanged for 3 and 5-year FX-denominated instruments. The objective was to reduce the 2001 roll-over burden of Treasury while simultaneously helping banks to close their open positions. With their acquisition of dollar-indexed securities, the private banks' on-balance sheet FX open position was reduced from \$8.4 billion at end-2000 to \$1.5 billion at end-2001.<sup>77</sup> Public debt management was also geared to reduction of private banks' interest rate risk exposures *via* issuance of more TL floating rate, government bonds (see Chapter II).

With the exchange of long-dated FX-indexed and floating-rate TL debt for banks' holdings of old-style debt, risk exposures were shifted to the Treasury. With similar developments observed for the state and SDIF banks above, this is another way of socialising potential losses. While there may have been no choice but to take these actions to stem systemic distress, it could be dangerous to go a much longer way down this road. Other emerging countries have shown that excessive government concentrations in FX-linked securities provoked currency crises independently of fragile banking systems, as fears of devaluation immediately raised questions about the debt servicing ability of the government. Annex II shows that the currency mix for Turkish public debt arising from the securitisations is already unstable: the debt simulations suggest that small differences in exchange rate assumption have major implications for borrowing need – it is the government that now has the open position. However, under a regime of flexible exchange rates, free market variability of the exchange rate should act as a self-disciplining device.

### *Recapitalisation scheme*

After the crisis, it was evident that the private bank risk management systems were inadequate and that the capital base was weak. All private banks found to be adversely affected by the crisis were required to submit recapitalisation and restructuring plans in the form of letters to the BRSA. Although these plans were confidential, BRSA followed closely their viability and implementation. Five banks which could not fulfil their commitments were subsequently taken under the administration of the SDIF, and two banks whose plans were not considered credible were closed. Shareholders were forced to take losses.<sup>78</sup>

The plans to restore CARs *via* shareholder equity injections were largely realised by the end-2001 deadline (\$1.3 billion out of \$1.4 billion committed). In the meantime, a shift of strategy was taking place as it was becoming clear that the

deeper than expected economic recession was reducing asset quality as well as the value of loan collateral. As full provisioning requirements would be put into effect they would lead to a deterioration in profitability and of the CAR itself (since provisions are a charge and retained profits are counted in capital). But with limited scope for raising new capital from domestic and foreign investors, efforts to restore the risk-adjusted CAR could lead to further loan contractions and so deepen the economic crisis, in a vicious cycle. Real loan volumes in fact contracted sharply, amplifying the crisis. This was felt to justify the use of public money, and it was estimated that \$4 billion in budget support would be needed for the purpose of private bank recapitalisation. It was moreover strongly suspected that NPLs were being underreported despite new guidelines for loan loss classifications: according to bank data, the NPL ratio of private banks actually fell in 2001 despite a nearly 10 per cent contraction in GNP. Thus, a much clearer picture of the NPL problem coming out of the crisis was needed in order to assess capital needs. Accordingly, the government announced a new plan to recapitalise the banks featuring more rigorous accounting procedures and the possible use of public money (Box 10).

The plan has been subject to some delay, changes and uncertainties, largely reflecting the need to adapt to evolving circumstances, yet a remarkable amount was achieved in a relatively short period of time. Indeed, prompt action is one of the most essential ingredients of all bank restructuring (Dziobek and Pazarbasioglu, 1997). In addition, crisis resolution demands a complete and systemic evaluation of the size of the problem and its causes (OECD, 2002a). The rigorous triple-check auditing of the banks was thus a chance to improve transparency and enhance confidence in the banking sector.<sup>79</sup> The modest overall need for further capital injections that was revealed by the audits can be reconciled with the initial estimate of \$4 billion by the facts that: *a*) around \$2 billion had in the meanwhile been raised by the banks themselves (\$1.3 billion in 2001 and a further \$640 million in 2002), and *b*) one large insolvent bank (Pamukbank) with an estimated capital gap of \$2 billion was taken out of the system as a result of its audit. The lack of information on individual banks, or at a minimum banking sub-groups, raised the possibility that strong capital positions in some larger banks (*e.g.*, those benefiting disproportionately from inflationary adjustments) mask weaker positions among the numerous smaller banks within the overall average.<sup>80</sup> On the other hand, the announced NPL ratio of 25 per cent for the audited banks has boosted credibility of the process, as it seems consistent with those reached in other crises (Table 22), and with earlier market estimates for Turkish banks. It is likewise encouraging that the BRSA has moved so decisively against the problem of group loans by way of the post-audit take-over. The solution of divestiture and discipline of the controlling group is appropriate.

The audit results reveal that incentives in the plan successfully maximised the contribution by bank owners so as to limit moral hazards – another fea-

### Box 10. The bank capital strengthening programme

In February 2002, the government announced a new plan to recapitalise banks after a strict 3-level audit of the 26 major private deposit money banks. The first two audits would be by major audit firms (the first chosen by the bank itself and the second by the BRSA), and the third by the BRSA, with emphasis given to an examination of the loan book and related (and third) party exposures. Prior to the audit, all banks would have to switch to inflation adjusted financial statements, to be prepared on both consolidated and non-consolidated basis, and recognising all past and potential loan losses. The audit would provide a snapshot of the situation as of 31 December 2001. The next phase of the plan involved the possible use of public money but with incentives to maximise shareholders' contributions, as well as to merge with other banks, since accepting public resources would entail also accepting a government representative, with power of veto, on the board and/or reputational loss. The plan furthermore sought to accelerate new lending by mandating that a portion of any public funds be on-lent to non-related parties (for further details see BRSA, 2002a).

The auditing stage was completed in mid-June 2002, against the initial target date of mid-May. At the same time, the 7<sup>th</sup> largest private bank, Pamukbank, was taken over as the audit had ascertained that it suffered extensive losses from non-performing credits to its controlling shareholder, the Cukurova group; the latter, moreover, was henceforth prohibited from owning more than 10 per cent of any bank in Turkey, in accordance with provisions established in the Banks Act.<sup>1</sup> The audit results showed that, apart from more than \$2 billion capital need of Pamukbank (to be met by the SDIF), capital needs as of end 2001 were under \$900 million (Table 25). Of this, a large part was already covered by measures taken by banks, leaving a gap of only about \$150 million.

The capital need may seem low in view of the severity of the asset price and credit quality shocks sustained by the sector, not to mention the costs of immediate full provisioning. Indeed, non-performing loans of the audited banks reached 25 per cent after the audit, compared with 6.5 per cent before (Table 26). However, it needs to be recalled that the private banks hardest hit by the crisis, with combined capital needs of \$10-15 billion, had already been intervened by the SDIF in 2001. Moreover, several factors helped to protect banks' capital position against further deterioration. *First*, given that Turkish banks traditionally relied on collateral to secure the return of credit rather taking into account project assessment and expected repayment capacity, almost  $\frac{3}{4}$  of the increase in non-performing loans was covered by the high collateral values accepted by the audit, implying only a moderate additional provisioning need, hence only a small deduction from bank profits and capital. *Second*, the acceptance of inflationary accounting for purposes of the audit added around \$3 billion to the value of bank capital, and around 7 percentage points to the CAR, via revaluation of TL-denominated non-monetary assets and hence a stock adjustment of profits and capital.<sup>2</sup> *Third*, the use of asset risk-weighting under the new regulations, along with the large pre-existing share of securities receiving a zero credit risk weight, cut the denominator of the CAR by almost 50 per cent compared with total unweighted

Box 10. **The bank capital strengthening programme** (cont.)

assets. *Fourth*, the transfer of exchange risk to the government, plus some recovery of asset prices since November 2001, endogenously restored part of capital values. The resulting aggregate CAR for the audited banks was 14.8 per cent, well above the statutory minimum (Table 27).

1. Pamukbank had in fact been non-viable for the past two years, as the regulators had been forbearing while the various rehabilitation attempts proposed by the bank failed (see BRSA, 2002b). Furthermore, as Yapi Kredi Bank, one of the top 4 banks in Turkey, was controlled by the same group, all of the group's shareholder rights in YKB would pass to the BRSA. It also turned out that 40 per cent of Yapi Kredi shares were pledged to Pamukbank as collateral for group companies' loans, which could ultimately pass to SDIF under foreclosure proceedings. (Yapi Kredi had one week earlier applied for permission to take over Pamukbank). As the announcement on the bank take-over occurred in the context of an already adverse movement in interest rates due to concerns about Prime Minister Ecevit's health, there was a risk of market nervousness, further pressure on interest rates, and perhaps even panic-driven deposit withdrawals. Thus, the Central Bank announced special facilities to provide liquidity to banks. It was also announced that Yapi Kredi had a capital adequacy ratio of 10 per cent and was in no danger of being taken over by the BRSA.
2. Annex VII shows that private banks are substantial losers from inflation, as most liabilities are in FX. However, the BRSA (2002a) has pointed out that the main beneficiaries of the inflation adjustment were the larger banks, mostly with already healthy capital adequacy ratios. Thus, the inflation adjustment cannot be said to have been a major factor in bringing banks to the minimum CAR of 8 per cent.

Table 25. **Summary results of private bank audit**<sup>1</sup>  
(\$ million)

Total capital need assessed as of 31/12/01	866
Measures taken by banks	635
Cash capital increase	106
Collection of NPLs	482
Change in market risk <sup>2</sup>	47
Revaluation of securities in 2002	85
Remaining capital need	146

1. Excludes Pamukbank, with assessed capital needs of \$2.1 billion.

2. Reflects impact of debt swap operation.

Source: BRSA (2002a).

Table 26. **Balance sheet impacts of the bank audit**  
(December 2001, TL trillion)

	Pre-audit (without inflation accounting)	Pre-audit (with inflation accounting)	Post-audit (with inflation accounting)
<b>Assets</b>			
Cash, due from banks, interbank market, CBRT	20 829	20 829	19 777
Securities portfolio	28 546	28 546	28 344
Loans (I II)	29 182	29 182	24 032
Non-performing loans (III IV V)	2 224	2 334	7 821
(less) Loan loss provisions	(1 0 88)	(1 0 88)	(2 5 83)
Subsidiaries affiliates and fixed assets		11 468	10 942
<i>of which: TL dominated</i>	5 384	..	9 887
Other assets	14 423	14 423	13 785
<b>Total</b>	<b>100 994</b>	<b>105 692</b>	<b>102 119</b>
<i>Memo items:</i>			
NPL ratio	7%	7%	25%
Value of loan collateral	35 786	35 786	30 385
<b>Liabilities</b>			
Deposits	72 751	72 751	72 752
Interbank money market	711	711	711
Credits received	12 677	12 677	12 677
Other liabilities	5 511	5 511	5 403
Own funds	9 613	14 042	10 574
Paid-up capital	5 248	5 248	5 248
Reserves	957	957	957
Revaluation funds	2 168	18	474
Capital reserve	0	12 643	13 564
Valuation difference	0	1 143	973
Profit / loss	1 240	-5 967	-10 641
<b>Total</b>	<b>100 994</b>	<b>105 692</b>	<b>102 119</b>

Source: BRSA (2002a).

ture of successful bank resolutions (OECD, 2002a). Yet the anticipated incentives for mergers and acquisitions largely failed to work.<sup>81</sup> The plan also included incentives to credit expansion, not only by shoring up bank capital positions but also by mandated on-lending of public capital injections to the private sector. The latter channel was flawed as it could have given rise to unproductive credits in the presence of credit rationing, but in any case irrelevant, as now there will be no need for public money. Furthermore, even though capital adequacy ratios have been restored in a regulatory sense, banks may not yet be in a position to regain profitability and resume lending. As long as the economy stays weak and extending new credit looks risky, banks will want to protect their core capital by holding large amounts of cash.<sup>82</sup> And although banks are now fully provisioned against non-performing loans, in the event of default collateral values may be difficult to

Table 27. **Capital adequacy ratio of the audited banks**  
(December 2001, TL trillion)

	Pre-audit (without inflation accounting)	Pre-audit (with inflation accounting)	Post-audit (with inflation accounting)
I. Core capital	7 445	12 858	9 128
Paid-up capital	5 248	5 248	5 248
Reserves	950	2 848	3 775
Capital reserve due to inflation correction	0	10 726	10 719
Profit / loss	1 240	-5 964	-10 641
II. Supplementary capital	2 473	2 451	1 739
General loan provision	115	886	213
Revaluation funds	1 047	64	492
Subordinated loans	3	8	8
Securities value increase fund	1 121	1 160	955
Free provision	187	333	71
III. Third-tier capital	0	0	0
IV. Capital subject to the ratio	9 890	14 579	10 858
V. Values reduced from the capital	2 242	2 851	2 731
VI. Own funds (IV-V)	7 648	11 728	8 128
VII. Risk-weighted assets	53 796	54 999	54 977
0% risk-weighted	0	0	0
20% risk-weighted	6 260	4 112	3 737
50% risk-weighted	6 722	6 390	6 028
100% risk-weighted	34 288	37 971	37 308
Amount subject to market risk	6 526	6 526	7 904
<i>Memorandum items (percentages):</i>			
Capital adequacy ratio (VI/VII)	14.2	21.3	14.8
Tier 2 capital / Tier 1 capital	33.2	19.1	19.0
Tier 2 capital / Risk weighted assets	13.8	23.3	16.6

Source: BRSA (2002a).

recover, given inefficient bankruptcy procedures. With the liquidity squeeze slowly lifting,<sup>83</sup> and banks continuing to reap high returns from their government securities portfolios, at this point a major constraint on their ability to return to profitability may be the lack of health of the corporate sector. Indeed, non-performing loans continue to rise, raising the risk of erosion of banks' capital despite the momentum gained on banking reform.<sup>84</sup>

### **Co-ordination of corporate and bank restructuring**

Close links between banks and their corporate clients, and often government, has been a common feature of crisis in developing and transition economies. In some cases, financial institutions were controlled by the corporations (*e.g.*, chaebol in Korea), as in Turkey, making joint rehabilitation of banks and



enterprises imperative. The failure to co-ordinate restructuring of financial institutions and their corporate clients often resulted in the need for repeated recapitalisations, thereby raising total restructuring costs (Claessens, 1998). Another key characteristic of successful bank restructuring has been the principle of loan workout, *i.e.* foreclosure or asset sales to recover some of the costs of bank restructuring and to send signals to delinquent borrowers.<sup>85</sup> One promising way of integrating these two objectives (adopted *inter alia* by the transition countries) has been to provide voluntary debt relief to borrowers by engaging in enterprise restructuring. This was especially relevant where bankruptcy proceedings were in effect liquidation procedures, so that pursuit of loan restructuring *via* the formal legal framework would be slow, inefficient, and excessively costly (OECD 2002a).

In this vein, the Banks Association of Turkey together with the main business groups and under the supervision of the authorities, have devised the Istanbul Approach (a variant of the London Approach) to voluntary restructurings of corporate debt with financial institutions.<sup>86</sup> The aim is to ease the credit crunch and put the economy back on a growth path. The plan was under negotiation for more than a year before a framework agreement was finally signed on 23 May 2002, although the foreign banks did not participate. Under the plan, a consortium of lender banks, which will be created on the basis of every firm, will be empowered to require the firm to liquidate its businesses that are not related to its primary field of operations, to raise its capital, change its management structure, or list its share on the stock exchange whenever it deems necessary. In exchange, the debt of the firm will be rescheduled. The scheme mainly applies to large firms.<sup>87</sup> The Industrial Development Bank of Turkey will administer the plan, and an arbitration committee will intervene to resolve within 5 days any disputes that may arise.

The Istanbul approach has much merit in theory because of the concentration of corporate debt among a limited number of large corporate borrowers. If properly implemented, it could go a long way to resolving the NPL problem while promoting corporate restructuring without triggering massive bankruptcies. However, there appear to be a number of problems with this approach in practice. Speed of action is of the essence in recovering NPLs, and precious time has already been lost during the lengthy negotiations. It will also be important that political influence be absent from the process, as it would only operate to keep nonviable firms afloat. A too-big-to-fail policy for firms, as for banks, would cause continued risk-taking in the system (Mishkin, 2001). Accounting issues are also critical. Whereas the banks have been required to switch to international accounting standards this year, corporate accounting reform has been delayed to next year, making it difficult to get an accurate picture of the firms' financial health.

Furthermore, the approach is weakened by the fact that not all banks have signed up – the foreign banks have abstained. If a bank that does not partici-

pate in the agreement pursues legal action against a defaulting debtor to recover collateral, then all the banks who participate in the out-of-court rehabilitation would suffer losses.<sup>88</sup> The initiative may need legal support to be effective. The legal system makes attaching collateral a very costly and time-consuming process, reducing its effectiveness to limit bank losses (and limit adverse selection). Similarly, bankruptcy procedures are highly inefficient and involve long court processes, delaying recovery from crisis and release of information about the true situation of delinquent debtors. For this reason, implementing the bankruptcy reform (now in the drafting stages) without further delay is a major condition of the World Bank Loan in support of the debt workouts.<sup>89</sup> The Istanbul Approach also poses a dilemma to banks in that the moment that a loan is restructured, the bank has to declare it as non-performing and provision accordingly, reducing bank capital. Finally, it must be considered that the restructured loans will carry lengthened maturities. On top of the debt swap, this could imply a further increase in maturity mismatch as a result of restructuring, as was the case for the public and SDIF banks. In spite of these problems, however, the Istanbul Approach has already become operational and apparently going well: so far, 128 firms have been included in the "Framework Restructuring Programme" (FRP),<sup>90</sup> of which 28 have already restructured their debts of close to \$300 million with banks.<sup>91</sup>

The Istanbul Approach will deal only with the problem loans of large and viable corporate debtors. Hence, other arrangements, for example an asset management company (AMC), will still be needed to dispose of small and non-viable company NPLs. An AMC would serve the needs of all undercapitalised banks by purchasing non-performing assets from them. The SDIF has presented an action plan to establish an AMC in Turkey by September 2002, although it will probably take longer for it to become fully operational, the main problem being that financing has to be found in the private sector.<sup>92</sup> It also will need to acquire sufficient human capital in order to adequately price the NPLs before they deteriorate beyond rescue – a major task. Exchanging a portion of loans to heavily indebted but viable companies for shares would be an alternative avenue for undercapitalised banks. This has been successfully used in debt work outs elsewhere and could help to deepen capital markets if banks are required to sell the shares to the public once the company is again profitable. In cases of commercial real estate assets, this could help jump-start the secondary market in mortgage securities.<sup>93</sup>

## **Main issues ahead**

This section briefly addresses some of issues likely to shape the agenda for follow-up to the recent actions taken. It first touches upon two important challenges for the medium run: the issue of bank transition if the current programme achieves a low inflation environment, and financial market development. It con-

cludes with a brief summary of the main conclusions and policy recommendations that have been developed in the chapter.

### ***Banking sector transition to low inflation***

It is worth exploring the factors that are likely to come into play on the assumption that bank restructuring in Turkey takes place in an environment of disinflation. This would bring windfall profits to the private banks, outweighing the loss of float income (see Annex VII). It would also encourage reverse currency substitution to set in, with beneficial impacts on domestic real interest rates and credit demand. It is crucial that banks use any such windfall as a cushion to start restructuring of operations in advance of the negative longer run profitability effects of disinflation, arising from lower risk premia on government debt and elimination of inflationary profits, and that credit quality not be allowed to suffer from a too rapid expansion of volumes, once demand picks up. In 2000, the opposite happened. The disinflation windfall was largely taxed away, and instead of restructuring, banks sought to exploit new high-yield, high-risk profit opportunities by a sharp expansion of asset price and credit risk exposures. Although recurrence of such a scenario is unlikely, at least while banks display high risk aversion, extreme vigilance by the regulator will be required during the entire transition to low inflation and restructured banking operations.

In the medium term, given the expectation that the burden of the public debt will abate, high real interest rates will fall back to reasonable levels, and the banking sector will be forced to shift its emphasis from public debt financing to credit extension. They will then have to worry about cultivating real banking relationships, managing assets and liabilities, controlling operating costs, and finding sustainable sources of income, such as lending and fee income. Just as in most normal banking environments, government securities will be held primarily for liquidity purposes and most income will derive from fee and loan income. Currently, however, banks have weakened skills to select good borrowers and projects, and to monitor them.<sup>94</sup> The ability to generate fee income is also not highly developed. In such circumstances, banks might be prone to fall back on lending to related parties or to otherwise take excessive risks, as was observed in the 2000 boom and in other countries following disinflation.

Hence, banks are now being encouraged to increase their internal control systems by greater transparency and external auditing (Box 8), but the safeguards afforded by these techniques will always be limited to the extent that connected lending remains important.<sup>95</sup> Indeed, if banks are made solvent and given access to new funds in the absence of measures to address weaknesses in management and internal governance, they may have less incentive to work out loans and to take losses, choosing instead to roll over non-performing loans to corporate clients. Similarly, if corporate clients have access to new funds from their banks, they may have lit-

tle incentives to restructure (OECD, 2002a). This only reinforces the importance of enforcing the direct regulations on connected lending, as well as for instituting strong bankruptcy procedures to allow efficient restructuring of banks and corporations. It may also be necessary to go farther and impose a separation between financing activities and corporate activities in ownership and control structures. According to Mishkin (2001), "preventing commercial enterprises from owning financial institutions is crucial for promoting financial stability in emerging markets (p. 27)."

Achieving economies of scale will also be important under the new, more competitive bank environment. Table 28 is suggestive of the challenges involved for different bank groups. The top part indicates that the state banks are the least profitable and the least efficient while non-performing loans are a bigger problem, as may be expected. On the other hand, state banks reveal a comparative advantage in earning income from "core" banking activities, which should be built upon. Foreign banks, by contrast, are the most profitable and enjoy the highest profits from arbitrage gains, with domestic private banks close behind, but the former are less engaged in credit activities. Paradoxically, foreign banks are more adept at earning fee income, suggesting greater attention to customer service. The bottom half of the table suggests that some of these differences may be due to size. Small banks, including the small-scale foreign banks, have been the most profitable since lucrative financial speculation activities did not require economies of scale. By the same token, small banks were able to tolerate low efficiency and high overhead costs. The implications for the future are that most of the smaller banks would lose their competitive power in the new environment, implying the need for liquidation or merger. The number of banks would need to fall further. Foreign banks, similarly, would need to grow in size to be able to compete with the larger domestic banks in retail banking through mergers and acquisitions. Conversely, public bank scale is probably too big and breaking up these banks in advance of privatisation may be warranted, while mergers involving already large private banks could be counter-efficient as well as potentially inimical to competition.

In order to prepare the sector for an environment where medium sized banks extend credits to the real sector and earn moderate levels of profits, a new regulation on banking mergers and acquisitions was passed and tax advantages provided (Box 8). Nonetheless, private banks appear to have little interest in merging under current conditions. On the one hand, they are afraid of selling their banks for a low value after the crisis; on the other hand, mergers may mean that families will lose control over their small sized banks. It may not be until macro-economic stabilisation becomes reality, and lowers profits, that banks may be convinced to merge. In this context, mergers or acquisitions involving foreign banks should be seen as a key opportunity to strengthen the banking system. Accelerated foreign entry would help to correct ownership structures, stimulate competition, and enable diffusion of new risk management techniques and best practices throughout the sector, as indeed would FDI more generally in the economy

Table 28. **Performance characteristics of Turkish banks**  
(1999)

	Total Assets <sup>1</sup>	"Core banking" net interest income <sup>2</sup>	Value added <sup>3</sup>	Net non-interest income <sup>4</sup>	Profits before tax <sup>4</sup>	Overhead costs <sup>1</sup>	Non-performing loans <sup>4</sup>	Change in credit <sup>4</sup>	Off-balance sheet items <sup>4</sup>
<b>By ownership:</b>									
Private	46.1	-2.5	17.3	-0.0	6.4	4.8	0.3	13.3	123.2
Public	32.5	-0.1	5.8	0.7	2.1	3.4	0.9	8.0	32.4
Foreign	4.9	-3.8	9.5	2.8	8.5	4.9	0.1	5.9	222.8
<b>By size (asset/GNP ratio):</b>									
Over 1%	60.7	-0.6	13.2	-0.7	4.3	4.0	0.6	10.9	52.7
0.5 to 1%	14.0	-5.1	10.4	1.2	5.8	4.8	0.2	10.5	201.9
0.1 to 0.5 %	1.3	-4.4	12.7	2.0	6.5	4.9	0.6	10.5	199.7
Less than 0.1%	1.2	4.3	4.3	-0.9	8.1	7.3	0.4	10.3	228.8

1. As per cent of GNP.

2. Net interest income excluding that from securities portfolio as per cent of total assets.

3. Total revenues as per cent of total expenditures minus 100.

4. As per cent of total assets.

Source: Adapted from Alper *et al.* (2001).

(Annex IX). Moreover, foreign banks can potentially help to insulate the banking system from domestic shocks, having more diversified portfolios and globalised access to funding sources.<sup>96</sup>

### **Financial market development**

Once the banking crisis has been overcome, and banks can see themselves on a transition path to low inflation, it will be critical to nurture Turkey's future growth potential in order to reduce the burden of the public debt and to raise living standards. Financial markets have a major role to play in this regard. The OECD Growth Study has confirmed the relationship between financial market development, investment, efficiency, and growth. Chronic macroeconomic instability has contributed importantly to keeping markets immature. Turkey should therefore strive to realise the vision of fuller capital market development by attaining the objectives of the macroeconomic stabilisation programme and even going beyond them, and by pursuing capital market reforms in tandem with banking reforms.

Properly functioning intermediaries could not only provide finance but also help in evaluating business plans, especially for SMEs. Long-run bank relationships are probably the best way to overcome asymmetric information problems that currently hamper the functioning of financial markets. A dynamic SME sector, in turn, is the only real safety net for workers displaced by reforms. Capital market development could mobilise further funding, especially for firms that grow to the size enabling stock market entry. Larger corporations may prefer direct financing by the issue of corporate bonds once limits on connected lending are effectively enforced and/or they are divested of their house banks. The greater transparency that normally comes with capital market development would help to ensure better monitoring of risks and corporate governance. Developed capital markets would also help to spread risks more diffusely, reducing the cost of capital. Insurance and mortgage markets will have a special role to play in managing risk, especially earthquake risk, and even in helping to establish a normal housing market to replace the haphazard pattern of *gecekondu* urban development. Once inflation is durably reduced, planning horizons will be extended and both the demand and supply of longer term instruments needed to feed such markets would be forthcoming. Annex VIII looks at requirements for the development of non-bank financial intermediaries, such as insurance and pension funds, key to the future growth of capital markets. Development of the secondary market for government securities will also be important, and it has been given a significant push by the recent introduction of a primary dealership system (Chapter II).

Capital market development would imply positive externalities for the banking sector as well, notably by allowing banks to develop hedging instruments for risk, such as forward transactions, swaps and other derivatives. Indeed, the Capital Markets Board has just implemented measures to establish a forward foreign

exchange market in Turkey. Commercial paper and bond markets could also provide banks with liquid asset alternatives to government securities, and impart liquidity to markets. Moreover, credit risks will come to matter more after bank restructuring, and maturity mismatch will be larger (though shocks should be smaller), so that securitisation could provide insulation against the cycle.<sup>97</sup> It is notable that banks are currently the owners of most non-bank financial institutions. Whether or not this implies potential conflicts of interest, or has implications for optimal regulation, is an issue that should be explored (Annex VIII). At the same time, research shows that restrictions should not be placed on the range of bank activities, as diversification of income sources seems to be an important determinant of banks' stability and their ability to withstand shocks (Barth *et al.*, 2001).

### Résumé

Since May 2001 a sea-change has occurred in the banking regulatory and supervisory situation in Turkey. Regulations have been brought up to EU standards, and tax and accounting distortions reduced or eliminated. The banking system is now being effectively supervised by a competent authority. This progress needs to be consolidated by further efforts on the part of the authorities. The regulations have been established in law but where they are to be proven is in their enforcement, namely in ongoing prompt corrective actions by the BRSA. This may require eventual separation of the BRSA and SDIF to avoid future conflicts of interest. Urgent actions have to be undertaken in order to privatise the public banks. This is because incentives have been corrected in the sector, but public ownership continues to distort the response to those incentives. Moreover, the reforms on duty losses and independent management themselves are more easily reversible *via* the political process if the banks were to remain in public hands.

The banking system has been cleared of deadwood, and its losses capitalised, though future profitability remains an issue. Banks' "own" risk has been sharply reduced. FX open positions have been shifted to government and maintained at low levels in the context of floating exchange rates and enhanced risk management. Credit risk has been downsized as the NPL hit has been taken, and a loan workout process is designed to limit further loan deterioration. However, with higher fiscal crowding out, prudent banking still means lending to the government. Hence, a main risk to banks is sovereign risk on their vast holdings of government securities. Such risk will not materialise if the stabilisation programme proceeds according to plan, but if the programme succeeds, most of the smaller banks will become unprofitable. Thus further financial restructuring to reduce sovereign risk exposure, especially in state banks, and further operational restructuring toward traditional banking, especially in smaller banks, are warranted.

Box 11 proposes a banking system policy agenda to support the above stated goals, drawing on the main conclusions reached in this chapter.

**Box 11. The policy agenda in banking**

Looking forward, the following policy programme would seem essential in order to complete the process of banking system restructuring:

1. Pursue diligently the stabilisation programme in order to provide the proper *macroeconomic context* for undistorted banking incentives – it is the only real way to address the problems of maturity mismatch and open positions in private banks and political influence in public banks, and excessive holdings of government securities by all the banks;
2. Eliminate moral hazards in the banking system by imposing limits on *deposit insurance* and emphasising the responsibility of bank managers and shareholders in bad asset resolution schemes;
3. Continue to improve *banking regulation and supervision* as follows: *i)* safeguard BRSA independence and accountability; *ii)* close remaining regulatory loopholes, especially as regards lending to related parties, and speed up the transition to compliance with reduced limits on such lending; *iii)* complete the shift to better accounting transparency; especially regarding non-performing loans and provisions; *iv)* place emphasis on proper risk management techniques in supervised institutions; *v)* attend to strong prompt corrective actions both during and after financial restructuring, with eventual separation of deposit insurance from bank regulation functions;
4. Implement elimination of remaining *tax distortions* by equal treatment of income from government securities and traditional bank contracts (loans and deposits), ending of all tax and regulatory forbearance on repos, removal of remaining financial transactions taxes, and allowance of inflation accounting for tax purposes;
5. Foster a change in *corporate culture* by splitting financial from industrial group ownership, while ensuring that there are no barriers to foreign take-overs of domestic banks during the bank resolution process; accelerate governance and accounting reforms in the corporate sector to complement bank reforms; regulate effectively related parties lending;
6. Assist the *loan work-out process* (properly structured arrangements to absorb losses) envisaged by the Istanbul Approach by urgently implementing a bankruptcy reform, allowing non-viable firms to fail, and speeding the establishment of a fully functional AMC;
7. Promote *economies of scale* in banking by allowing the market mechanism to work, in particular by mergers and acquisitions among smaller and medium sized banks;
8. At the same time protect *banking sector competition* by scrutinising mergers involving already overly large banks and by enhanced BRSA regulatory oversight of public banks;
9. Prepare and implement a *privatisation plan for all the public banks* which satisfactorily resolves the problem of market failures and pays attention to corporate governance issues;
10. Take actions to *develop capital markets e.g.* by: *i)* establishing mortgage based securities market and secondary markets for other illiquid assets to improve bank liquidity management; *ii)* reviewing conflicts of interest issues arising from bank ownership of most non-bank intermediaries, such as pension funds and insurance companies.



## Notes

1. When the \$16 billion front-loaded package was approved in February 2002, Turkey became the then-largest debtor ever to the IMF.
2. One reason may be that Turkish tourism depends little on the US market.
3. See Gunduz (2001).
4. The Central Bank does not endorse this measure.
5. According to the State Institute of Statistics, the year-on-year decrease in manufacturing hourly real wage was 16 per cent and 4.2 per cent in the first and second quarters of 2002, respectively, compared with around 20 per cent in the last quarter of 2001.
6. The projections are provisional as of the time of writing and will be finalised by December.
7. Since 1990, Turkey has steadily climbed the ranks of high inflation countries, so that in 2001 it was among the top five with an annual inflation of 54.4 per cent, with only Angola, Belarus, the Democratic Republic of Congo and Zimbabwe higher (IMF, 2002a).
8. In contrast, the boom in capital inflows in Mexico lasted several years and inflation had fallen to single digits by the time the bust came in late 1994. The Brazilian programme was first launched in 1994 and inflation had come down to 6 per cent before the collapse in 1999. Similarly, the Russian crawling peg programme of 1995 resulted in a decline in inflation from three-digit rates to 20 per cent before the outbreak of the crisis in August 1998. For the comparison, see Akyuz and Boratav (2002).
9. See Alper (2001) and Serdengeçti (2001).
10. Total gross debt rose from around 60 per cent of GNP to nearly 120 per cent. The domestic component rose from about 30 per cent of GDP to close to 70 per cent.
11. On the SEE side, measures include: *i*) a rise in SEEs' tariffs and prices in line with their indexed costs; *ii*) a reduction in SEEs' operating expenses in real terms; *iii*) a cut in the sugar beet quotas from 12.5 to 11.5 million tons; *iv*) limiting the volume of support purchases of cereals and offloading additional grain stocks; *v*) keeping agriculture support price increases in 2001 to at most targeted inflation; *vi*) maintaining the average price of electricity sold by TEAS at 4.5 US cents/kwh; and *vii*) replacing up to a maximum of 15 per cent of retiring personnel in the SEEs and in Turk Telekom.
12. In August 2001, withholding tax rates on repo interest income were further increased by 4 percentage points while the rates on deposit interest income were differentiated according to maturities.
13. Consolidated public sector definition includes consolidated central government, EBFs, SEEs, local authorities, social security institutions, unemployment insurance fund.

14. The Executive Board of the IMF approved a three-year Stand-by credit of \$16 billion. Turkey had immediate access to \$9.1 billion in February. The total amount of funds available are \$14 billion for the year 2002, while the remaining \$2 billion will be made available in 2003-2004. Furthermore, \$6.1 billion of the total was used to repay outstanding resources under the Supplemental Reserve Facility, representing a swap of a short-term expensive loan with cheaper long-term funds.
15. The transfer of profits from the Central Bank contributes 8.5 per cent of total budget revenues by June 2002 but is not counted in the primary balance.
16. Turkey government (2002c).
17. The shift was more drastic in the composition of cash debt where the share of fixed-rate notes more than halved and the combined share of foreign exchange denominated or indexed bonds increased from 4 per cent in 2001 to 35 per cent in 2002.
18. For example, a real depreciation of 10 per cent compared with the baseline, holding domestic real interest rates constant, would require additional borrowing of 5.5 per cent of GDP. Alternatively, a rise in real domestic interest rates by 10 percentage points, at a constant real exchange rate, would burden the total domestic debt by a further 3.5 per cent of GDP (Annex II).
19. Initially, the IMF credits appear as an increase in Central Bank international reserves offset by an increase in liability to the IMF, with no change in net international reserves (NIR). Subsequently, as Treasury starts to use this credit, this decreases NIR, and therefore NFA, while increasing NDA as Treasury draws down its deposits with the Central Bank.
20. Base money is defined as currency issued plus the banking sector's deposits in Turkish lira with the Central Bank. Net foreign assets (NFA) of the Central Bank are defined as the sum of the net international reserves (NIR) of the Central Bank, medium-term and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding Central Bank's net lending to domestic banks in foreign exchange). Net domestic assets (NDA) of the Central Bank are defined as base money less the NFA valued in Turkish lira at end-month actual exchange rates. For more details, see Monetary Policy Reports published in 2002 by the Central Bank of Turkey.
21. Metin (1998) finds a significant link from higher budget deficits to higher inflation for 1948-1985 period, while Akcay *et al.* (1996) find a weakened link from budget deficits and money growth to inflation in the post-1985 bond-financing era highlighting the increasingly inertial nature of inflation. Analysing the 1970-2000 period, Akcay *et al.* (2001) argue that changes in the consolidated budget deficit have no permanent effect on inflation.
22. Alper and Ucer (1998).
23. Central Bank of Turkey (2002a).
24. Turkey government (2001a).
25. The Central Bank cut short-term rates in February, March, April and August 2002 totaling 1 300 basis points throughout the period.
26. Liquidity requirements can be met by averaging over the holding period and are set for all deposit types where can be met with a variety of different instruments. However, reserve requirements are subject to partial averaging and shorter holding periods which can be met with limited number of instruments.

27. The interbank reference rate TRLIBOR (Turkish lira interbank offer rate) was introduced on August 2002.
28. Central Bank of Turkey (2002a).
29. See, for example, Levine, Loayza and Beck (2000).
30. Foreign banks have focussed on trade credits, interbank lending, and financial and derivatives trading, for the most part refraining from competing with domestic banks in lending and investment activity. See Bossone (1999), who adds: "Thus, much of the expected benefits in terms of higher imported efficiency standards and expanded business opportunities have not materialised."
31. See OECD(2001a), Annex III, on how seignorage revenue for both banks and the Central Bank was maintained despite high inflation, preventing high inflation from degenerating into hyperinflation as elsewhere.
32. See Isik and Hassan (2002) on scale economies in the Turkish banking sector.
33. "Ponzi-like" debt dynamics have likewise impacted on the government debt, even though until 2001 it was not particularly high in terms of GDP. Interest payments on domestic debt as a ratio of net new domestic borrowing was close to 100 per cent during the 1990s, and rose above 100 per cent in the early 2000s. See Yeldan and Ertugrul (2002).
34. The strategy, nevertheless, had a perverse rationality: it maximised (in a myopic sense) resources for the financing of public consumption.
35. See Kaminsky, Lizondo, and Reinhart (1998).
36. There may also have been cultural reasons, for example the Islamic prohibition on interest, although there are a few Special Finance Houses operating to meet such concerns.
37. Capital flows to fund the current account deficit were likewise channelled primarily to private and public consumption, rather than productive investment. Real appreciation of the exchange rate also tended to favour consumption over investment.
38. *a)* Banks were allowed to defer tax payments on securities interest income while deducting borrowing interest costs as they were paid – whereas in the case of corporate loans, accrued interest was recorded as income and immediately subject to tax; *b)* there was no reserve requirement and, until 1998, no income tax on repo transactions – whereas full reserve requirements were applied to deposits and income tax was charged on income arising from deposit and loan interest; *c)* loan provisions were not treated as an expense item for tax purposes; *d)* the reserve requirement was much higher for TL than for FX deposits, and neither paid interest; *e)* the former 12 per cent withholding tax on government bills and bonds was reduced to 6 per cent in 1998, and eliminated in 1999.
39. Moreover, a "windfall profits tax" was imposed on banks at the start of the 2000 stabilisation programme. This greatly contributed to the fiscal effort, but international banks regarded it as a confiscation.
40. In the year prior to the November 2000 crisis, the six banks that were taken over by SDIF were all insolvent because of connected lending credits, as was a major bank taken over in 2002.
41. The concept of lending to related parties covered credits to major interests directly in and by the bank, but not to other companies, including other banks, within the same group, giving rise to serious abuses. On the other hand, even if it was common knowl-

- edge that these family banks were providing cheap credits to their connected firms, the problem was not considered to be an important one.
42. They were also involved in sophisticated financial engineering operations in international markets, using subsidiaries and special purpose vehicles, and made substantial investments abroad, but the quality of such foreign assets is unknown. The existence of such unsupervised cross-border financial transactions affected the foreign exchange liquidity of the system and added to the severity of balance of payments crises (Celasun *et al.*, 1999).
  43. The 1999 banking reform tightened regulatory limits on connected lending from 75 to 25 per cent and on open positions from 50 to 20 per cent, and introduced the consolidation principle for purposes of regulation, but did not address the most egregious accounting loopholes. The latter were not corrected until the 2001 reforms (below).
  44. The 70 per cent provisioning rule was lenient compared with the 100 per cent international standard, while rules on collateral were also generous. The reformed rules for loan classifications in 1999 were still inadequate. A major step backward was the abolition of “special follow-up” procedures, which had sought to allow banks to classify loans according to perceived potential problems (Bossone, 1999). However, the 2001 reforms (below) brought the rules on loan provisioning into line with Basel and EU standards.
  45. Co-ordination with securities market regulation was difficult as well. The Capital Markets Board has requested that “fire walls” be established between banking and non-banking activities, without success.
  46. See Alper and Onis (2002), who state: “It might be fair to argue that collecting banking regulation and budgetary financing under a unified institution constituted the single most important distortion in the system.”
  47. See Alper and Onis (2002), who add: “The lax regulatory regime may have played a role in the fact that the presence of foreign banks has been both negligible and counterproductive. In the absence of a well-regulated and closely supervised banking system (where foreign banks would contribute to efficiency and development of the financial markets), the only type of bank that was interested in entering are those typically interested in collaborating with domestic banks in sharing excess profits originating from market imperfections”. See also Ersel (2000).
  48. It is instructive that the six banks allowed entry after the 1991 elections all failed within a decade of their inception.
  49. According to Mishkin (2001), because bank panics have such potentially harmful effects, governments almost always provide an extensive safety net to prevent them. The downside is that it increases moral hazard incentives for excessive risk taking making it more likely that a financial crisis will occur. Thus, strong regulation and supervision is needed to accompany the safety net (see Annex V).
  50. Moreover, with subsidised borrowing rates set at around 50 per cent and nominal market interest rates at least double that, the incentives to use public bank loans in order to purchase repos would have presumably been strong.
  51. This was perceived by the private banks as “unfair competition” from the public banks. It caused a great deal of resentment and increased their resistance to regulation by Treasury. See Alper and Onis (2002).
  52. See BRSA (2002c).
  53. BRSA (2001a).

54. The Programmatic Financial and Public Sector Adjustment Loan II includes a major banking component (team leader: L. Raina), which continues a succession of banking reform loans since 1999.
55. Zekeriya Temizel, the former chairman of BRSA resigned on 3 March 2001. Engin Akcakoca was appointed on 17 March.
56. According to Mishkin (2001), a key problem in emerging markets and transition economies is that connected lending limits are not enforced effectively (use of dummy accounts or lack of authority of examiners to trace where funds are used). Strong efforts to increase disclosure and increased authority of bank examiners to examine the books of banks are therefore needed to root out connected lending.
57. Osmanli and Korfez Banks merged on 31 January 2001; Tekfen Yatirim and Bank Ekspres on 26 October 2001; Garanti and Osmanli on 14 December 2001; HSBC and Demirbank on 14 December 2001; Morgan Guaranty and The Chase Manhattan on 14 December 2001; Oyak Bank and Summerbank on 11 January 2002; and Sinai Yatirim Bankasi and T. Sinai Kalkinma Bankasi on 29 March 2002. See BRSA (2002c).
58. For example by 1995, Singapore has set the national requirement at 12 per cent. For other countries, even if the required minimum is 8 per cent, most of them exceed it (Goldstein and Turner, 1996).
59. See BRSA (2002a).
60. According to the BIS rules, all OECD countries' government paper is considered free of default risk. On the other hand, longer maturities of such securities are accorded market risk weights, reflecting the risk of changes in capital value in response to changes in interest rates. However, the market risk weights are significantly lower than credit risk weights.
61. See Barth, Caprio and Levine (2001). The mission statement of the BRSA, in fact, states that regulation and supervision remains only a secondary means for ensuring the soundness and efficiency of the banking sector: the primary means will be market discipline, which requires emphasis on internal accountability and control, and independent auditing (see BRSA, 2002c). Mishkin (2001) adds that besides disclosure, requirements on banks to obtain credit ratings and to issue subordinated debt are needed. These could help to discipline banks and give bank examiners more information (*e.g.*, on the market pricing of risk), as well as help the public to evaluate whether the examiner has been sufficiently tough on a particular bank.
62. See Turkey government (2001e).
63. By March 2001, overnight liabilities of these banks together were \$13.6 billion, of which \$5.2 billion belonged to the SDIF banks and \$8.4 billion to the public banks.
64. OECD (2002a) points out that when problems are widespread, there is real difficulty in distinguishing illiquid from insolvent institutions, especially when actors have an incentive to distort the facts (borrowers to overstate their financial strength to avoid restructuring and banks to conceal balance sheet weakness to protect clients). With imperfect information especially in the early stages of crisis, the Central Bank risks stepping in to provide liquidity to avert a collapse in credit whereas a different solution may be required. See also Dziobek and Pazarbasioglu (1997).
65. Out of 30 major banking sector crises, only Argentina 1980, Chile 1981, Cote d'Ivoire 1988, Mexico 1995, Uruguay 1981 and Venezuela 1994 had fiscal costs larger than 20 per cent of GDP. The average cost of the 30 countries was 10 per cent of GDP (Caprio and Klingebiel, 1996).

66. At the same time, public banks were enabled to determine their loan interest rates by taking their resource costs into account.
67. By end-June 2001, some \$4 billion in FX liabilities were transferred. With 5 more banks taken over in July, and then another one in June 2002, the FX open position each time momentarily increased, but was then reduced again via public operations.
68. Eight banks bought the deposits in a 5 stage auction process. A total of TL 479 trillion (TL deposits) and \$2.6 billion (dollar deposits) were sold off, being backed by matching government securities portfolios.
69. By 2000, the share of non-performing loans in Emlak was 39 per cent, the share of liquid assets to total assets was 17 per cent, and all profitability ratios were negative.
70. State banks are organised in a pyramid structure, with the Board overseeing five sub-departments: non-branch profit centres, marketing, operations, loan and risk management, and control. In early 2002, a new law was passed in order to make the managers immune from prosecution.
71. Number of branches and employees:

	December 2000	December 2001	May 2002
Number of employees	61 601	47 985	38 303
Ziraat Ban kasi	36 576	33 023	23 993
Halk Bankasi	10 000	14 962	
Emlak Bankasi	15 025	14 310	
Number of branches	2 494	2 398	1 792
Ziraat Ban kasi	1 287	1 499	1 233
Halk Bankasi	804	899	559
Emlak Bankasi	403		

*Note:* According to Turkey government (2001c) the number of branches and personnel is to decrease to rational levels within 18 months (*i.e.* by end-2002).

*Source:* BRSA, Joint Board of Directors of State Banks.

72. The profit of Ziraat rose from TL 188 to TL 640 trillion between August 2001 and March 2002, though being erased by the following May due to provisions set aside for agricultural loans. Halk turned around from a loss of TL 759 trillion in June 2001 to a profit of TL 191 trillion by May 2002. At the same time, Ziraat and Halk are required by law to extend additional loans of at least TL 1.5 quadrillion from their own resources to the agricultural sector, tradesmen and artisans, SMEs and exporters.
73. While 62 per cent of the total personnel in the public deposit banks are high school graduates only, this ratio is 45 per cent for the private deposit banks and 27 per cent for the foreign banks (Banks' Association of Turkey). On the other hand, these statistics may exaggerate the education gap, as in recent years Ziraat Bank has been operating its own training institute.
74. Meeting the deadline for Vakif will require an urgent restructuring of the bank (mainly eliminating a host of ancillary services and assets that potential buyers find unattractive); that for Halk, the hiring of an investment bank to start the sale preparations immediately; and for Ziraat, a strategic plan as outlined above. In respect of the latter, the World Bank has hired a consulting consortium led by Rabo Bank to prepare a study on the future strategic role of Ziraat.

75. There was a foreign offer (jointly with a domestic bank) for Toprakbank which was rejected as being too low, and some initial foreign interest in Pamukbank, whose sale process however is proving difficult. Unicredito has also forged an alliance with a solvent medium sized bank, Kocbank.
76. Cote d'Ivoire, Latvia, Peru and Spain have imposed limited losses on depositors and other creditors without provoking bank runs. See Dziobek and Pazarbasioglu (1997).
77. They also made capital gains of approximately \$1.2 billion (Kogar, 2001). With the further takeover of Pamukbank in June 2002, the private banks' open positions were virtually eliminated.
78. Unlike in the case of previous bank take-overs, no criminal actions were taken against bank managers and owners, nor were interdictions to practice banking in the future imposed, as the severity of the crisis was deemed to be overriding factor in the insolvency.
79. Earlier market fears were that the accounting results would be "fudged" in order to underpin public confidence and bolster the image of the BRSA as a tough enforcer of regulations, rather than the transparent route of being rigorous in the accounting and then showing leniency in its application.
80. Bankers Association of Turkey publishes individual bank data, however the post-audit accounts will be known with only a substantial delay.
81. The one major merger that was applied for, that between Yapi Kredi and Pamukbank, was rejected because the combined capital ratio of the two banks would still have been inadequate while the merger would have been prejudicial to minority shareholders. See BRSA (2002b). A merger between two smaller banks took place on 29 March 2002.
82. An econometric study of banking behaviour in Turkey (Ersel, 2000) shows that the share of credits in total bank assets is quite sensitive to economic growth (elasticity of 0.6). It is also sensitive to the share of total credits in GNP (-0.5), since too many credits relative to need imply worsened marginal credit quality, which implies a second exogenous growth channel so long as lending remains restrained. Reductions in the public debt pressure variable (the ratio of debt to broad money supply, a proxy for financial market depth) will also expand credits as banks reduce their liquidity demand because of lower perceived financial market risk, albeit to a small extent (-0.1). Reduced inflation volatility would operate in the same fashion (-0.2). Thus, once growth gets going, positive momentum could quickly build into credit expansion. Fiscal consolidation and disinflation should provide added impetus. Such developments would be needed to allow a return to bank profitability and complete their financial restructuring.
83. Financial pressure has been relieved by the sanitising of state and SDIF banks, and the Central Bank has been easing policy in response to recent good inflation news. Since March, the Central Bank has been lowering the key policy rate, and it has had an average of \$4.5 billion balance in open market operations, equivalent to almost 18 per cent of private banks' credit stock. Also, the public banks, having already completed the financial phase of their restructuring, may now be in a position to resume lending.
84. See Morgan Stanley Sovereign Research, Turkey, "Positioning for the End of the Lull", 15 October 2002.
85. Dziobek and Pazarbasioglu (1997).
86. The Turkish banks have, in fact, in the past pursued bilateral restructuring remedies.

87. These are defined as employing at least 100 people as of 31 December 2000, export at least \$15 million in goods and post sales of at least TL 25 trillion annually, and that are in arrears of at least \$10 million in debt with a minimum of two financial institutions.
88. See Morgan Stanley Sovereign Research, Turkey, "Stay Tuned to the Lending Channel", 11 June 2002. However, this risk is mitigated by the fact that the foreign banks have relatively limited lending exposure.
89. The Bank's Corporate Rehabilitation Loan to underpin the Istanbul Approach provides access to new working capital for enterprises undertaking the restructuring process. It will not refinance existing loans of these companies.
90. The World Bank is also close to finalising its work towards supporting the FRP by placing a \$500 million loan to help the banks meet additional financing needs within the FRP.
91. So far, several major companies have applied or benefited from the programme. Köyta (textiles) has applied to Halk Bank, another state bank, for a deferment of its debt payment; Tümteks and Boyasan (sister companies) are seeking to restructure \$17.7 million in bank debts; the Raks Group (media) is seeking deferment of \$225 million in debt to Garanti, Yapi Kredi and Arap-Türk Banks; and Yapi Kredi and Is Banks restructured \$81 million of debts owed to them by Isklar Holding (real estate). See *The Banker*, August 2002.
92. The SDIF can finance only 20 per cent of an AMC. According to the SDIF, the timing of the effective launch of such a company (*i.e.*, asset transfers) primarily depends on the valuation and pricing methods that it uses, in other words, the ability of the new AMC to acquire suitable assets whose value can be increased by enhanced stewardship. For example, while the purchase of assets on a fixed discount value shortens the period, a detailed analysis/ evaluation of the market value of the assets will lengthen the starting-up period.
93. This was the experience of the US Resolution Trust Corporation after the savings and loan crisis. See OECD (2002a).
94. Opinions from bankers suggest that bank information capital has eroded, together with the banks' ability to evaluate and manage real sector risks appropriately. See Bossone (1999).
95. Some authors, notably Mishkin (2001), have recommended setting prudential limits on how fast bank borrowing can grow, as well as restrictions on bank lending and borrowing in foreign currencies. Brazil, for example, allows no FX deposits or loans in its banking system.
96. See Mishkin (2001), who also observes that foreign banks would reduce moral hazards and increase market discipline since bailing out foreign banks may be perceived as being politically unpopular.
97. See Alper (2001).
98. A Local Administration Bill long awaits parliamentary approval. The Bill introduces further revenue sharing between local administrations and the central administration leading to a greater financial autonomy for lower levels of government. However, financial autonomy is not coupled with stronger decision-making powers, but it is only aimed at providing enough resources to local governments for carrying out their assigned functional responsibilities (like the construction of hospitals and schools). Even after the passage of the Bill, therefore, local administrations will still lack effec-



- tive accountability. See OECD (2001a) and (2002b) for a description of the shortcomings of the current devolution system in Turkey.
99. See World Bank (2001) and European Commission (2001).
  100. The number of projects in the 2002 Annual Investment Programme is 4414, 12.5 per cent fewer than in the previous year's programme. Moreover, the average time for project completion is 8.5 years in the 2002 Programme compared with 12.5 in the previous Programme.
  101. The Bill on Financial Management and Internal Control provides that the Court of Accounts on behalf of the Parliament carries out the external auditing of all general government. Moreover, the Bill ensures that the internal audit is performed both *ex ante* and *ex post*. While the *ex ante* control is carried out by a "financial control official" appointed by the public institutions, the *ex post* audit will be performed by a functionally independent internal auditor. The internal auditors of all public institutions will be co-ordinated by an Internal Audit Committee.
  102. OECD (2002b).
  103. Turkey government (2002b).
  104. That is to say, only 15 per cent of those leaving are to be replaced through new hires.
  105. The public workforce in Turkey is divided into *public sector workers* and *civil servants* reflecting different work arrangements.
  106. According to SIS's data, in 2001 employment in the public sector was around 3.1 million, *i.e.* 6.1 per cent higher than two years earlier.
  107. Initial estimates from the Turkish Undersecretariat of the Treasury show that net saving in case of retirement of all public workers and civil servants having the right to retire would be negative at around -265 billion Turkish lira in the first year of implementation mainly due to severance payments. Afterwards, annual net saving should turn positive at around 205 billion Turkish lira.
  108. See Republic of Turkey (2002).
  109. Galal *et al.* (1994) consider twelve case studies from the United Kingdom, Chile, Malaysia and Mexico. In all cases except for the privatisation of Mexicana de Aviacion, the divestiture programmes lead to welfare improvements. La Porta and Lopez-De-Silanes (1999) estimate that in Mexico privatisation of public companies was followed by a 24 per cent increase in their ratio of operating income to sales in the period 1983-1991, with productivity gains accounting for 64 per cent of this increase. Claessens and Djankov (2002) show that in Eastern European countries, privatised companies showed significant increases in sales growth and labour productivity, and fewer job losses with respect to state-owned companies after three years following divestiture in the period 1992-1995.
  110. Tansel (2002).
  111. By interviewing a sample of laid-off workers from SEEs in Turkey, Tansel (2002) found that half of them still in the labour force were self-employed after their dismissal. Moreover, their unemployment spells were shorter than for laid-off workers with a new dependent job.
  112. Turkey also signed Build-Operate-Own contracts with the private sector. In this case, the ownership of the company remains in the private sector even after the specified period of operation.
  113. IEA (2001).

114. As TEAS and TEDAS passed these high prices on to consumers only partially, the resulting deficits of the two companies had to be covered by the public budget.
115. As explained in OECD (2002b), the gap between electricity prices charged to households and to business is relatively low. Given that the marginal cost of providing electricity to households is significantly higher, this price structure implies cross-subsidisation from the business to the household sector.
116. When energy prices are measured in PPP terms, this negative performance is even more marked. In particular, energy prices for households appear significantly higher than in other OECD countries.
117. According to the Petroleum Market Bill currently under discussion by Parliament, the Energy Board will also regulate on the oil market. The Bill aims at liberalising all the segments of the oil market.
118. For a review of policy issues and experiences regarding the reform of network industries in OECD countries see Gonenc, Maher and Nicoletti (2000) and OECD (2001b).
119. The initial version of the Electricity Market Law also contained a provision terminating BOT contracts, which are not yet finalised. However, the Constitutional Court cancelled this clause on the ground of breaching the principle of contract freedom.
120. See OECD (2001a) and (2002b) for details of the Telecommunication Law.
121. The decrease in employment in the first half of the 1990s is also due to the split of Postal Services into Postal Administration and Turk Telecom.
122. OECD (2001c).
123. This method is based on determining a mark-up over the long-run marginal costs incurred by the incumbent in the provision of access. See Gonenc, Maher and Nicoletti (2000) for more details.
124. The need to simplify dispute resolution and to enhance the role of the Authority is evident in the ongoing dispute on national roaming in the mobile telephony between the two incumbents and the two new entrants. Given the inability to find an agreement, the Authority was asked to provide terms and tariffs for the arrangement. However, the Authority's decision was brought to Court and the issue is not solved yet.
125. The lack of cost accounting also makes it difficult for the Authority to determine the extent of cross-subsidisation. However, benchmarking studies carried out by the Authority suggest that tariff re-balancing will be necessary between local, national and international calls.
126. The increase of the agricultural share was particularly marked in the second and third quarters of 2001. Afterwards, the share started decreasing to reach little more than 30 per cent in the first quarter of 2002.
127. For four provinces, the DIS payments already started in 2000 under a pilot project. Moreover, in 2002 DIS payments cover not only the amounts for the whole year but also the amounts that were not disbursed in 2001 because of a delay in the implementation of the program.
128. The project is currently implemented only in East and Southeast Anatolia. The share of applicants over the total in these two regions is 2.1 per cent.
129. The State transfers for R&D, infrastructure and marketing are classified under General Service Support Estimate (GSSE). The increase in the share of GSSE over TSE in 2001 compared to 2000 (Table 34) is mainly due to the drop of the other forms of support. In fact, in nominal terms GSSE decreased from \$ 2.6 billion in 2000 to \$ 2.3 billion in 2001.

130. See FIAS (2001a) and (2001b), European Commission (2001), OECD (2002b) and Ariman (2001) for reviews on explanations of low foreign investment in Turkey.
131. The nine areas are company registration, hiring of foreigners, sectoral licensing, land access and site development, taxation and state aids, customs and technical standards, intellectual property rights, FDI legislation, and investment promotion.
132. Onaran (2002).
133. Unpaid family workers are registered as employed by the Turkey's State Institute of Statistics.
134. See OECD (2001a) for a more detailed description of the unemployment insurance system.
135. Some support to job search for the unemployed should result from the activity of private employment services that started operating in September 2002. However, it is till too early to assess their effectiveness in improving job matching in the Turkish labour market.
136. For example, in 2000 the female participation rate stood at only 39 per cent even in rural areas. See Tansel (2001).
137. According to Tansel (2001), rural-to-urban migration and education improvements among women are the main reasons for the observed U-shaped trend of female participation rates in developing countries. Her regressions confirm this theory for Turkey. A significant rise in female participation rate should then be expected in the next decades.
138. OECD (2002d). For men, differences are less marked. In 2000, participation rates were 84.4 per cent for males with less than upper secondary education, 87.7 per cent for males with upper secondary education, and 87.3 per cent for males with tertiary education.
139. The latest increase in the tax burden on labour was introduced in April 2001 when the contribution ceiling was increased from four to five times the "minimum pensionable wage".
140. The definition of informal sector used by the State Institute of Statistics includes unincorporated firms hiring fewer than 10 workers and not paying taxes or paying lump-sum taxes.
141. Despite the 1999 reform, in the two-year period 2000-2001 budgetary transfers to social security institutions still averaged 2.8 per cent of GDP, though it represented an improvement of 0.5 per cent of GDP compared with the average for the period 1998-1999.
142. Although it should be recalled that life expectancy of the elderly in Turkey is the lowest among the OECD countries so that the expected number of years in retirement could be smaller.
143. Further sub-regulations were introduced in February 2002.
144. However, such a measure should be only one-time and accompanied by a credible programme of tax audit to limit tax and contribution evasion in the future.
145. OECD (2001e). In 1998, life expectancy at birth was 71 and 66 for females and males, respectively. Infant mortality, measured as the number of deaths of children under one year of age as a ratio of thousand live births, was 37.5. As a comparison, in the best performer country (Japan) life expectancy was 84 and 77 for females and males,

- respectively. Infant mortality was only 2.4 in Iceland, best performer country in this output indicator.
146. See OECD (1999) for a comprehensive assessment of the health sector in Turkey.
  147. The government's downsizing programme does not envisage personnel reduction in health, education and national security. Hence, a more decisive dismissal strategy in other sectors will be needed in order to maintain consistency with the overall objective of public personnel reduction.
  148. A Project on Health Reform is expected to start in 2003. Consultations with the World Bank for its financing will take place in October 2002.
  149. Defined as the share of families with income below one half of national median income.
  150. The main existing assistance instruments are provided by the Social Aid and Solidarity Encouragement Fund, by the Law on Granting Pension for Indigent People over 65, by the General Directorate of Child Protection and Social Services, and by the General Directory of Foundations.
  151. Data provided by the Turkey's State Institute of Statistics. Funds for education have been largely protected from budget cuts through a special earmarked tax (25 per cent of the commissions on the transaction value in the Turkey's Stock Exchange).
  152. According to the Turkey's Ministry of Education (2000), the *gross* enrolment rate in primary education was almost 98 per cent during the school year 2000-2001. However, the *gross* enrolment rate differs from the *net* enrolment rate used by the OECD because it includes also overage students. Moreover, the definition of primary education by the Ministry of Education covers only the 8 years of compulsory schooling (ages 6-13). Using this definition, the Ministry of Education estimated that the enrolment ratio was already 90 per cent in the school year 1995-1996, *i.e.* before the reform was implemented.

## Glossary of acronyms

<b>AMC</b>	Asset management company
<b>ARIP</b>	Agricultural Reform Implementation Project
<b>ASCU</b>	Agriculture Sales Co-operatives Unions
<b>BAT</b>	Banks' Association of Turkey
<b>BOT</b>	Build-Operate-Transfer
<b>BOTAS</b>	Petroleum Pipeline Corporation
<b>BRSA</b>	Banking Regulation and Supervision Authority
<b>CAR</b>	Capital asset ratio
<b>CAS</b>	Country Assistance Strategy
<b>CMB</b>	Capital Markets Board
<b>CPI</b>	Consumer Price Index
<b>DIS</b>	Direct income support
<b>EBF</b>	Extra-budgetary fund
<b>EC</b>	European Commission
<b>EFIL</b>	Export Finance Intermediation Loan
<b>EMRA</b>	Energy Market Regulatory Authority
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FRP</b>	Framework Restructuring Programme
<b>FX</b>	Foreign exchange
<b>GDP</b>	Gross Domestic Product
<b>GNP</b>	Gross National Product
<b>GSSE</b>	General Service Support Estimate
<b>IAIS</b>	International Association of Insurance Supervisors
<b>IMF</b>	International Monetary Fund
<b>IT</b>	Information Technology
<b>ISKUR</b>	Turkish Employment Organisation
<b>JBDST</b>	Joint Board of State Banks
<b>NDA</b>	Net domestic assets
<b>NFA</b>	Net foreign assets
<b>NII</b>	Net interest income
<b>NIR</b>	Net international reserves
<b>NPL</b>	Non-performing loan
<b>PFPSAL</b>	Programmatic Financial and Public Sector Adjustment Loan
<b>POAS</b>	Petroleum Company
<b>PPP</b>	Purchasing Power Parity
<b>ROIC</b>	Return on Investment Capital
<b>SDIF</b>	Savings Deposit Insurance Fund
<b>SMP</b>	Staff Monitored Programme

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<b>SEE</b>	State Economic Enterprise
<b>SIS</b>	State Institute of Statistics
<b>SME</b>	Small and Medium Enterprises
<b>TEAS</b>	State electricity company (generation and transmission)
<b>TEDAS</b>	State electricity company (distribution)
<b>TL</b>	Turkish lira
<b>TOOR</b>	Transfer-Of-Operating-Rights
<b>TSE</b>	Total Support Estimate
<b>TT</b>	Turk Telekom
<b>UNCITRAL</b>	United Nations Commission on International Trade Law
<b>VAT</b>	Value added tax
<b>WPI</b>	Wholesale Price Index
<b>YKB</b>	Yapi Kredi Bank

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## Annex I

**Turkey's previous stabilisation attempts****Background**

As past programmes designed to fight inflation have never been successfully carried through or were subsequently reversed, chronic high inflation has troubled Turkey for over two decades.<sup>1</sup> Inflation imposes a heavy burden on the economy and society, worsening the inequality of incomes, exacerbating social tensions, and distorting the planning horizons of investors and savers. Consequently, the economy was under the constant threat of instability, discouraging foreign and domestic investment.

Large budget deficits have been the base of the inflation process. The financing of these deficits has accelerated money growth, as well as generating high real interest rates. The pressure of government borrowing, in turn, has locked in inflation expectations and pro-

Table A.1. **Stand-by agreements between the IMF and Turkey**

DATE	LOANS (Millions SDR)
01 Jan 1961	37.5
30 Mar 1962	31.0
15 Feb 1963	21.5
15 Feb 1964	21.5
01 Feb 1965	21.5
01 Feb 1966	21.5
01 Feb 1967	27.0
01 Apr 1968	27.0
01 Jul 1969	27.0
17 Aug 1970	90.0
24 Apr 1978	300.0
19 Jul 1979	250.0
18 Jun 1980	1 250.0
24 Jun 1983	225.0
04 Apr 1984	225.0
08 Jul 1994	610.5
22 Dec 1999	15 038.4
04 Feb 2002	12 821.2
<b>Total</b>	<b>31 045.6</b>

Source: Directorate General of Press and Information, IMF.

jected them forward in the form of high interest rates. Basing increases in public sector wages and agricultural support prices on past inflation has contributed to inflation inertia. The policy of stabilising the real exchange rate and expanding the money supply in line with expected inflation further reinforced the process. Changing this entrenched pattern of behaviour needs concerted action on many fronts.<sup>2</sup> The past five years have witnessed four major attempts at addressing underlying weaknesses in Turkish economy and aiming to reduce inflation on a permanent basis.<sup>3</sup> This Annex summarises the two attempts covering the period between July 1998-May 2001. The subsequent attempt, related to the recent arrangements with the IMF, are discussed in detail in Chapters I and II.

### **First attempt: 1998 Staff Monitored Programme (SMP)**

In July 1998, the Turkish authorities initiated a disinflation programme that was later regarded to the backdrop to the subsequent stabilisation attempts of 1999 and 2001. The three-year programme was intended to reduce wholesale price inflation from over 90 per cent at end-1997, to 50 per cent by end-1998, 20 per cent by end-1999, and to single digits by end-2000. The main policies to achieve the planned reduction in inflation were: *i*) an increase in the primary surplus of the budget, that would be sustained during the disinflation process; *ii*) a shift in the management of key variables, such as public sector wages and agricultural support prices, so that they would be in line with targeted rather than past inflation; *iii*) a supportive and closely co-ordinated monetary policy; *iv*) structural reforms to ensure the progressive strengthening of public finances over time; and *v*) stepped-up privatisation to lower the domestic borrowing requirement and enhance economic efficiency. At the request of the Turkish authorities, a quarterly IMF review process backed up the programme, and the announcement of short-term targets for implementing a range of macroeconomic and structural policies was intended to increase transparency and continuity.

#### ***Fiscal policy measures***

In order to gradually reduce the heavy burden of interest payments, the primary surplus of the budget was targeted to increase to above 4 per cent of GNP in 1998, from near balance in 1997. Fiscal measures on the revenue side included:

- the introduction of a withholding tax on interest income;
- to reduce evasion, tax identification numbers were introduced for motor vehicle purchases and real estate transactions;
- by the end of 1998, tax identification numbers were required for all bank accounts;
- as regards privatisation receipts, the aim was to generate at least \$3 billion in 1998 and at least a further \$5 billion in 1999. Before the end of 1998, a number of companies were planned to be sold, with substantial additional sales scheduled in 1999. The Council of Ministers approved for the sale of 49 per cent of Turk Telekom;
- in line with the goals on privatisation, the government introduced international pricing for petroleum products effective July 1 and, by end-December 1998, should have been submitted to Parliament an appropriate regulatory framework for the telecommunications and energy sectors.

On the expenditure side, the measures included:

- public sector salaries and agricultural support prices were planned to be set in line with the targeted inflation, a major shift in policy. Public sector salaries were adjusted by 30 per cent in January, and were to be increased by no more than 20 per cent in July. Agricultural support prices were increased by 60 per cent for wheat, 64 per cent for tea

and 71 per cent for tobacco, in line with projected average inflation in 1998. It was intended to continue applying these policies in the remainder of 1998, in 1999 and beyond.

### ***Monetary and exchange-rate policies***

Monetary policy was directed at sustaining the disinflation effort and, in the second half of 1998, the exchange rate was to be managed in a manner consistent with the target of 50 per cent wholesale price inflation by end year.

- Given the difficulty of projecting the behaviour of demand for base money in a period of disinflation, the monetary framework under the programme placed greater emphasis on control over the growth of net domestic assets (NDA) of the Central Bank. The expansion of this aggregate was kept under tight restraint, including the continuation of the policy that the Central Bank should not extend credit to the public sector.
- The Central Bank planned to intervene less aggressively in managing day-by-day liquidity, allowing short-term interest rates to move more freely.

### ***Measures to strengthen the banking sector and supervision***

Capital adequacy requirements were made more strict and the ceiling on banks' net open foreign exchange positions were lowered:

- net foreign exchange exposure ceiling was reduced from 50 per cent of capital to 30 per cent by end-December 1998.
- in order to equalise the taxation of interest income from repos and deposits, reserve requirements on repos were to be the same as on bank deposits before the end of the year.
- to reduce the gap between the average cost of funds and the average rates charged by the agricultural bank (Ziraat Bankasi), interest rates on agricultural credits would not be lowered until they were equal to Ziraat's average cost of funds, and from that point on would be kept in line with funding costs.<sup>4</sup>

### ***The programme failed to achieve the decline in interest rates***

The programme achieved some improvements concerning the inflation rate and fiscal imbalances and hence inflation slowed sharply as programmed, the primary fiscal balance was strengthened in line with programme targets. The Central Bank limited the expansion of its net domestic assets within the programme ceiling. In the first half of 1998, the privatisation programme gained momentum, international pricing was adopted for petroleum products, agricultural support prices were raised broadly in line with targeted inflation, tax reform legislation was adopted to reduce tax collection lags and widen the tax base and the authorities initiated a phased reduction in the ceiling on banks' net open foreign exchange position from 50 per cent of net worth to 30 per cent by end-1998.

However, the positive momentum in the first half of the year was not sustained and key structural reform measures envisaged in the SMP were not implemented, including: *i*) approval of a regulatory framework for the telecommunications and energy sectors to facilitate privatisation; *ii*) a long-postponed social security reform designed to raise the minimum retirement ages and extending the minimum contribution period to be eligible for full benefits; *iii*) progressive privatisation process; and *iv*) the adoption of a banking sector reform bill to establish an independent regulatory body, depoliticise supervision practices, and clarify

remedial measures for banks.<sup>5</sup> This slow progress on structural measures and political uncertainty contributed to the high real interest rates that, in turn, placed a heavy burden on the economy and the budget. The Russian default during the summer 1998 and the general elections in April 1999 were followed by a deterioration in fiscal balances, that were further hit by the two devastating earthquakes in August and November 1999.<sup>6</sup>

### **Second attempt: 1999 Disinflation Programme**

The new government established after general elections in April 1999 launched another three-year stabilisation programme in December 1999, centering on an ambitious goal of freeing Turkey from inflation. Aided with supervision and technical support of the IMF, under a stand-by arrangement with a credit facility of \$4 billion, the new programme relied on exchange-rate based disinflation and monetary control by setting upper limits to the NDA position of the Central Bank. The Central Bank committed itself to a policy of no sterilisation whereby expansion of the monetary base was directly limited to the changes in the net foreign assets. The programme further entailed a series of measures on fiscal expenditures and set performance criteria on the balance of non-interest primary budget.

#### ***Fiscal policy instruments***

The main fiscal goal for 2000 was to raise the primary surplus of the public sector (which includes the consolidated central budget, the extrabudgetary funds, local government, the non-financial state enterprises, the Central Bank, and the so-called duty losses of state banks) to 2.2 per cent of GNP in 2000 (or 3.7 per cent excluding earthquake-related expenses). Fiscal policy was complemented by a more active and diversified debt management policy and through the acceleration of privatisation, so as to contain the burden of interest payments. To underpin the above targets for 2000 the programme required fiscal measures worth some 7.5 per cent of GNP, of which more than two-thirds resulted from revenue raising initiatives and the remainder from spending cuts. Some of the measures were:

- withholding tax on income from fixed assets and on the self-employed was increased from 15 to 20 per cent, withholding tax on interest income from deposits and repos was increased by 2 percentage points, and the increase in tax brackets and the special exemption for wage and salary earners was limited to the targeted inflation rate;
- with respect to indirect taxes, the standard VAT rate was increased by 2 percentage points and, in addition, Treasury approval was required for the setting of fuel prices, with fuel price levies adjusted automatically depending on movements in fuel prices so as to allow the attainment of the targeted savings in the budget.
- additional savings through cuts in non-investment public expenditures, including savings from a reduction in personnel expenditure in 2000 and cuts in other current expenditures.

#### ***Monetary and exchange rate policies***

In order to reduce the uncertainty on the value of financial contracts for both residents and non-residents, there was a need to a shift to a more forward-looking commitment on exchange rate policy, and to avoid to be locked into a stringent monetary and exchange rate framework there was also a need for a transparent and pre-announced exit strategy from this exchange-rate regime:

- within this context, other than for short-term fluctuations, all base money was to be created through the balance of payments and domestic interest rates were to be fully



market determined. Capital inflows would not be sterilised, allowing a rapid decline in interest rates and avoiding an excessively large interest rate differential, which would perpetuate the inflows.

### **Incomes policy**

- To support disinflation and the exchange rate policy, and in particular, to guide the private sector to set wage and price increases in line with the inflation target, salary increases for civil servants were set in line with targeted CPI inflation (25 per cent during 2000).
- Minimum wage increases would be determined by the Minimum Wage Commission, consisting of representatives of the government, the trade unions, and the employers. However, the government would endeavour to ensure that the increase was in line with targeted inflation.

### **Structural reforms**

The structural reform programme aimed at making sustainable over the medium term the fiscal adjustment implemented in 2000, lowering the burden of interest payments on public sector debt, improving transparency and economic efficiency, and reducing the contingent liabilities of the public sector. The measures included:

- addressing distortions built up in the agricultural sector, the government by phasing out existing indirect support policies over a two-to-three year period and replacing them with a direct income-support programme;
- social security reforms launched in 1999 which were deepened both *via* undertaking further administrative measures to improve coverage, compliance and administrative efficiency and *via* creating a legal framework more suitable to the expansion of private pension funds;<sup>7</sup>
- measures to broaden the effective coverage of the budget, so that three-fourth of the budgetary funds were scheduled to be closed by August 2000 and the remaining ones by mid-2001. Further progress in this area would be achieved by introducing in 2001 accounting and reporting on a commitment basis for the consolidated central budget; and
- enhancing transparency and accountability in budgetary operations. The government committed itself to include in the 2000 budget the cost of credit subsidies of state banks and to establish a public registry of guarantees, while setting explicit limits to issuance of new guarantees in the 2001 budget. As to extra-budgetary funds (EBFs), the scope of their activities would be reviewed and the ones not functional would be eliminated and no new budgetary or EBFs would be created.
- in the area of privatisation, the government was committed to disengage further from economic activity, raising sizeable receipts for debt reduction, including through major privatisation operations in the key sectors of telecommunications and energy. The privatisation programme was targeted to realise some \$7.6 billion in 2000.
- pushing ahead the implementation of the reform of the banking system and banking regulation along the lines stipulated in the banking law approved by Parliament in 1999.<sup>8</sup> Hence, the government committed itself to the introduction of new measures to strengthen prudential regulation and tools to deal with problem banks.<sup>9</sup>

### ***Exchange rate peg collapsed after just one year***

The economy rebounded sharply in 2000. Domestic interest rates fell more sharply than expected and lower interest rates, coupled with increased confidence, induced a stock market boom. Expanding domestic activity increased tax revenues, so that fiscal targets on primary surplus were easily met. However, macroeconomic tensions appeared by the second half of the year. Inflation turned out to be stickier than expected, and given that the predetermined path for the nominal exchange rate was met, the Turkish lira appreciated significantly in real terms. Booming domestic demand and real appreciation, accompanied by adverse external factors, led to a widening of the current account deficit to unprecedented levels. Meanwhile, the structural reforms needed to attract foreign capital began to falter in the late summer, raising concerns about the continuity of the programme and current account sustainability, which in turn, reversed the declining trend in nominal interest rates provoking the first financial turmoil in November 2000 (see Chapter I).

## **Notes**

1. Although yearly inflation was over 100 per cent in certain years, it never reached hyperinflationary levels, but increased in a stepwise fashion over time: the average annual inflation rate was 20 per cent in the 1970s, 35-40 per cent in the early 1980s, 60-65 per cent in the late 1980s and early 1990s, and around 90 per cent before the disinflationary programme in late 1999.
2. Government of Turkey (1998).
3. Turkey has signed 18 Stand-by arrangements with the IMF since 1961 bringing Turkey as the highest debtor to the Fund. The IMF has extended nearly \$40 billion in loans of which 90 per cent was approved in the last two arrangements, dated December 1999 and February 2002 (Table A.1).
4. Government of Turkey (1998).
5. IMF (1999).
6. See OECD (2001a) for an analysis of the policy implications of the 1999 earthquakes.
7. The reform package was approved by Parliament in September 1999 and included increases in the minimum retirement age for new entrants to 58/60 immediately and to 52/56 for existing contributors over a ten-year transition period; raising the minimum contribution period for entitlement to a pension; reducing the average replacement ratio from 80 per cent to 65 per cent; extending the reference period for calculating pensions to the lifetime working period; indexing pension benefits to the CPI; and increasing the ceiling on contributions.
8. By the new banking law a new supervision authority (BRSA) was established in place of the former split responsibilities between the Treasury and the Central Bank. Also, in late September 1999, the limit on commercial banks' net open foreign position was lowered to 20 per cent of capital. However, some important weaknesses remained in the new act, and amendments were urgently needed in order to place the banking supervision framework on a proper foundation.
9. Government of Turkey (1999).

## Annex II

### Debt sustainability in Turkey

Debt sustainability is a key objective in the stabilisation programme. Using a standard debt sustainability analysis, this annex shows that in spite of the high real Turkish lira (TL) interest rates, the current debt situation is sustainable because of the real appreciation of the currency that has reduced the cost of servicing foreign-exchange (FX)-denominated debt. The analysis is extended to a medium-term framework to investigate the decrease in interest rate required for sustainability should real appreciation halt.<sup>1</sup>

The primary deficit is defined as domestic and foreign interest payments subtracted from the overall budget deficit.<sup>2</sup>

$$PD = G - T - (r + \pi)B_g - (r^* + \pi^*)eB_g^* \quad (1)$$

where

- PD Primary deficit
- G Government expenditures
- T Taxes (and other government revenues)
- r TL real interest rate
- $\pi$  Domestic inflation
- $\pi^*$  Foreign inflation
- $r^*$  FX interest rate
- e Effective nominal exchange rate
- $B_g$  Domestic debt
- $B_g^*$  FX debt

Equation (1) can be rearranged as:

$$PD + (r + \pi)B_g + (r^* + \pi^*)eB_g^* = G - T \quad (2)$$

The budget deficit is financed by domestic borrowing, foreign borrowing or by borrowing from the Central Bank:

$$G - T = \Delta B_g + \Delta B_g^* + \Delta DC_g \quad (3)$$

where  $DC_g$  is Central Bank's credit to the government.

The balance of the Central Bank is simplified by assuming that change in credit to the government is equal to the change in base money:<sup>3</sup>

$$\Delta DC_g = \Delta H \quad (4)$$

Combining equations (2) to (4) and assuming that change in net foreign assets of the Central Bank is zero, we have:

$$PD + (r + \pi)B_g + (r^* + \pi^*)eB_g^* = G - T = \Delta B_g + e\Delta B_g^* + \Delta H \quad (5)$$

After several manipulations, the following equation emerges, which will be used for the debt sustainability analysis:

$$\delta + (r - n)b + (r^* + \hat{s} - n)b^* = Db + Db^* + m\hat{H} \quad (6)$$

where

- $\delta$  Primary deficit/GNP
- $b$  TL-denominated debt/ GNP
- $b^*$  FX-denominated debt/ GNP
- $m$  Base money/ GNP
- $n$  Real growth rate
- $s$  Real exchange rate ( $eP^*/P$ )
- $\wedge$  Percentage change in a variable

and the last expression in equation (6) is seignorage and makes use of the identity:<sup>4</sup>

$$\frac{\Delta H}{Y} = \frac{H}{Y} \times \frac{\Delta H}{H}$$

We can use (6) to analyse if the debt in Turkey is sustainable under current macroeconomic conditions. The macroeconomic indicators used in the simulations are as shown in Table A.2.

Plugging these numbers into equation (6), it can be seen that current debt levels are sustainable at current interest rates, inflation and depreciation, even if government primary balance decreases by 9 per cent of GNP in 2002 with respect to current levels, as foreseen in the IMF programme. Therefore it can be said that the current primary balance target is consistent with debt sustainability. However, the current debt sustainability is very sensitive to movements in exchange and interest rates. An additional nominal depreciation of 10 per cent, holding interest rates constant, would cut the decrease in primary balance consistent with debt sustainability by 5.5 percentage points. A rise in real domestic interest rates by 10 percentage points, *ceteris paribus* would cut the decrease in primary balance by 3.5 percentage points by itself. The two effects combined together would mean that there should be no change in primary balance, in order to keep debt sustainable (Table A.2, columns 2, 3 and 4).

A closer look at the macro variables reveals that the Turkish economy is in a very special situation today. What is happening is that real appreciation is making the real interest rate on foreign currency debt negative (in TL terms). Therefore, the negative TL-adjusted interest rate on foreign borrowings is currently easing debt sustainability, even though the domestic interest rate (in both nominal and real terms) is very high.

Another disequilibrium in the system, which is helping debt sustainability for the time being, is seignorage. Seignorage is very high, mainly because of the high inflation tax. Once inflation comes down to reasonable levels, as foreseen in the stabilisation programme seignorage will fall as well, as 83 per cent of seignorage revenues are currently coming from inflation, compared with only 17 per cent from the non-inflation components. A 2-3 per cent seignorage (rather than the current 6-6.5 per cent) is more in line with a projected 12 per cent inflation 2 years from now.

Therefore, it is important to analyse what would happen in a situation where the real exchange rate is constant, seignorage is reasonable and the primary surplus is lower (this may be denoted as medium-run equilibrium). Solving for how large the interest rate on domestic currency need to be to make the debt sustainable in the medium-run, we find that domestic real interest rates need to be anywhere between 5-20 per cent to prevent explosive debt dynamics: a primary surplus of 5 per cent projected by the IMF gives an upper limit of 20 per cent, whereas a primary balance equal to zero yields a lower limit of 5 per cent (Table A.2, columns 5 and 6).<sup>5</sup>

Table A.2. Scenarios of public debt sustainability

	<i>Baseline Scenario</i> <sup>1</sup>	<i>Scenario 1</i> lower real appreciation	<i>Scenario 2</i> higher interest rates	<i>Scenario 3</i> both lower real appreciation and higher interest rates	Medium-term equilibrium (primary deficit/GNP = 0%)	Medium-term equilibrium (primary deficit/GNP = -5%)	Medium-term equilibrium (primary deficit/GNP = 0%, debt/GNP ratio to 64%)	Medium-term equilibrium (primary deficit/GNP = -5%, debt/GNP ratio to 64%)
% shares in GNP								
<b>Primary deficit</b>	-6.5	-6.5	-6.5	-6.5	0.0	-5.0	0.0	-5.0
<b>Debt in Turkish lira</b>	34.0	34.0	34.0	34.0	34.0	34.0	26.0	26.0
<b>Debt in foreign currency</b>	48.0	48.0	48.0	48.0	48.0	48.0	38.3	38.3
Per cent values								
<b>Domestic nominal interest rate</b>	76.5	76.5	86.5	86.5	15.0	29.7	16.9	36.1
<b>Real growth</b>	3.0	3.0	3.0	3.0	5.0	5.0	5.0	5.0
<b>Real domestic interest rate</b>	36.5	36.5	46.5	46.5	5.0	19.7	6.9	26.1
<b>Real world interest rate</b>	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
<b>Real depreciation (+) or appreciation (-)</b>	-21.6	-11.6	-21.6	-11.6	2.0	2.0	2.0	2.0
<b>Seignorage</b>	6.3	6.3	6.3	6.3	2.4	2.4	2.4	2.4
<b>Change in primary balance to attain stability of debt/GNP</b>	-9.4	-3.8	-6.0	-0.4	0.0	0.0	0.0	0.0

1. In the baseline scenario, the primary balance and real growth are the 2002 objective set in the government programme. The figure for 2002 total debt is +4 on provided by IMF, 10<sup>th</sup> Review, February 2002. Debt in Turkish lira has been estimated by considering that 70 per cent of net domestic debt is denominated in Turkish lira. The debt in foreign currency includes both foreign debt and the part of net domestic debt denominated in foreign currency. Seignorage has been estimated by considering base money as a percentage of GNP equal to 15 per cent and growth in base money equal to 42 per cent.

Source: OECD.

## Notes

1. The analysis is a financial programming exercise in its simplest form. Most of the policy variables like deficit and growth are assumed exogenously. An extended version of the financial programming framework for Turkey from 2002 to 2007 can be found in Deliveli (2002a).
2. This equation assumes that real interest rate plus inflation equals the nominal interest rate. The true relation is  $(1 + r)(1 + \pi) = (1 + i)$ , or  $r + r\pi + \pi = i$ . The interaction term, which is usually small enough to be negligible, may be important in high-inflation countries like Turkey. However, dropping this assumption does not change the results significantly. It should also be noted that this equation and all the calculations implicitly assume that all outstanding debt is short-term. The interest actually paid on debt (either domestic and foreign currency denominated) can vary even if market rates remain unchanged if the maturity structure of the debt is changing over time. Although this complication does not alter results much (because almost all of Turkey's debt is short-term), Deliveli (2002a) uses a more complete framework to calculate interest payments.
3. This is the same as assuming that net foreign assets of the Central Bank do not change.
4. Here,  $H/Y$  is the inverse of velocity of money.
5. Repeating the medium-term projections with debt levels pulled down to Maastricht criteria (IMF projections for 2006) gives the same results (the last two columns of Table A.2).

*Annex III***The political economy of reform**

Political stability and a functioning democracy are crucial for the overall success of economic reform. The viability of technocratic solutions cannot be evaluated without taking into account the political constraints. In countries such as Turkey where there is a lack of political stability and the occurrence of an economic crisis cycle almost every ten years, there is a strong link between the achievability of the structural reforms and a stable functioning democracy.

The role and the effects of politics and the bureaucracy on the economy are well recognised. For instance there are many studies that particularly investigate the detrimental effects of political instability on economic outcomes. One of these, for example, tries to explain the simultaneous occurrence of large external debts, private capital outflows and low domestic capital formation (Alesina and Tabellini, 1989). A general equilibrium model is built in which two government types with conflicting distributional goals randomly alternate office. It appears that the uncertainty over the fiscal policies of future governments generates capital flight and small domestic investment, and induces the government to over-accumulate external debt. Another study considers a model where countries with a more unstable and polarised political system have more inefficient tax structures and, thus, rely more heavily on seigniorage (Cukierman, Edwards and Tabellini, 1992). The prediction of the latter model was tested on cross-sectional data for 79 countries. It was found that after controlling for other variables, political instability is positively associated with seigniorage. Thus, the evolution of the tax system of a country depends also on the features of its political system, and not just on those of its economic structure.

“Economic society” is one of the arenas of a stable and functioning democracy, whose main organising principle is an “institutionalised market”. The other arenas of such a democracy work interactively to provide the necessary support for the realisation of an institutionalised market. This support consists of the legal and regulatory framework produced by “political society”, respected by civil society and enforced by the state apparatus. The core institutions of a democratic “political society” are the political parties, elections, electoral rules, political leadership, inter-party alliances, and legislatures. Modern democracy needs also a functioning state and a state bureaucracy, considered usable by the government in order to be able to perform its vital functions, which are the effective capacity to command, regulate and extract. Without the support from the other arenas an institutionalised market cannot be crafted (Linz and Stepan, 1996).

Turkey has a strong State tradition. This finds its roots back in the foundation years of the Republic. The Turkish State assumed an interventionist role in every sphere of life in reconstructing the new Turkish Republic. Consequently the State dominated the economy. In the 1930's Turkey was the second country to establish a planned economy after the USSR (Kazgan, 2002). However Turkey's approach was distinct in that the planned model was

accommodated with policies encouraging the private sector and entrepreneurship. Until the end of 1940's Turkey followed the "mixed economy" model (Kazgan, 2002). With the passage to multi-party democracy at the end of 1940's and with the new "Democratic Party" taking on power there was more stress on the merits of a market economy. The will to liberalise the economy and empower the private sector became apparent in this period. However the Democratic Party was also following an authoritarian approach towards the press and the universities, and restraining the civil rights, which created conflicts in the society. This lasted till the military coup in 1960. The 1961 Constitution that was established by the State elites after the coup was a "mixed" Constitution in that "national sovereignty was to be exercised not only by Parliament but also by "the authorised agencies". These included the bureaucratically staffed agencies such as the Constitutional Court and the National Security Council (Heper and Landau, 1991, p.3). The 1961 Constitution strengthened the Council of State's role (the Turkish version of France's Council d'Etat) and granted autonomy to the universities and the Turkish Radio and Television besides enhancing the civil rights of freedom of association and communication. However, the political party elites were not willing to share power with the state elites whom they viewed as serving their selfish interests. Consequently, political party elites did not accept the 1961 Constitution on the grounds that it established an authoritarian arrangement, therefore undemocratic. "The basic rationale behind the notion of mixed Constitution-that of obtaining prudent government alongside political participation through constitutional means when political elites are perceived not to pay adequate attention to the need for prudent government-had been alien to the political elites" (Heper and Cinar, 1996, p.489).

The 1960's were a new era in the economy. The State Economic Planning Organisation was established and the five-year economic development plans were introduced. The new economic development model took into account the developments in modern economics and was established with the help of foreign economists. It aimed to bring a systematic and scientific approach to the handling of policies (Kilicbay, 1994). However the political party elites did not welcome the plans in general as they thought this would put constraints on their political power. This resembled their reaction to the mixed 1961 Constitution. The five-year economic development plans continued to exist, but their effectiveness and utilisation were highly constrained (Kilicbay, 1994).

After the May 1960 coup the military intervened two more times, in 1971-1973 and 1980-1983. Prior to both interventions there was political turmoil accompanied by severe economic crisis. The State institutions were highly politicised and polarisation was prevalent. The 1982 Constitution, which in turn was written in the wake of the 1980 military intervention, introduced into Turkish politics a stronger state-politics duality. A strengthened National Security Council and a presidency with extensive powers took their places alongside the more "political" institutions.

The 1980's brought also a rapid process of economic liberalisation with the aim to pass onto a market economy. The barriers were lifted together with a speedy deregulation. However, the governing parties did not take into account one detrimental factor in such a transition, namely the behaviour and mentality of the other individual and institutional actors that are effective in shaping economic policies and decisions. Therefore the interaction and co-existence of a "strong state tradition" with "multi-party democracy" is one of the main reasons for the economic crisis cycle in Turkey (Onis and Riedel, 1993). Under the constraints imposed by parliamentary democracy, the state and the business elite who constituted the governing coalition have been confronted with the problem of maintaining a broader "national coalition" in order to obtain a numerical majority of the votes and thereby preserve their position of power. The governing party plays the key-mediating role in uniting the governing coalition representing the corporate sector and upper-level bureaucracy with the



“broader national coalition”, which may include small business, the lower-level bureaucracy, labour and peasants. The instrument used by the party to reconcile divergent interests of these groups is rarely consistent with economic logic. For instance, while economic logic might argue for a slower but more stable rate of economic growth, political logic demands rapid growth, even if it proves unsustainable. Therefore the support from the political society, which is necessary for the realisation of an institutionalised market, has not been very effective in the Turkish context.

The imbalance between “State autonomy” and “State capacity” has been one of the key elements of Turkey’s political economy. This has been detrimental for any type of government reform efforts in Turkey. Turkish bureaucracy has always been too important to be kept outside the sphere of politics and unstable coalitions have formed the nature of political life. In the course of the nineties, 11 different formations of governments have been in power in the political arena. The lack of stability and continuous uncertainty have prepared the ground for the economic crisis cycle in Turkey. It has further been detrimental for the implementation of economic reforms. Success of any prescription for improving the economy in Turkey should be evaluated with such a perspective.

Thus there is a strong need to build political stability and increase efforts for consolidation of democracy. A consolidated democracy can be defined as the institutionalisation of uncertainty: “a form of institutionalisation of continual conflicts... [and] of uncertainty, of subjecting all interests to uncertainty” (Przeworski quoted in Reisinger, 1997). The efforts to establish such an environment should be taken without any further delay considering its likely positive effects on macroeconomic policies.

## Annex IV

### Financial market liberalisation in Turkey

#### Domestic financial liberalisation and banking sector competition

Following financial market liberalisation in the early 1980s, the banking sector became exposed to greater competition as financial repression was lifted, directed credit programmes curtailed, and entry barriers eased. The 1980s reforms also started a process of financial deepening. The quality and variety of financial services improved and policies to develop equity and bond markets were adopted. A universal banking model was established whereby banks were authorised to engage in banking and non-banking financial activities. Banks seized the opportunity to expand their activities beyond traditional banking. The liberalisation allowed banks to: freely price their products and services; underwrite and trade securities; manage their own as well as their clients' securities portfolios; establish and operate mutual funds; engage in insurance business; participate in the capital of non-financial corporations; and undertake foreign exchange transactions. Given the institutional set-up, banks were able to resist competition from non-bank financial institutions such as insurance companies, brokerage houses, and mutual funds, and in fact acquired control over most of them.

The number of private banks expanded rapidly in response to financial market liberalisation. At their peak in 1999 there were 81 banks, almost twice as many as at the start of liberalisation, of which 44 were domestic private banks, and 22 were foreign (see Chapter III, Table 15). Besides commercial banks, there were 19 small-scale investment and development banks, both state and privately owned. As private banks proliferated, concentration in the sector declined, with the share in total assets of the five largest banks declining by 20 percentage points since the early 1980s. The share of the public banks declined by a similar amount (from 60 to 40 per cent). It could be presumed that with declining concentration and few barriers to entry, banking system competition increased. However, empirical studies have shown that although reforms eased barriers to entry, they did not eliminate barriers to mobility (Denizer *et al.*, 1998). Thus, the entry of small-scale firms was not sufficient to increase competition, and leading banks were able to co-ordinate their pricing decisions.

There is strong evidence that market in general could benefit from more competition (Denizer, 2000). Foreign entry, in particular, should have had a positive impact on banking sector competition. Foreign entry in Turkey did reduce overhead costs of the domestic banking system, as it helped to raise formerly low human capital and technological standards in the sector. But the high concentration associated with inefficient resource allocation reduced the positive impact of foreign entry on competition. Moreover, despite the significant increase in the number of foreign banks, the evolution of their market share in terms of assets, loans, and deposits have fluctuated but did not increase over time. In other words the number of the banks and their shares did not increase proportionally. Foreign banks are, in general, smaller

than local banks. They have smaller branch networks and they are not engaged in retail banking business. Therefore their impact on concentration has been minimal (Denizer, 2000). The lack of macroeconomic stability, high and variable inflation, and weak supervision also acted to reduce the positive implications of foreign entry in the market.

In such a situation, the sector became clearly overcrowded and after the 2000-2001 crisis, the number of banks declined by one-quarter, and is expected to decline further as bank restructuring and macroeconomic stabilisation proceed. The liberalisation reforms further did not address the problem of bank ownership by large industrial conglomerates, which had developed during the pre-liberalisation era of planned industrialisation policies, and also acted to thwart competition notwithstanding new entry.

After financial liberalisation, the expected effect on efficiency gains in the production process of banking was not realised. The Turkish banking system's relatively lower efficiency scores in intermediation than production suggests that the banking system performed relatively poorly in terms of its basic function: transforming deposits into loans. High profitability in the sector appears to have resulted from the banks' uncompetitive pricing rather than their efficiency.

According to empirical studies, greater bank development lowers bank profits and margins. Lower profitability and lower interest margins are in turn deemed to be reflections of greater competition among banks. There is also empirical evidence that for most countries a larger foreign ownership share of banks is associated with a reduction in the profitability and margins of domestically owned banks. But there is no evidence this happened in Turkey. During 1988-1995, the net interest margin in Turkey was 7.5 per cent for banks with domestic ownership whereas it was 8 per cent for banks with foreign ownership. After Brazil and Costa Rica, Turkey ranked the third, in highest net interest margin for domestic ownership, among 80 countries. (Claessens *et al.*, 1998)

The result of a study that examines the period 1980-1997 indicates that neither the number share of foreign banks nor their market share was related to net interest margin in a significant way in Turkey. It is not the number of foreign banks in the system that explains net margins but probably the products and services they provide, and the way they are managed (Denizer, 2000). The study also suggests that a higher interest margin is associated with higher overheads in the form of large branch networks, high maintenance costs, and large salary expenses. Inflation was another significant variable: higher inflation increases overhead costs and the frequency of transactions; and banks can benefit from delayed payments to customers in an inflationary economy like Turkey's. Furthermore, the market structure variable was significant and positive suggesting that all banks have benefited in terms of higher profitability from market concentration.

### **Capital account opening**

Full capital account opening in 1989 completed the process of financial liberalisation. With relatively low sovereign risk (Turkey has never defaulted), Turkey participated in the surge of capital inflows to developing countries of the 1990s. Short term bank deposits and interbank borrowings were the major channel whereby private capital entered the country, rather than portfolio investments as in most emerging market countries. Banks' net foreign asset position remained positive until 1997, when a mild negative net position emerged – in sharp contrast to major capital importing countries such as Thailand, Indonesia, Mexico, and Chile where the banking sector had large negative foreign asset positions in the 1990s (Celasun *et al.*, 1999). This reflected the fact that foreigners were less willing to directly purchase domestic government securities because of Turkish exchange risk, and also that a large portion of domestic banks' foreign currency borrowing comes from domestic currency substitu-

tion. Turkish banks also became important investors abroad, by off-shore branching and equity investments in foreign banks, thus enhancing their global integration.

In 1996, following a crisis which revealed the vulnerability of the financial system to volatility in capital flows, Turkey imposed an effective tax on short term capital inflows (the Resource Utilisation Fund Tax). However, this was not sufficient to stabilise the system as banks started to obtain foreign exchange credits with a maturity slightly over a year, in order to include them in long term credits (see Altinkemer, 1996). Capital outflows due to contagion effects from the Russian crisis in 1998 pushed up real interest rates sharply and led to a large jump in the public debt to GNP ratio by 1999, setting up a new cycle of unstable debt dynamics and banking system stress. Renewed capital outflows in late 2000 and 2001 reflected a loss of confidence in the subsequent IMF exchange rate-based stabilisation programme. This in turn triggered the programme's collapse and the next severe crisis (Annex VII).\*

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\* There has been a discussion recently on to what extent countries where more successful exchange rate-based stabilisation programmes relied explicitly or implicitly on capital controls, *e.g.* China and Chile. Fischer (2001) says that: "The IMF has cautiously supported the use of market-based capital inflow controls, Chilean style. These could be helpful for a country seeking to avoid the difficulties posed for domestic policy by capital inflows. The typical instance occurs when a country is trying to reduce inflation using an exchange rate anchor, and for anti-inflationary purposes needs interest rates higher than those implied by the sum of the foreign interest rate and the expected rate of currency depreciation. A tax on capital inflows can in principle help maintain a wedge between the two interest rates. In addition, by taxing short-term capital inflows more than longer-term inflows, capital inflow controls can also in principle influence the composition of inflows". Also, see Atiyoshi *et al.* (2000) for a detailed study. However, the OECD view remains that capital controls are, on the whole, harmful to development.

## Annex V

### Deposit insurance, moral hazard and banking crises

The consensus, among academics, policy-makers and international institutions on the effects of deposit insurance is that “there are benefits from the contribution of deposit insurance to overall financial stability [*the stability argument*], but deposit insurance imposes costs because of the encouragement of risk taking and misallocation of resources, and because of reduced market discipline and moral hazard, there is an intensified need for government supervision [*the risk-taking argument*].”<sup>1</sup> The case of deposit insurance in general, or a particular deposit insurance scheme thus depends on the relative strengths of these two counteracting forces. For example, the recent statement of IMF financial services consultant Mats Josefsson that “full deposit insurance in Turkey should be abolished in six to nine months” (Milliyet, 24 July 2002) is based on the belief that the risk-taking effect outweighs the stability effect, at least for full deposit insurance.

In this annex, it is argued that the relationship between deposit insurance and banking crises is not robust and whatever relation there is may not operate through the commonly-proposed moral hazard mechanism. Alternative views are proposed. Specifically, it is argued that *i*) moral hazard may not lead to banking crises when precautionary measures are taken by strong bank supervision as well as full bank management and shareholder liability; *ii*) by the same token, limiting deposit insurance may not suffice to prevent the moral hazard problem; *iii*) moreover, bank runs and liquidity crises may happen even with optimal deposit insurance because of correlated bank portfolios.

Because of the difficulty with collecting comprehensive cross-country data, empirical studies of systemic banking problems are quite recent. In their seminal paper, Demirguc-Kunt and Detragiache (2000) find that deposit insurance increases risk by weakening market discipline and encouraging excessive risk-taking; similar results have been obtained in more recent studies. However, Gropp and Vesala (2000), among others, claim that deposit insurance decreases crisis risk by preventing bank-runs because of depositor panics and that this effect is overall stronger than the adverse moral-hazard effects. By performing an extensive sensitivity analysis with different datasets, sample of countries and time periods, Eichengreen and Arteta (2000) find that the relationship between deposit insurance and banking crises is not clear from an empirical point of view: “there is at least as much evidence that deposit insurance has favourable effects – that it provides protection from depositor panics – as that it destabilises banking systems by weakening market discipline in emerging markets, but neither effect is robust”. Moreover, they find that the moral hazard effect, as proxied by the interaction of deposit insurance with domestic financial liberalisation,<sup>2</sup> is not significant. They attribute the lack of a consistent effect to “small differences in coding, sample and estimation”, but results are pointing to something more fundamental, within the stability and risk-taking views themselves. This possibility is explored at a theoretical level below.

As mentioned above, the traditional view is that full deposit insurance can cause banks to increase risk and depositors to choose riskier banks; both of these effects can, in fact, reinforce each other. However, on the depositors' side, decreasing deposit insurance will only affect very wealthy depositors, as depositors can often get around a limited deposit insurance by opening multiple accounts. On the other hand, effective monitoring and punishment can decrease the extent of excessive risk-taking by banks to an extent that moral hazard may not be a problem even under full deposit insurance. In other words, there is not necessarily a trade-off between the *stability* and *risk-taking* arguments; it may be possible to prevent bank runs without undertaking increased risk associated with moral hazard even under full deposit insurance. The other side of the coin is that, as illustrated by Deliveli (2002b), maturity mismatches, an example of excessive risk-taking attributed usually to moral hazard, can occur in the absence of moral hazard as well. It is shown that profit-maximising banks can engage in maturity mismatches even without bailouts, encouraging banks to pay insufficient attention to the maturity composition of their balance sheets (a simplified version of the framework is presented in the Appendix). Therefore, a liquidity crisis may result even when there are no safety nets, as long as banks find it optimal to engage in mismatches.

The traditional argument also assumes that lack of deposit insurance will decrease depositor confidence in the soundness of the banking system and result in bank runs even if the banking system is sound in the first place.<sup>3</sup> However, this argument is based on the simplification of one big bank operating in the economy. With a financial sector made up of several banks, a different picture emerges as regards the possibility of contagious bank runs. Deliveli (2002c) shows that a contagious bank run can only occur if there is a high correlation between portfolios of banks. Without deposit insurance, a contagious bank run can cause huge losses and in that case, the banks will choose less correlated portfolios in order to prevent a contagious bank run in the first place. Less-correlated portfolios further weaken the relation between maturity and currency mismatches and liquidity crises by reducing the financial system's vulnerability to systemic shocks (see Annex VII). However, a deposit insurance scheme will not give any incentive to banks to reduce the correlations of their portfolios. Therefore, although deposit insurance will make it less likely for a *run on a particular bank* to occur, such a run will be more likely to spread to the whole banking system if it does occur. Because of these two opposing forces, the traditional *stability argument* can be questioned: the overall effect of deposit insurance on the stability of the financial system (in terms of preventing bank runs) is uncertain, at least at a theoretical level. Although the relationship between portfolio correlation of the banking system, deposit insurance and banking crises has not been empirically researched,<sup>4</sup> the common vulnerability of the banking sector was one of the key causes of the recent Turkish crisis and continues to be one of the main sources of liquidity risk for the near future (see Appendix VII for a description of this problem).

It is important to note that it is not claimed that moral hazard has not played a role in banking crises. The effect of moral hazard on the recent Asian and Turkish experiences is not disputed. Therefore, bringing deposit insurance to European Union levels will undoubtedly reduce the moral hazard problem as well as maintaining depositor confidence in the financial system. However, the bottom line of this annex is that limiting deposit insurance in Turkey in the near future should not make the BRSA "sit back and relax". Limited deposit insurance will not be binding on most depositors. Moreover, limited deposit insurance means that bank portfolios may continue to be correlated. Therefore, the risk of another banking crisis will not disappear totally when the moral hazard problem is mitigated. To ensure that the banking system is not faced with another crisis, mechanisms and incentives should be designed to encourage banks to hold more diversified portfolios. For example, one of the consequences of deeper and more liquid capital markets will be to diversify banks' securities portfolios and prevent a crisis from being transmitted to the real sector in the form of a credit crunch (this

argument is reiterated in Annex IX).<sup>5</sup> Finally, it should not be forgotten that the relationship between economic and financial stability is a *two-way street*: Although financial stability is a necessary condition for economic stability, economic stability is very important in attaining financial stability as well. The incentives to engage in maturity mismatches will undoubtedly decrease as the economy stabilises (this is proxied by the difference between long and short-term rates in the simple framework in the appendix; as the economy reaches a stable path, the difference between short and long-term rates will decrease as well, reducing the incentives of banks to engage in maturity mismatches).

### Appendix: Maturity mismatches without moral hazard

The importance of moral hazard has been emphasised in currency and maturity mismatches. The simple framework below shows that banks can engage in maturity mismatches even under the absence of moral hazard.<sup>6</sup>

It is assumed that there are two types of loans in the economy, short-term and long-term loans and the long-term interest rate is higher than the short-term one.

$$i^s < i^l \quad (1)$$

Assume that the liabilities of the banks are all short-term and exogenously given. In this simple framework, banks choose only how much of the debt they will have short-term; the ratio of short-term to total loans in banks' balance sheets is denoted by  $\lambda$ . It is further assumed that during a liquidity crisis, banks will have to liquidate their assets; therefore, the interest rate on long-term loans liquidated prematurely is zero. The probability of a liquidity crisis "p" depends on the degree of maturity mismatch of the banking system; *i.e.*, the more long-term loans the banks have, the more likely is a liquidity crisis. More formally:

$$p = f(\lambda) \quad (2)$$

where

$$f'(\lambda) < 0, f(0)=1 \text{ and } f(1)=0$$

The banks maximise their utility in the standard way:

$$E[U] = pU[\lambda i^s] + (1 - p)U[\lambda i^s + (1 - \lambda)i^l] \quad (3)$$

where the first term on the right hand side (RHS) denotes the crisis case and the second term the no-crisis case. (3) can be simplified in this manner:

$$E[U] = pU_c + (1 - p)U_s \quad (4)$$

Substituting (2) into (4) and differentiating with respect to lambda gives: (5)

$$-f'(\lambda)U_s + (1 - f(\lambda))U'_s(i^s - i^l) + f'(\lambda)U_c + f(\lambda)U'_c i^s \quad (6)$$

Using the first order condition (FOC) and solving for the probability of crisis gives:

$$f(\lambda) = \frac{U'(i^l - i^s) + f'(\lambda)(U_s - U_c)}{U'_s(i^l - i^s) + U'_c i^s} \quad (7)$$

Total differentiation of this equation with respect to lambda yields:

$$-2f'(\lambda)U'_s(i^s - i^l) + 2f'(\lambda)U'_c i^s + (1 - f(\lambda))U''_s(i^s - i^l)^2 \quad (8)$$

Note that this equation is always less than zero.

Assume a simple functional form for EQUATION which satisfies all the conditions of (2):

$$f(\lambda) = 1 - \lambda \quad (9)$$

The bank's optimal (*i.e.* utility maximising) share of short-term to long-term loans will in this case be:

$$\lambda = \frac{U'_c i^s + U_s i^l - U_c}{U'_s (i^l - i^s) + U'_c i^s} \quad (10)$$

From this equation, it can be seen that as long as

$$i^l - i^s > \frac{U_s - U_c}{U'_c} \quad (11)$$

$\lambda$  will be greater than zero, *i.e.* the bank will choose to give out some long-term loans. The interpretation of this condition is simple and intuitive: A bank will choose to hold long-term loans in its portfolio as long as the extra monetary gain from holding those in this portfolio is more than the utility loss resulting from a crisis.

The model above has undertaken some simplifications to focus on a specific aspect of bank balance sheet management. It has simplified the bank balance sheets by concentrating on asset management and assuming banks' liabilities are given. Moreover, although the liquidity crisis itself depends realistically on the extent of maturity mismatches, shocks to liquidity are random rather than being based on fundamentals.<sup>7</sup> Moreover, although this model implicitly assumes a closed-economy framework, differences between domestic and foreign interest rates may be important as well. Deliveli (2002b) extends the simple framework into an open-economy model with a fundamentals-based liquidity crisis and arrives at the conclusion that both currency and maturity mismatches can occur and result in crises in the absence of moral hazard. However, even this simple framework has some important implications for Turkey. The difference between short-term and long-term rates is around 16 per cent.<sup>8</sup> The model above implies this difference between short and long-term rates is giving banks incentives to engage in maturity mismatches. If the stabilisation programme succeeds and the interest rates go down as planned, these incentives will decrease as well.



## Notes

1. Testimony of Lawrence H. Meyer, member of Board of Governors of the Federal Reserve.
2. This is a popular proxy for moral hazard, first proposed by Hutchison and McDill (1998). It is based on the assumption that allowing banks to compete for deposit interest rates under deposit insurance can lead to risk-taking by banks; the full theoretical framework can be found in Hellmann, Murdoch and Stiglitz (2000).
3. The seminal theoretical paper is Diamond and Dynvig (1983).
4. Early results from Deliveli (2002c), however, suggest that there might be relationship between deposit insurance and correlation of bank portfolios just before the Asian and Turkish crises.
5. In this sense, the results of this annex may be seen as the theoretical basis behind Alan Greenspan's remarks a couple of years ago that the financial system needs to be diversified; a remark which had been seen as puzzling when it was originally made. If the US needs more diversification, probably Turkey could do with a lot more!
6. In Turkey, as discussed in Annex VII, both currency and maturity mismatches have contributed to the fragility of banking system *via* banks' balance sheets. For simplicity, the model of the appendix is limited to maturity mismatches. For a framework including both currency and maturity mismatches, refer to Deliveli (2002b).
7. An example of a "fundamentals-based" liquidity crisis is in Agenor and Aizenmann (2000).
8. As of mid-August 2002, the one-month business loan rates are 49 per cent and six-month rates 65 per cent.

*Annex VI***The World Bank in Turkey****Background**

In 1999, the Turkish Government launched an extensive economic reform programme to overcome chronic high inflation and restore sustained growth. The World Bank was fully engaged in supporting this effort. After the crises in late 2000 and early 2001, the Government outlined a new economic programme to bring about a rapid turnaround in the economy. The new programme was a much deeper attempt than the previous ones in addressing the structural roots of the crisis – weak public finances and a fragile banking system – while strengthening social programmes.\*

**Focus of World Bank assistance**

The World Bank supports Turkey's economic transition with an extensive programme of lending, technical assistance, as well as analytical and policy advice. The Bank's Country Assistance Strategy (CAS) for 2000 was built around five themes:

- implementing reforms for growth and employment generation;
- improving public management and accountability;
- expanding social services and social protection;
- strengthening environmental management and disaster mitigation;
- accelerating connectivity and technological capability.

In July 2001, the Bank issued a CAS Progress Report that restructured the 2000 program to make it more responsive to changed circumstances. The key structural and social elements of this new economic programme were a strong focus on:

- banking and public sector reform;
- strengthening the country's social protection system;
- continuation of the Bank's long-term support to programmes in education, health, community-based watershed management, and community development and heritage.

To support the banking and public sector reform, the CAS Update included a first Programmatic Financial and Public Sector Adjustment Loan (PFPSAL) of \$1.1 billion in July 2001, followed by a second PFPSAL II approved in May 2002, for the amount of \$1.35 billion. The CAS Update also included a loan to support the Social Risk Mitigation Project, which was approved in September 2001. Finally, an Agriculture Reform Implementation Project was

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\* This Annex has been prepared on the basis of information in World Bank (2001b), (2002a) and (2002b).

also introduced to support structural reform in agriculture and the implementation of a direct income support system for farmers.

### Impact of the assistance

The major results achieved by the programme are :

- Higher enrollment in schools and improvement of the quality of education.
- Provision of back-to-school and winter heating support.
- Afforestation, irrigation and training leading to improved management of natural resources.
- Delivery of assistance to victims of the Marmara earthquake.
- Improvement of public expenditure management.
- Progress in institutional reform and governance.
- Cleaning-up of the banking sector.
- Preparing the framework on corporate sector restructuring (Istanbul Approach).
- Promotion of Foreign Direct Investment.
- Liberalisation of the energy and telecommunication market.
- Reform of the agricultural sector.

### World Bank Lending to Turkey

21 projects are ongoing, including two grants – a Biodiversity Project funded by the Global Environment Facility equivalent to \$ 8.2 million, and a Second Ozone-Depleting Substance Phase-Out Project supported by Montreal Protocol funds equivalent to \$14.0 million.

### Challenges Ahead

The priorities of the programme in the near term are:

- further reduction of the society's economic divide;
- starting health reform;
- developing and implementing local government reform, critical for improvements in local infrastructure.

Table A.3. **Total IBRD / IDA Commitments from 1991 to 2002**  
(by fiscal year, in nearest US\$ millions)<sup>1</sup>

	up to 1995	1996	1997	1998	1999	2000	2001	2002	<b>Total</b>
Commitments	2 143	312	20	603	528	1 770	1 028	3 550	<b>9 954</b>
Disbursements	1 900	611	328	259	249	958	820	1 679	<b>6 804</b>

1. Fiscal year from July 1-June 30. A new Bank sector and thematic coding system was introduced in FY02. Under this new system, themes represent the development objectives of the operation, whereas sector codes for investment operations reflect the parts of the economy receiving direct support, and for adjustment operations, the sectors being impacted by the operation's conditionalities. Thus, a given adjustment operation may span a number of sectors depending on the reform measures being implemented by the loan and may, for example, show up in education, health, trade and industry or other categories, even though there may not be a direct investment in that sector.

Table A.4. **World Bank (IBRD) Projects in Turkey**

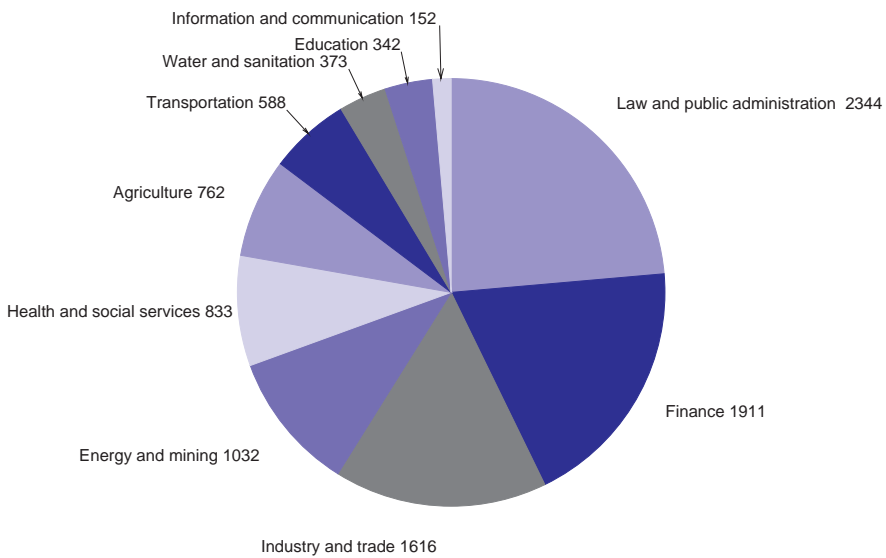
Project name	Lending instruments	Approval date	Closing date	IBRD commitments (US\$ millions)	Grants (US\$ millions)	Sector name	Project status
Phaseout of Ozone Depleting Substances Project (02)	Specific Investment Loan	05.10.1995	6/30/2004	0.0	14.0	General industry and trade sector	Active
Antalya Water Supply and Sanitation Project	Specific Investment Loan	5/25/1995	6/30/2003	100.0	0.0	Water supply	Active
Commodities Market Development Project	Learning and Innovation Loan	7/16/1998	3/31/2003	4.0	0.0	Agricultural marketing and trade	Active
Road Improvement and Traffic Safety Project	Specific Investment Loan	6/20/1996	3/31/2003	250.0	0.0	Roads and highways	Active
Protected Areas and Sustainable Resource Management Project	Specific Investment Loan	6/13/2000	12/31/2006	0.0	8.2	Central government administration	Active
Marmara Earthquake Emergency Reconstruction Project	Emergency Recovery Loan	11/16/1999	5/31/2005	505.0	0.0	Housing construction	Active
Privatization Social Support Project	Specific Investment Loan	12/21/2000	12/31/2004	250.0	0.0	Agro-industry	Active
Basic Education Project (02)	Adaptable Program Loan	7/16/2002	2/28/2006	300.0	0.0	Primary education	Active
Cesme – Alacati Water Supply and Sewerage Project	Specific Investment Loan	4/14/1998	12/31/2003	13.1	0.0	Sewerage	Active
Industrial Technology Loan Project	Specific Investment Loan	6/17/1999	12/31/2003	155.0	0.0	General industry and trade sector	Active
Economic Reform Loan Project	Structural Adjustment Loan	5/18/2000	3/31/2003	759.6	0.0	General agriculture fishing and forestry sector	Active
Programmatic Financial and Public Sector Adjustment Loan (02) Project	Programmatic Structural Adjustment Loan	04/16/2002	12/31/2002	1350.0	0.0	Central government administration	Active
Participatory Privatization of Irrigation Management and Investment Project	Sector Investment and Maintenance Loan	10/14/1997	12/31/2002	20.0	0.0	Irrigation and drainage	Active
Health Project (02)	Specific Investment Loan	09/22/1994	6/30/2003	150.0	0.0	Health	Active

Table A.4. **World Bank (IBRD) Projects in Turkey** (*cont.*)

Project name	Lending instruments	Approval date	Closing date	IBRD commitments (US\$ millions)	Grants (US\$ millions)	Sector name	Project status
National Transmission Grid Project	Specific Investment Loan	06.11.1998	12/31/2005	270.0	0.0	Power	Active
Emergency Flood and Earthquake Recovery Project	Emergency Recovery Loan	09.10.1998	3/31/2003	369.0	0.0	Housing construction	Active
Export Finance Intermediation Loan Project	Financial Intermediary Loan	07.06.1999	2/28/2003	252.5	0.0	Other industry	Active
Agricultural Reform Implementation Project	Sector Adjustment Loan	07.12.2001	12/31/2005	600.0	0.0	Crops	Active
Public Financial Management Project	Specific Investment Loan	9/21/1995	12/31/2002	62.0	0.0	Central government administration	Active
Social Risk Mitigation Project	Sector Adjustment Loan	9/13/2001	6/30/2006	500.0	0.0	Other social services	Active
Basic Education Project	Adaptable Program Loan	6/23/1998	6/30/2003	300.0	0.0	Primary education	Active
Health Sector Reform Project	Adaptable Program Loan			200.0	0.0	Health	Pipeline
Agricultural Pollution Control Project	Specific Investment Loan		10/30/2003	0.0	6.0	General agriculture fishing and forestry sector	Pipeline
Secondary Education Project	Specific Investment Loan			250.0	0.0	Secondary education	Pipeline
Renewable Energy Project	Specific Investment Loan			200.0	0.0	Renewable energy	Pipeline
Koykent Development Project	Specific Investment Loan			300.0	0.0	Roads and highways	Pipeline
Turkey – Anatolia Watershed Rehabilitation Project	Specific Investment Loan			50.0	0.0	General agriculture fishing and forestry sector	Pipeline
Community Development and Heritage Project	Specific Investment Loan			25.0	0.0	Central government administration	Pipeline

Source: World Bank.

Figure A.1. **Total commitments by sector from 1991**  
in nearest US\$ millions



*Note:* A new bank sector and thematic coding system was introduced in FY02. Under this new system, themes represent the development objectives of the operation, whereas sector codes for investment operations reflect the parts of the economy receiving direct support, and for adjustment operations, the sectors being impacted by the operation's conditionalities. Thus, a given adjustment operation may span a number of sectors depending on the reform measures being implemented by the loan and may, for example, show up in education, health, trade and industry or other categories, even though there may not be a direct investment in that sector.

*Source:* World Bank.

*Annex VII***Balance sheet fragility and crisis-proneness in the Turkish banking sector**

The latest financial crisis in Turkey occurred because the private banking system (and the private sector more generally) reacted to policy incentives in ways which exposed them to mounting exchange-rate risks, while inducing them also to follow practices that increased their credit and liquidity risks, without sufficient check on their activities, because of weak prudential oversight and implementation. The State Banks meanwhile were forced to borrow very short term at increasingly high interest rates, to cover their losses on subsidised loans (which it was their “duty” to extend), losses which were not adequately covered by Treasury. When the lira was floated and the macroeconomic policy environment changed, the latent risks became real, and the banking system was plunged into crisis.

**Exchange-rate risk**

The banking sector gradually accumulated large liabilities denoted in foreign currency. By the year 2000, such liabilities comprised more than half the total (see Table 19, Chapter III).<sup>1</sup> Banks’ currency risk on their foreign exchange (FX) liabilities was apparently to a large extent offset by foreign assets and domestic loans in foreign currency (see Table 19, Chapter III). Indeed, FX loans were the preferred borrowing vehicle since few (if any) investments in real assets could provide expected yields to justify borrowing at Turkish lira (TL) rates. However, firms used part of these FX loans to purchase government debt, thus also engaging in open arbitrage,<sup>2</sup> but as they did not have the corresponding cash flow in foreign currencies, they became just as exposed to FX risk as were the banks, which diminished the quality of much of the “hedge” that such FX lending provided. However, the regulatory limit applied only to the net position. Also, since the maturity of FX assets exceeded that on FX liabilities, potential FX liquidity problems further diminished their usefulness on balance-sheet cover.

Banks’ off-balance sheet transactions further affected their exchange-rate risk exposures. Larger corporations were able to borrow abroad directly mainly on the basis of bank guarantees, transferring back to the banking system much of the substantial exchange risk of the non-banking sector (off-balance sheet positions). Banks also engaged in forward foreign-exchange types of contracts, which however provided little protection due to the thinness and one-sidedness of the market.<sup>3</sup> By end-2000, the net open position of private banks amounted to \$1 billion, or 12 per cent of bank capital, well within the regulatory limit (see Table 20, Chapter III). However, the “true” open position was much higher, as the forward cover was of dubious quality, more was at risk due to FX credit guarantees, and an unknown amount was hidden in off-shore bank and domestic non-bank affiliates. Excluding just the forward position raised the open position to some 80 per cent of capital. This implied huge capital losses in the event of devaluation.

Table A.5. **Off balance sheet positions**  
(US \$ billion, end-period)

Period	Original currency of denomination	Credits <sup>1</sup>	Contingencies		Forward FX transactions and money swaps	Total	Total as % of banks assets
			Repos and reverse repos	Other commitments			
1997	TL	8.1	16.4	2.5	9.4	36.3	67.4
	FX	21.3	0.2	3.6	23.0	48.2	121.4
	Total	29.4	16.6	6.1	32.4	84.5	94.4
1998	TL	9.3	15.8	3.5	12.6	41.2	60.6
	FX	24.0	0.1	2.4	34.7	61.2	140.0
	Total	33.4	15.9	5.9	47.3	102.5	91.6
1999	TL	8.0	18.3	4.3	21.7	52.3	65.6
	FX	23.5	0.1	4.2	55.4	83.2	175.2
	Total	31.5	18.4	8.5	77.1	135.5	106.5
2000	TL	9.9	21.4	5.2	21.9	58.4	60.4
	FX	26.0	0.5	2.5	65.6	94.6	184.4
	Total	35.9	21.9	7.7	87.5	153.0	103.4
2001	TL	6.1	7.4	2.6	2.9	19.0	33.1
	FX	18.7	0.2	2.2	19.4	40.5	77.5
	Total	24.8	7.6	4.8	22.3	59.5	54.3

1. Letters of guarantees, acceptance credit, documentary credit, guarantees of bank- giro, prefinancing credit with letter of guarantee.

Source: The Banks' Association of Turkey.

## Interest-rate risks

Given that their liabilities have tilted more and more toward the overnight-to-one month maturity range, banks in Turkey have run considerable risks in terms of potential capital and income losses from interest rate fluctuations. Maturity mismatch has been exacerbated by off-balance sheet holdings of government securities funded by overnight repurchase agreements with bank customers.<sup>4</sup> The volume of repos, encouraged by favourable tax and regulatory treatment, rose sharply after 1997 (off-balance sheet positions). A simple "maturity gap" analysis (Box A.1) indicates that by end-2000, the combined on and off-balance sheet maturity gap was some TL100 quadrillion, so that a 10 per cent interest rate increase could cause losses equivalent to the whole of banks' capital.

## Credit risk

Limited lending to the real sector and the short-term orientation of these credits should have implied a relatively limited risk of exposure to borrower default. Indeed, the reported NPL ratio for private banks has been usually very modest, even falling to under 5 per cent in the crisis year 2001 (see Table 20, Chapter III). However, macroeconomic shocks have been much bigger in Turkey than in most other OECD countries, and there are reasons to believe that the true NPL situation was much worse than revealed by the statistics. Faulty loan classifications may not have provided an accurate picture of potential loan losses in the banking



**Box A.1. The maturity gap and banks' exposure to interest rate risk**

Nominal interest rate risk reflects two components: inflation risk and real interest rate risk. The exposure to inflation risk alone is gauged by the "net nominal position" (NNP), *i.e.* the net asset position that is not protected (or indexed) against variations in inflation. Net assets denominated in FX are protected, due to relative stability of the real exchange rate, as well as real assets such as participations in subsidiaries and other firms, fixed assets, and, on the liabilities side, bank net worth. It is seen from Table A.7 that the net nominal position for the banking sector, as a percentage of bank capital, is quite large and negative, especially for private and foreign banks. Thus, a sudden rise in inflation will degrade the real value of banks' assets more than that of liabilities, since a much larger share of the former are not indexed against inflation. State banks are much less exposed because a much larger share of their deposits is in TL terms. By the same token, the private and foreign banks have much more to gain from a sharp disinflation. For the banking sector as a whole, the NNP is 90 per cent of net worth. This gives a useful indication of the inflation exposure of banks in Turkey. For private banks, the figure is 109 per cent, for foreign banks 119 per cent, and for state banks only 25 per cent. Another way of seeing this is that the former two banking groups are more exposed to domestic inflation risk because of the high share of FX-denominated deposits in total liabilities, *i.e.* because of their proclivity to open positions. Thus, domestic inflation risk on the net nominal position is to a large extent the obverse of foreign exchange risk on the net open position.

The next step in the analysis is to gauge the sensitivity of banks' net interest income (NII) to changes in interest rates by way of the "gap" between rate sensitive-assets and rate-sensitive liabilities, *i.e.* the percentage of nominal assets and liabilities that can be repriced during the so-called "gapping period". As seen in Table A.6, the majority of banks' nominal (TL) assets and liabilities – 51 and 92 per cent, respectively – are in maturities of less than 6 months, which may be chosen as the relevant period of analysis. Table A.7 shows that, if off-balance sheet commitments are included, a negative "gap" of almost TL100 quadrillion emerges, meaning that in the event of an interest rate increase, the amount of liabilities to be repriced would be to that extent greater than that of assets, resulting in significant losses for the banks. The risk exposures would be clearly much larger than the system average for the private and foreign banks, because of their larger negative net nominal positions, than for the state banks.

system. Along with lax regulation and tax disincentives, this led to inadequate loan loss provisioning and overstatement of capital adequacy positions.

There are several factors underlying the presumption of high credit risks in the Turkish banks:<sup>5</sup>

- *Connected lending* within industrial groups often involved insider lending practices where terms and conditions were not on an arms-length basis. Banks' lending departments were not encouraged to scrutinise such loans closely nor to monitor borrowers.

Table A.6. **Shares of bank nominal assets and liabilities by maturity\***  
(per cent of the balance sheet total, December 31, 2000 – all banks)

TL denominated assets and liabilities		
	Assets	Liabilities
Maturity		
0 – 1 month	29.48	58.69
1 – 3 months	8.67	25.39
3 – 6 months	12.99	8.37
6 – 12 months	11.65	3.75
More than 1 year	37.21	3.81
Total	100.00	100.00

\* See Table A.7 for definitions of nominal assets and liabilities.

Source: Central Bank of Turkey.

Prudential limits on connected lending credits were full of loopholes and easily evaded.

- *Very fast credit growth* does not augur well for loan asset quality, as it does not allow time to make careful credit risk evaluations. This pertains in particular to the 4-fold increase of consumer credits in 2000, seen by banks as being easy to monitor and enforce.

Table A.7. **Maturity gap analysis**  
(2000, in TL quadrillion)

<b>1) Nominal assets</b>	<b>74.6</b>		
= Total on balance sheet assets	104.1		
+ off-balance sheet securities (repos)	14.8		
– FX assets	36.8		
– Real assets	7.5		
<b>2) Nominal liabilities</b>	<b>153.2</b>		
= Total on balance sheet liabilities	104.1		
+ Contingencies + commitments	105.0		
– FX liabilities	48.7		
– Net worth	7.2		
<b>3) Interest rate-sensitive assets</b>	<b>47.7</b>		
= 0.64 * (1)			
<b>4) Interest rate-sensitive liabilities</b>	<b>134.8</b>		
= 0.88 * (2)			
Gap = (3)-(4)	–87.1		
<i>Memo items:</i>			
Gapping period = 6 months			
Impact on net interest rate income of interest rate increase of:			
10%	20%	30%	
In TL quadrillion	–8.7	–17.4	–26.1
As % of net worth	121	242	363

Source: Data from Banks' Association of Turkey, using methodology from Cilli and Kaplan (1998).

- Credit risk materialised strongly during *economic contractions*, notably in 1994, 1998-99, and 2001. Imprudent concentrations of credit to particular sectors because of connected lending practices exacerbated this channel, *e.g.* in the textile and tourism sectors after the Asian and Russian crises of 1997 and 1998.
- Credit risk was also magnified by its *positive correlation with exchange risk*, insofar as direct FX lending and FX guarantees were provided by banks to corporations without foreign trade related activities. The operation of this channel was observed in both devaluation years 1994 and 2001.

In the event of crises, credit risk turned out to have lasting and often intractable impacts. Asset prices righted themselves relatively soon whereas the real side effects were more enduring, as corporate and household distress stemmed from both economic contraction and balance sheet wealth losses similar to those in banks.<sup>6</sup>

### Liquidity risk

The liquidity situation in the banking sector has deteriorated in recent years. Private banks responded by steadily reducing the maturities of their credits, so that by 2000 their TL coverage ratios were high (see Table 20, Chapter III). Coverage ratios were much lower in state and unresolved SDIF banks because of their growing losses. A number of private sector banks have also worked hard on improving their ability to tap the international markets, and the state banks have continued to benefit from high depositor confidence as it is widely believed that the government would never let its own banks fail. Central Bank reserve and liquidity requirements also give a measure of comfort.<sup>7</sup>

The most serious liquidity problems arise from the system's vulnerability to systemic shocks. Virtually all banks are positioned in the same direction, holding short foreign currency positions and borrowing short-term and investing/lending long-term.<sup>8</sup> Banks are also the dominant players in both currency and government securities markets. Therefore, in the event of an initial adverse movement in these positions, all banks would move in unison to shed their holdings, pushing the lira down and interest rates up, leaving the Central Bank as the sole stabilising force in the market. As seen above, these unfavourable asset price movements would immediately push up banks' interest and FX obligations. As banks would seek to liquidate securities to meet heightened cash flow needs, they would find themselves liquidity constrained owing to unexpected losses on the realised values of these assets. With the Interbank market also drying up, especially given underlying pressure from state and SDIF banks, banks might default on obligations and transmit the liquidity shortfall to their creditors *via* the payment system. Deeper and more liquid securities markets, allowing a more diversified structure of bank securities portfolios and a greater variety of market participants, would reduce this risk.<sup>9</sup>

This type of risk highlights the Central Bank's dilemma while disinflating so long as banks remain fragile. The Central Bank has long sought to protect banks by its managed float exchange rate policy, along with smoothing operations in the overnight market. Under an exchange rate peg or inflation targeting disinflation strategy, its options are more limited. If it wants to defend the currency or stem an incipient rise in inflation by raising interest rates sharply, such an action would have serious consequences for banks because of capital risk exposures. This factor was present to an extreme degree during the defence of the currency peg in November 2000 (below). Under inflation targeting, the Central Bank has more flexibility, but effective use of the interest rate tool will still be constrained by large maturity mismatches in banks.

Another significant risk for banking sector liquidity comes from its dependence on international capital. Inflows have become more and more short term throughout the 1990s in response to the perceived risk of investing in Turkey. Such flows can easily reverse direction when there is a sudden change in market sentiment, as happened in late 2000 in response to current account deterioration and structural policy slippage, which in turn helped to trigger the above scenario among domestic banks. Clearly, Turkey's access to international liquidity, and the terms on which it is obtained, is more and more dependent on the credibility of Turkey's overall economic policy stance. Sentiment can also deteriorate with a generalised increase in risk aversion to developing markets (contagion). Hence, besides macroeconomic and policy stability, a greater share of foreign direct investment in the structure of capital inflows would help to make the banking system's liquidity situation more robust.

### **The 1990s: from one crisis to another**

By end-1993, a rising current account deficit and unfavourable debt dynamics prompted the government to reverse policies toward a low interest rate and higher depreciation mix (return to monetisation). The initial exchange rate decline in January 1994 was a modest 13 per cent, but it destroyed the balance sheet of banks. In April, the government adopted a stabilisation programme with the IMF, imposed full deposit insurance and after closing banks' open positions, devalued by another 65 per cent. As foreign capital flowed out, real interest rates shot up (to 140 per cent for the year on average), a deep recession ensued and most banks were hit by huge losses, loan defaults, and liquidity problems. The state banks lost 90 per cent of their net worth, and a steady decline in the state banking sector set in thereafter.

However, with a rapid export-led recovery, the stabilisation programme was soon forgotten. The government had learned its lesson, so to speak, and reverted to a policy of high real interest rates and trend real exchange rate appreciation in order to attract capital flows. Open positions started to rise again as capital flowed back in. Turkey was even regarded as something of a safe haven after the Asian crisis of 1997. But the Russian crisis of 1998 exerted strong contagion effects. Capital outflows due to heightened international investor risk aversion caused real interest rates to rise sharply. After another deep recession in 1999, the government turned once again to the IMF to try to bring stability to the economy. The Stand-By agreement signed with the IMF in December 1999 was aimed at attaining single digit inflation within three years and the main policy tool was a pre-announced exchange rate crawl to break entrenched inflation expectations. The monetary rule was set in a framework that strictly linked liquidity creation to the inflow of external capital and forced the Central Bank to act as a quasi-currency board. The exchange rate policy was bolstered by incomes policy and supported by a restrictive fiscal policy which, together with proceeds from privatisation, aimed at achieving significant primary surpluses. The macroeconomic programme was complemented by a broad structural reform agenda. An important structural development was the formation of an independent regulator, the Banking Regulatory and Supervisory Agency (BRSA), which did lay the groundwork for a strengthened regulatory framework.

The 2000 programme was perceived by the markets to be highly credible as it involved a strong fiscal correction together with a nominal exchange rate anchor, and consequently real interest rates fell sharply. The crawling peg policy caused the real exchange rate to appreciate markedly. Inflation fell in response, and nominal interest rates continued to fall in parallel, implying substantial windfall profits for private and foreign banks. But major problems were emerging. Perhaps the most significant of these was undershooting of interest rates (Box A.2), which in turn led to an overheating economy and overshooting of the end-

**Box A.2. Interest rate undershooting in the failed programme**

The *undershooting of interest rates* became one of the fundamental factors leading to the banking and balance of payments crisis in late 2000. The disinflation programme, insofar as it gained credibility, eliminated exchange rate risk since a pre-specified path of the currency basket was announced. The tightened fiscal policy measures and ambitious structural reform agenda reduced concerns on debt default, hence diminishing default risk. However, domestic interest rates were still high enough to create considerable international arbitrage opportunities, since the nominal depreciation of the currency fell far short of the differential with foreign interest rates. Consequently, the economy enjoyed strong capital inflows which lowered interest rates through the policy of non-sterilisation, shifting the yield curve downwards and lowering the future burden of interest payments on the debt stock and thus lowering default risk, and prompting further capital inflows. Hence, interest rates were undershot.\* Furthermore, banks' aggressive positioning in government securities enhanced the decline in interest rates. Endowed with expectations of falling interest rates, banks exerted an excessive demand for government paper, and also offered large consumer credits, relying on repos, Interbank loans, and open positions for their funding. Of course, the low transparency of banks and the poor or badly-managed supervision by both national and international institutions also shows that investors were poorly informed. If investors had known about banks' mounting debts, real interest rates would have been much higher. Thus, when these problems came to light later in the year, as financial pressures became inevitable, a crisis erupted.

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\* See Alper (2001).

year inflation target. As the predetermined path for the nominal exchange rate was met, the result was a significant real appreciation of the Turkish lira. Booming domestic demand and real appreciation, plus adverse external factors, led to widening of the current account deficit to an unprecedented 5 per cent of GDP, about three times as large as the level targeted in the programme. The Central Bank was unable to counter the overheating because its hands were tied by the "quasi currency board" rules of the exchange rate peg.

Also, exchange rates had become even more predictable than formerly as the rate of nominal depreciation was pre-announced in line with the official inflation target, which strengthened incentives to take open positions. Meanwhile banks sharply increased their exchange-rate and interest-rate risk exposures in response to the incentives in the programme, against a background of inadequate banking supervision and enforcement. As long-term assets could be financed by very short-term borrowings continually rolled over at better terms, banks significantly increased their maturity mismatch and net open positions in response to the positive asset price shocks that were occurring. In addition, the quality of the credit portfolio declined with a major consumer lending boom by banks (mainly for purchases of imported cars). The new bank regulator arrived on the scene too late to prevent the

dangerous growth of bank risk positions. And although the need for a banking reform was recognised by the IMF, in part as a result of lessons learned in the Asian crisis, insufficient resources were available to finance such a reform.

Some domestic banks engaged in particularly aggressive positioning in the expectation of falling interest rates, and their enthusiastic demand at Treasury auctions contributed to the interest rate undershooting that proved so damaging to the programme. One medium-sized bank (Demirbank) at one point held 15 per cent of total government debt outstanding in its portfolio. As capital started to flow out in the autumn of 2000,<sup>10</sup> these banks quickly ran into serious liquidity difficulties. Several bank failures during the year also meant that more unresolved SDIF banks were exerting pressure in the overnight market, while also engaging in criminal activities,<sup>11</sup> while the public bank duty loss problem persisted. At the same time, liquidity provision was shrinking with the worsening in the balance of payments. By around mid-November 2000, with heavy excess demand in the overnight Interbank market and spreading bank losses, concerns about the domestic banking system grew. Rumours about illiquid and risk-exposed banks led to a withdrawal of foreign portfolio funds, provoking a severe bank liquidity squeeze, and a leap in interest rates. The Central Bank sold large amounts of foreign exchange, losing a substantial amount of international reserves. Foreign banks balked and exited Turkey, while domestic liquidity-flush banks refused to provide funds to the market.<sup>12</sup> At the peak of the liquidity crisis, overnight interest rates reached 7 000 per cent, which began to cause systemic distress *via* the Interbank payments and settlements system. The Central Bank then stepped in to provide liquidity, which violated the IMF programme. This caused panic among investors, and to restore calm, the IMF provided emergency funding of \$7.5 billion from the Supplementary Reserve Facility, Demirbank was taken over by the SDIF, and a full guarantee of bank liabilities was announced in early December. Nevertheless, interest rates remained very high (around 60 per cent in real terms) as foreign private capital stayed away and domestic banks in that situation demanded high interest rates to fund the government debt. This set the stage for the next crisis.

On 20 February 2001, a political spat between the Prime Minister and the President just before a major Treasury auction sparked a rush out of Turkish lira by domestic investors, and desperate attempts by domestic banks to cover their open positions, shrinking domestic liquidity. By that time, the overnight borrowing requirement of the state and SDIF banks had grown to enormous proportions, and the inability to fund these banks was a major reason that the currency was let go two days later. The lira ultimately plunged by 60 per cent and derailed the disinflation. Interest rates continued to hover above 100 per cent levels for many months. The combined upward inflation, interest, and exchange rate shocks had devastating effects on banks' balance sheets and led to widespread fears as to public debt sustainability. Although interest rates started to ease in late summer in response to the Strengthened Economic Programme, only after the 11 September events, when Turkey received massive new assistance from international donors, in support of the programme, did confidence start to turn around decisively and the original shocks begin to unwind. But by that time, the deepening economic crisis was impacting adversely on credit quality, implying a new hit to bank balance sheets.

## Notes

1. By comparison, FX liabilities as a percentage of the total were around 20 per cent in Mexico and 26 per cent in Greece in 2000.
2. A recent survey of corporations has also found that well more than half of the profits were reinvested in government securities rather than in productive investments. See Bossone (1999), p. 12.
3. Banks engaged in both interest and exchange rate forward and swap transactions to fine-tune their desired risk positions. However, as banks were, in the end, all positioned in the same direction, in the event of a major shock they were likely to move in unison and such forward hedging mechanisms would (and did) break down.
4. A repo, or repurchase agreement, was a simultaneous arrangement to sell marketable securities to customers and to repurchase them later at a specified day in return for cash bearing daily interest, hence a maturity transformation by banks. See Alper (2001).
5. See also Deliveli (2002f).
6. The Bank Capital Strengthening Programme of May 2001 has gone a long way to address many of these deficiencies: rules on reclassification of loans, loan loss provisioning, and capital valuation have been adapted to international standards. In parallel, regulations issued by the Ministry of Finance and the BRSA eliminated tax disincentives and overstatement of capital adequacy positions due to inadequate loan loss provisions.
7. Required reserves are 6 and 11 per cent for TL and FX deposits, respectively, and liquidity ratios are 4 and 1 per cent.
8. "Short-term" in the Turkish context means overnight to one month. "Long-term" means a few years at most.
9. See Bossone (1999).
10. Political stalling on the privatisation programme by mid-year gave rise to international investor concerns that there would be insufficient capital inflow to finance the growing current account deficit.
11. This came to light under a parallel ongoing anti-corruption campaign but it only further unnerved the markets. In fact, the main tension underlying the clash between the prime minister and the president the following February, which triggered the next crisis, was the question of whether the anti-corruption campaign was interfering with the economic reforms. In the prevailing atmosphere of that campaign, bureaucrats were afraid to take any actions or decisions, whereas a spirit of initiative was essential to the execution of reforms.
12. Some commentators believe that the large banks in question were anxious to punish the "upstart" Demirbank and moreover felt threatened by its extremely aggressive high-growth strategy. It had also broken their monopoly on the Treasury securities auction market. See Alper and Onis (2002).

## Annex VIII

### Pension funds and insurance markets

Capital markets in Turkey remain shallow and volatile, despite their rapid growth over the past decade (Table A.8). Recent research points to a strong link between contractual savings and equity market development. Capital market development implies positive externalities for the banking sector (Chapter III). Developing pension funds and the insurance sector and other domestic institutional investors requires patience and long-term commitment (Vittas, 1999). However the efforts to develop these sectors should be increased along with the Turkish banking restructuring programme and in the context of the macroeconomic stabilisation reform programme.

#### Pension Funds

##### *The Legal Framework*

In Turkey, a new law on individual pension savings and investment system was ratified on 28 March 2001 and has entered into force on 7 October 2001. By-laws regarding this system have also been published on 28 February 2002.

An Individual Pension Advisory Board was formed with the sole purpose of formulating individual pension policies and giving advice on actions required to be taken for implementation of such policies. It consists of representatives, working at least at a directory general level, from the Ministry of Finance, the Ministry of Employment and Social Security, the Undersecretariat of Treasury and the Capital Markets Board.

The Undersecretariat of Treasury and the Capital Markets Board are the regulating and supervisory bodies with regard to pension companies and pension mutual funds. The Capital Markets Board is responsible for the establishment and supervision of retirement funds while the Undersecretariat of Treasury handles the supervision of retirement companies. There is a clear separation of powers between the two regulatory bodies. The main characteristics of the system can be summarised as follows:

- The system will be supplementary to the existing state pension system.
- The system will be voluntary and will be based on defined contribution plans.
- The contributions collected from individuals will be transmitted to pension funds, which will be established in the structure of a mutual fund.
- Anybody who is able to use his civil rights can enter the system.
- Only retirement companies can offer the pension funds. Retirement companies will be established in the context of this new law with the permission of Undersecretariat of Treasury, and will require an initial capital of \$14.3 million. Half of this amount should be paid in cash when the company begins to operate.



- At least 3 different funds with different portfolio structures must be established. In this way individuals will be able to choose a fund according to their personal risk preferences and yield expectations.
- Although not clearly stated in the law both employees and employers, if any, as well as individuals can make contributions to the pension funds.
- The rights of the investors are portable and accumulations can be transferred into another retirement company.
- At retirement, the investors can take their accumulations as a lump sum or they can withdraw the accumulations partially. They will have an option to either buy an annuity from an insurance company or leaving the money in the funds to be invested. Retirement age is 56 providing contributions have been made to the fund for at least 10 years.
- The fund will be managed by portfolio management companies, which will be authorised by the Capital Markets Board.
- The assets of the fund will be deposited in a custodian bank, which will be selected by the pension company and approved by the Capital Markets Board.

### ***Pension funds and financial market development: a symbiotic relationship***

The basic objective of pension reform, and the *raison d'être* of pension systems, is the provision of adequate, affordable and sustainable benefits. Funded and privately managed pension plans can play an important role in the realisation of this objective. Furthermore, once this objective is realised there is evidence that the existence of a well-functioning private pension system can raise the efficiency of long-term investment and the growth of the economy. Even if there is no long-term impact on saving rates, the creation of funded pension plans changes the composition of financial assets and increases the supply of long-term contractual savings making it more likely that savings will be channelled into projects with high returns (Vittas, 1999). In Turkey, given that the private funds are voluntary, the incentives to put savings into them may be low because of low per capita income. Nevertheless, it is still necessary to set the stage for the development of pension funds. Despite the obstacles it is also important to note that “pension funds are critical players in ‘symbiotic’ finance, the simultaneous and mutually reinforcing presence of many important elements of modern financial systems” (Vittas, 1999).

The financial market benefits of systemic pension reform can further be summarised as follows (Vittas, 1999). They:

- act as a countervailing force to existing commercial and investment banks;
- stimulate financial innovation;
- exert pressure for greater market integrity and modernised trading facilities;
- strengthen corporate governance; and
- encourage more robust financial regulation with positive demonstration effects for other financial sectors, such as banking and insurance.

It is worthwhile to lay out the minimum preconditions of financial sector development for the success of pension reform and the promotion of funded pension plans, as well as those for allowing the pension funds to realise their potential impact on capital market development in turn. These could be distinguished as “feasibility preconditions” and “impact preconditions” (Vittas, 1999).

### *Feasibility preconditions*

The most important feasibility preconditions are a strong and lasting commitment of the authorities to maintain macro financial stability, to foster a small core of solvent and efficient banks and insurance companies, and to create an effective regulatory and supervisory agency.

Macroeconomic stability and low inflation are clearly essential for the success of pension reforms because neither the securities market nor institutional investors can function efficiently under high and volatile inflation, which prevents long-term planning horizons essential for fund development.

Fostering a core of sound and efficient banks and insurance companies is important for the handling of contributions and other payments, for the maintenance of individual records and accounts, for the provision of robust and efficient custodial services, and for the offer of reliable contracts (Vittas, 1999). Under a defined-contribution (or money purchase) system like the one that has been introduced in Turkey, the investment of the fund could be carried out by various financial institutions, such as insurance companies, unit trusts and banks. This underlines the importance of having a sound banking and insurance sector. The opening of the domestic banking and insurance markets to foreign participation can be helpful to fulfil this requirement. There are no barriers to foreign bank entry and one quarter of the banks in Turkey is foreign owned. However their share in total banking sector assets is quite small, remaining at 5 per cent. The banking sector in Turkey as in many developing countries is not very well developed and is characterised by fragmentation along with reduced competition, and diversification (Chapter III). It has also suffered from weak supervision and regulation and has been very fragile. The insurance sector suffers from the same weaknesses that have characterised the banking system and the sector remains small, commanding assets that correspond to 2.2 per cent of GDP (see below). Considering the interactive nature of the separate sectors and the mutual benefits that would arise from the development of each, banking sector reform should not be the sole objective of the whole reform process.

To create an effective regulatory and supervisory environment, there is a need for a firm and lasting commitment to the creation of a sound and robust regulatory framework, not just the prior existence of a strong agency. Bearing in mind the poor regulatory and supervisory records of Turkey, it is difficult to tell whether the two pre-existing bodies in charge will be able to sustain the financial soundness of private pension funds and safeguard the interests of workers. The agency's task should initially be limited to vetting applications and ensuring that only qualified institutions obtain licences to operate pension funds. Over time the regulatory agency must develop all its other functions, including the creation of a strong capability in undertaking off-site surveillance and conducting on-site inspections. Taking timely intervention action in cases of potential default and serious violations of regulations is also very important. The case resembles that of creating sound banks and insurance companies. It is further helpful to use the services of external private sector actuaries, accountants, auditors, and custodians. They should also bring extensive information disclosure. External custody, in particular, is very pertinent and critical for Turkey as it is crucial for protecting pension fund members from outright theft by asset managers or pension plan sponsors. Turkey's history of weak supervision has led to many cases of theft, which may have diminished trust in the new private pension system. Relying on international expertise provided by foreign regulatory agencies and international consulting firms would also contribute to the effective discharge of the regulator's functions (Vittas, 1999).

The new Advisory Board does not include any members of the private sector or any representatives of the specific interests. In Ireland, in contrast, where there is a similar system and a Board that was established by same purposes, 11 members of the 14 on the Board

were nominated by specific interests such as employers, life insurance companies, and the legal profession. It is essential to include representatives of different interests in the forming of pension funds policies for both the better supply and implementation of these policies.

Deriving from the experience of some other countries it is also necessary to emphasise the importance of using a variety of ways to provide the public with information. In UK, for instance, despite the existence of one of the longest established funded pension systems in the world, there was a significant lack of financial literacy amongst the public which led to weaknesses in consumer choice. The use of the internet and other media, the use of league tables and communications by regulatory authorities are all tools that could be used to disseminate information. The efforts in Turkey taken to make known the new system are very much welcome, *e.g.* the establishment of an internet site and the organisation of seminars, but these efforts should continue and concentrate further on creating financial literacy.

### *Impact preconditions*

The main impact preconditions, on the other hand, include the attainment of critical mass, the adoption of conducive regulations, especially on pension fund investments, the pursuit of optimising policies by the pension funds, and the prevalence of pluralistic structures (Vittas, 1999).

Attainment of “critical mass” is a major impact precondition for the emergence of the benefits of the development of financial markets. Although it is not easy to define “critical mass” precisely, the indications are that it is unlikely to be attained until pension funds and other institutional investors command resources corresponding to about 20 per cent of GDP and own around 20 per cent of outstanding equities. It is also important to note that a higher scale of domestic institutional investors would be required for critical mass when international investors are not active participants in the domestic market (Vittas, 1999). In Turkey the total share of the financial assets of institutional investors together with insurance and investment countries is 2.3 per cent of the GDP, which is well below the OECD average (Chapter III, Figure 7).

A further impact precondition is the adoption of conducive regulations. The experience of some countries points out that imposition of constraining regulations such as a requirement to invest resources in non-marketable government bonds or at most marketable government bonds and bank deposits, with very low limits imposed on equity holdings, has limited the impact of pension funds on capital market development.

A pluralistic structure is important for stimulating competition, encouraging innovation and promoting efficiency, but it is difficult to tell what constitutes a pluralistic structure (Vittas, 1999). On the one end there are countries dominated by national provident funds such as Malaysia, Singapore and Sri Lanka or those with one or two private pension funds, *e.g.* Bolivia. These apparently do not have pluralistic structures. At the opposite end there are countries with hundreds and even thousands of pension funds, such as the United States, the United Kingdom and Switzerland, that are characterised by a prevalent pluralistic structure. In the middle there are countries like Argentina, Chile, Czech Republic, Hungary, Mexico and Poland that have between 5 and 30 pension funds and for these it is difficult to say whether the institutional structure is sufficiently diverse to ensure the benefits of pluralism. Therefore in Turkey, it might be necessary to increase the minimum, which is currently set at three funds, for fully obtaining the benefits of a pluralistic structure.

Nevertheless it is important to note that the existence of pension funds is neither necessary nor sufficient for capital market development. Other forces, such as advances in technology, deregulation, privatisation, foreign direct investment, and especially regional and

global economic integration may be equally important (Vittas, 1999). The development of funded pension systems should be supported by the simultaneous strengthening of the infrastructure of the financial market, *e.g.* legal framework conditions and accounting systems. Pension funds in turn support the development of factoring, leasing and venture capital companies, all of which specialise in the financing of new and expanding small firms (Vittas, 1998).

### Insurance markets

The insurance sector in Turkey resembles the banking sector in the 1990s in many ways, and they share some common problems; the insurance sector is very fragile for reasons similar to those that caused banking crises in 1994 and 2000-01. Hence, the insurance sector and insurance regulators can learn from the mistakes made in banking regulation, and both sectors should take similar paths to solve their problems.

Like banking, the insurance sector is very small in Turkey. Total assets of all the insurance companies at the end of 2001 were around \$3 billion, or around 2.2 per cent of GDP, far below the OECD average (see Chapter III, Figure 7). This is partly because of lack of compulsory insurance, and of enforcement. Only very basic vehicle insurance is required, and because of lack of enforcement, a significant number of vehicles do not even have this minimum. Earthquake insurance has recently been made compulsory, after it was found out in the 1999 earthquakes that many buildings were not insured. Even now though, the amount of compulsory insurance is small to keep the premiums low. It is conceivable that one reason for the low level of insurance in Turkey is economic agents' risk-taking behaviour under economic uncertainty and high inflation. Although traditional economic theory implies that people will have more insurance under more uncertainty, this may not hold good in an economy characterised by chronic uncertainty to which agents have become accustomed. They may regard insurance not as a necessity but as a luxury good. Moreover, in the environment of chronic macroeconomic instability, people are more inclined to maximise their current than their life-time income. For example, apart from the requirement imposed by some banks when they extend consumer credit, life insurance is almost non-existent (Box A.3). The only exception is health insurance, which is provided by some large firms. Even this, despite the weakness of the social security system, is surprisingly small.

Although the insurance sector is very small for a country of Turkey's size, as with the banking sector it is characterised by many small companies.<sup>1</sup> According to the Treasury, there are 64 insurance companies in Turkey, of which 2 are state-owned, 57 domestic and 5 foreign. At the end of 2001, assets per insurance firm averaged \$46.9 million. The (relatively) large number of firms in this small sector has resulted in price competition within the sector by reducing premiums. For example, in order to increase their market share in health insurance by signing up industrial conglomerates, some companies have offered premiums lower than the previous year's indemnities.<sup>2</sup> Insurance companies are also trying to increase their market share by relying on agencies. Intense competition under conditions of poor regulation and supervision has prevented companies from careful selection of agencies, which lack the skills to engage in proper risk assessment and usually do not have adequate capital. Moreover, the relation between insurance companies and their agencies is not built on firm ground. In the high-inflation high-interest rate environment, agencies have preferred to place premiums in short-term high yield instruments before forwarding them to insurance companies, which has further worsened the balance sheets of insurance companies, whose liabilities according to the nature of the business are long-term. Moreover, declining profitability has induced insurance companies to move away from their core business practices to high-yielding government paper. Aggravating the profitability problems of the sector are col-

### Box A.3. The case for joint banking and insurance supervision

Most Turkish insurance companies are subsidiaries of banks, and a usual condition of consumer credit is that the borrower use the services of the bank's insurance subsidiary. This effect "balloons" the size of the insurance market. It also exposes banks and insurance companies to the same borrowers (just like most banks in Turkey have been exposed in the same direction) such that default will have similar domino-effect consequences for banks and insurance companies. Moreover, the fact that insurance companies are subsidiaries of banks makes it all the more necessary for banks and insurance companies to be regulated under one roof. Given the interrelationship of different financial instruments and institutions, regulation and supervision of the financial sector under a Financial Sector Regulatory and Supervisory Agency would be logical. While Turkey's Letter of Intent to the IMF (30 July 2002) states that measures will be taken "to strengthen the regulatory and supervisory framework of insurance companies in line with applicable EU Insurance Directives and IAIS Core Principles", it is also noted that insurance companies will be exempted from transfer of the supervision of non-bank financial institutions from the Treasury to BRSA.

lection problems. Of the \$1.9 billion insurance companies earned in 2001, they have been unable to collect \$500 million, or 26 per cent.

An inherent problem of the insurance sector is state involvement. State involvement as a market participant can distort competition not only in insurance but in any industry. Therefore, as in banking, regulation and supervision of the insurance sector should be the responsibility of an autonomous agency (Box A.3). Careful regulation in supervision will be necessary to monitor not only insurance companies but also the relationship between banks and insurance companies that are their subsidiaries as well as between insurance companies and their agencies. The supervisory agency also needs to ensure that agencies as well as insurance companies have adequate capital. In order to decrease the exposure of the sector to problems in collecting risk premiums, capital requirements will need to be not only increased for insurance companies but implemented for the agencies as well.

Table A.8. Capital market indicators

	1996	1997	1998	1999	2000	2001
Number of listed companies	228	258	277	285	315	310
Market capitalisations (% of GDP)	22.2	43.9	20.3	78.9	37.5	37.8
Stock market turnover (%) <sup>1</sup>	92.5	71.5	169.9	60.3	238.1	135.7

1. Turnover is defined as the ratio of total trading volume over capitalisation.

Source: Capital Markets Board.

Just like in the banking sector, lack of regulation and supervision, combined with the economic environment, has made the insurance sector fragile. However, if proper measures are taken, it would be possible for the insurance sector to bypass the painful experiences of banking.

### Notes

1. The top ten companies account for roughly 57 per cent of premium income (Association of the Insurance and Reinsurance Companies of Turkey).
2. In 2001, the insurance companies' income from premiums was \$1.1 billion, whereas indemnities amounted to \$900 million. Profits were negative when non-premium income and overhead costs are counted.

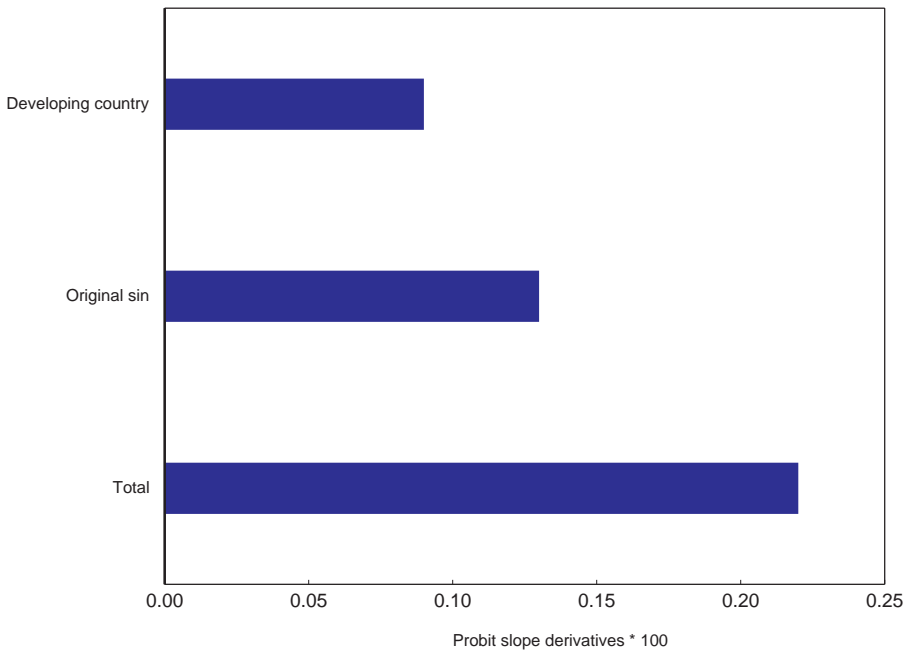
*Annex IX***A theoretical and empirical analysis of foreign direct investment, with special emphasis on Turkey**

In the current discussion of FDI, it is implicitly assumed that FDI is good for Turkey.<sup>1</sup> However, recent theoretical and empirical work has started to question the traditional view of FDI.<sup>2</sup> It is useful to briefly go over these arguments and discuss international evidence on the pros and cons of FDI. This evidence will in turn be used to analyse to what extent FDI can be beneficial for Turkey.

One of the most common arguments in favour of FDI is that it can be “bolted down” because “FDI also is less subject to capital reversals and contagion that affect other flows, since the presence of large, fixed, illiquid assets makes rapid disinvestment more difficult”.<sup>3</sup> However, Hausmann and Fernandez-Arias (2000) argue that financial capital may fly away even in the case of FDI: companies can borrow in domestic currency using FDI as collateral and invest abroad or simply lend to their parent companies. In a similar vein, the part of the FDI that is intercompany debt can be recalled easily. On the other hand, what makes FDI more stable is not only that machines are bolted down, but unlike short-term debt, it cannot be liquidated before the impact of crisis is priced into capital value, making an outflow in that case less likely. Moreover, FDI is not subject to contagion effects, which hit many emerging markets during the Asian crisis.<sup>4</sup> Empirical studies have traditionally shown that FDI is less volatile and more persistent over time than other forms of capital. However, although FDI’s long-run stability is important for countries to be able to reap most of the benefits associated with FDI, its performance around crisis time is at least equally important as well. One of the few papers in the literature that study the latter is Fernandez-Arias and Hausmann (2001), who incorporate FDI into Demirguc-Kunt and Detragiache (1998) style-probability-of-crises regressions. They find that FDI is less risky than other types of capital flows for developing countries only. They hypothesise that currency and maturity mismatches make non-FDI liabilities risky in developing countries. Since currency and maturity mismatches are unavoidable with *original sin*,<sup>5</sup> they test their hypothesis by looking at the relationship between extent of original sin and probability of crisis and find that it is of the expected sign and significant (Figure A.2 simplifies their findings). The implications of these results are obvious in the case of the recent Turkish crisis, where original sin has played a role in both maturity and currency mismatches (see Annex VII). In fact, a simple calculation from their results reveals that the last crisis would have been 23 per cent less likely if the FDI in Turkey and its share in total capital flows had been similar to those of transition economies. Until inflation and the exchange rate stabilise so that Turkish citizens can increasingly borrow and lend in their own currency, FDI will continue to offer the possibility of playing an important role for the stability of the Turkish economy, a fact which has been emphasised by Turkish policymakers as well.

The stability of FDI during times of crises can also explain a seeming paradox: some researchers have recently pointed out that FDI is higher in riskier countries with weaker insti-

Figure A.2. Effect of non-FDI capital flows on probability of crisis



*Source:* Fernandez-Arias and Hausmann (2001). The model used is a probit. The independent variables included are per capita GDP, exports/GDP, original sin dummy, developing country dummy, FDI/GDP, interaction term of FDI/GDP with original sin and developing country dummies, non FDI capital flows/GDP and interaction of non FDI/GDP with the two dummies. Probit slope derivatives (multiplied by 100 to convert into percentages) give the increase in probability of crisis (as defined by Frankel and Rose, 1996) when the independent variable increases by one unit (a discrete change from zero to one for the dummies).

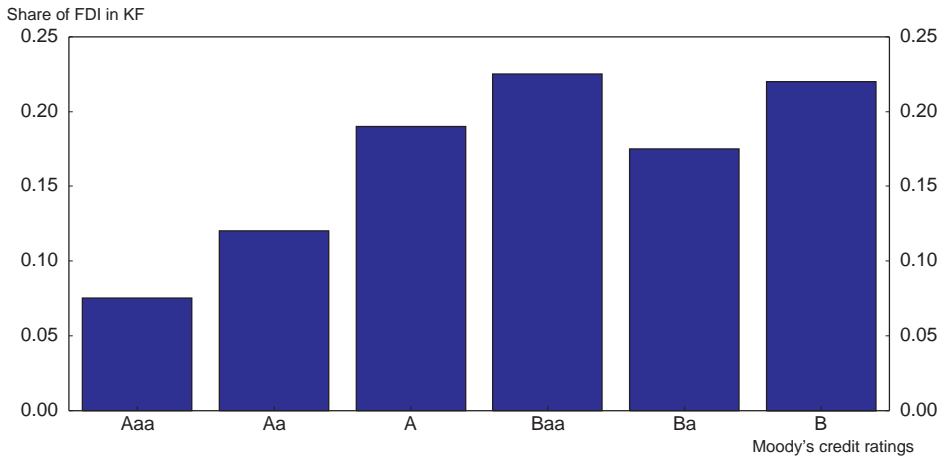
tutions (Figure A.3) and have suggested that FDI is a sign of weakness rather than strength. To investigate this issue further, a simple decomposition has been performed, which looks

at total capital flows (KF) of a country and its FDI relative to KF as well: 
$$\frac{\text{FDI}}{\text{GDP}} = \frac{\text{FDI}}{\text{KF}} \times \frac{\text{KF}}{\text{GDP}}$$

Without going into a deep empirical analysis, Table A.9. presents some correlations between cross-country variables and the different components of FDI. Although the results are similar to Fernandez-Arias and Hausmann (2001), a different interpretation is given here. By using accounting theories of the firm and corporate finance, they conclude that FDI is "more a financing decision than an investment decision" and that in countries with weak institutions (financial markets, legal system, etc.), foreign investors prefer to operate directly rather than rely on financial markets. Although their conclusion may be appealing theoretically, it is contradicted by some recent evidence: OECD (2001b) finds that multinationals operating in OECD countries pay higher wages and undertake significantly more training and human cap-



Figure A.3. **FDI's shares in countries grouped by their perceived risk to investors**  
As a percentage



Source: Albuquerque (2000).

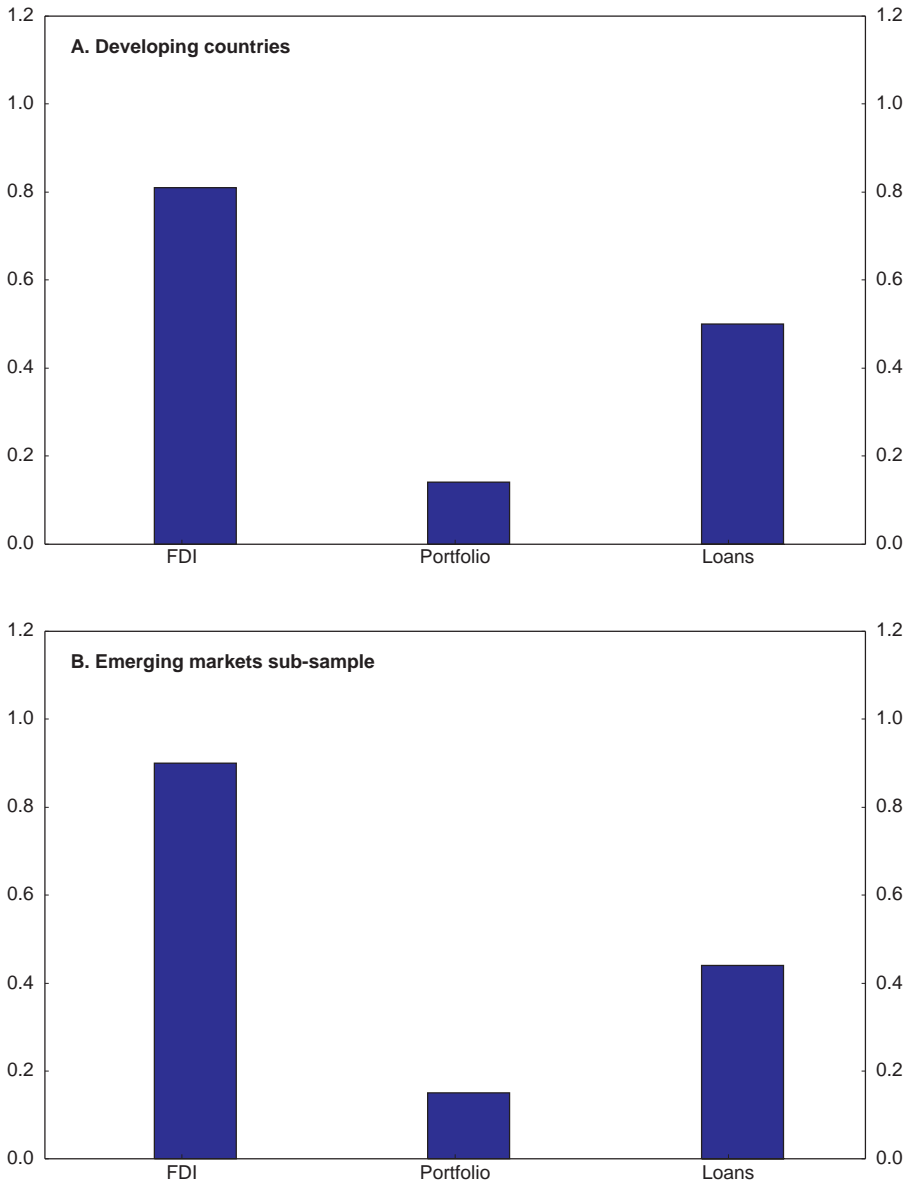
ital investment than home firms.<sup>6</sup> While FDI has a higher share of capital inflows in many countries with weak institutions, it would be wrong to infer causality from this relation. It is probably the case that without FDI, these countries would have been even poorer. This so-called paradox is thus probably a statistical artefact resulting from the stability of FDI in the long-run and especially in times of crises.

There is ample evidence for the role of FDI in economic stability, but an even more important question is whether FDI affects host countries directly through investment, productivity and growth. Bosworth and Collins (1999) find that all capital flows have a positive effect on domestic investment, but this effect is most pronounced for FDI (Figure A.4). On the other hand, World Bank (2001a) reports that this relationship weakens as a country becomes

Table A.9. **Capital flow decomposition**

	FDI/GDP	FDI/KF	KF/GDP
GDP	0.4	-0.5	0.75
Population	-0.1	-0.35	0.2
Openness(trade/GDP)	0.65	-0.3	0.65
Financial Development(WB)	0.35	-0.35	0.55
Institutions	0.4	-0.4	0.7
Country risk(ICRG)	-0.3	0.4	-0.6
Home currency debt/foreign currency debt	-0.05	0.38	-0.41

Figure A.4. The impact of different types of capital flows on domestic investment



Source: Bosworth and Collins (1999).

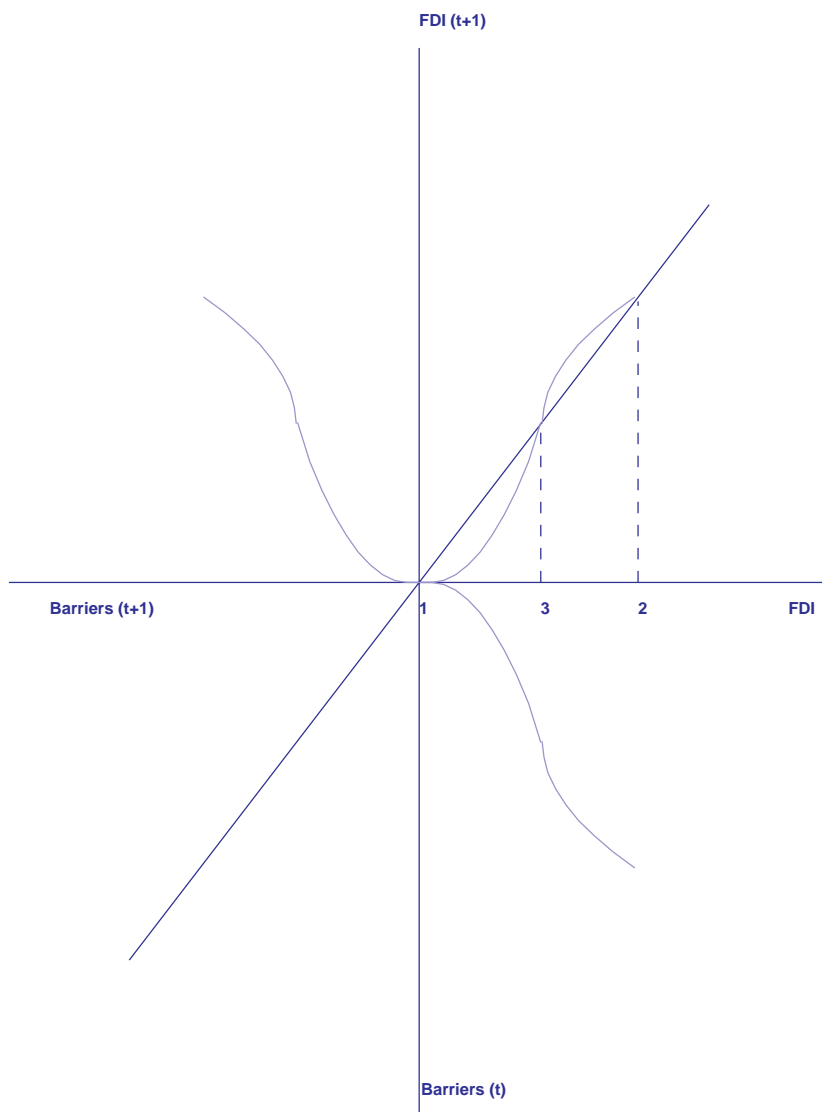
more integrated into the world, and moreover this effect has decreased somewhat in the last ten years.<sup>7</sup> Although the relationship between FDI and domestic investment may still be argued, most investigators now agree that FDI increases domestic productivity and that these productivity benefits are largest in countries with a skilled labour force and well-developed infrastructure.<sup>8</sup> This result is especially important in Turkey, as it shows that efforts to enhance human capital (discussed in Chapter IV) would result in more-than-expected gains in productivity if Turkey manages to attract more FDI at the same time. Moreover, the relationship between FDI and growth through technology transfers has been demonstrated by Campos and Konishita (2002) for transition economies. This would be another productivity and growth-enhancing effect for Turkey.

All of this provides significant evidence on benefits of FDI compared with other types of capital flows, especially for an emerging market with the original sin problem (implying volatile portfolio capital flows) like Turkey. Then, removing unnecessary administrative and legal requirements and other barriers to domestic and foreign investment (discussed in Chapter IV) should increase human capital and management skills, make the country less crisis-prone and bring with itself all the other benefits associated with FDI like productivity gains and increases in investment. Unfortunately, this is easier said than done, as the following graphic argument demonstrates (Figure A.5).<sup>9</sup>

Assume that, for countries with high barriers,<sup>10</sup> there is a threshold until which FDI will not respond much to decreases in barriers, but after which it will take off. This assumption is realistic in the sense that foreign firms will decide to invest if and only if entry and operation costs decrease; corruption, legal implementation and property rights improve, not just marginally but enough so that a multinational firm investing in the country will be as competitive not only as domestic firms but also as firms operating in other countries.<sup>11</sup> Therefore, FDI will be first a concave, then convex function of decrease in barriers, as shown in the fourth quadrant in the graph. It is also assumed that reduction in barriers is an exogenous process, as demonstrated by the one-to-one relationship between property rights in this period and the next period (third quadrant).<sup>12</sup> It is also assumed that the relationship between FDI and reduction of barriers does not change through time; the second quadrant is therefore a replica of the fourth one. Finally, these three relationships give us directly the dynamic evolution of FDI as a difference equation. It can be seen that this system has two long-run equilibria: a bad equilibrium with no FDI and a good one with high FDI. Moreover, an economy will be trapped in the bad equilibrium unless it can get its FDI above the threshold level denoted by point 3. It is agreed among policy makers that Turkey needs to reduce its barriers to investment. However, the analysis above shows that a small or medium reduction will not be enough; investment barriers need to decrease by a lot for Turkey to be able to attract a significant amount of FDI. Therefore, the analysis implies a *big-bang* approach to reduction of FDI barriers.

The framework can be generalised into a more general (and realistic) framework by dropping the assumption of exogenous determination of barriers to FDI. The intuition, given in the works of Olson (1982) and North (1990) is as follows.<sup>13</sup> The previous framework has assumed that reduction of barriers, while it enhances FDI, is also costly and requires resources that only exist in sufficiently wealthy economies. On the other hand, FDI is assumed to be growth-promoting (as documented in empirical literature), so FDI flows make it more likely for further decreases in barriers to occur (this is the assumption that differs from the basic framework and endogenises barriers to FDI), setting up a virtuous cycle. The analysis again identifies two steady-states: One with minimum reduction of FDI barriers and low FDI/income and another with full reduction of barriers and high FDI/income. The analysis illustrates how a low-income country with high barriers can be trapped in low FDI and growth, establishing the link between FDI, growth and administrative barriers to FDI.

Figure A.5. FDI



1. Bad equilibrium.
2. Good equilibrium.
3. Threshold FDI to get out of low- FDI trap.

## Notes

1. Feldstein (2000) reviews the recent theoretical literature on benefits of capital flows. A review of the recent empirical literature, which generally concludes that capital flows are beneficial for an economy can be found in Deepak *et al.* (2001).
2. These studies, as will be seen in the following discussion, are generally not against for FDI per se, but claim that FDI is not inherently more beneficial than other types of capital flows.
3. World Bank (2001a).
4. However, this observation may be explained by another problem: Domestic companies are in crises during times of crises and become good deals for foreigners, who can acquire these firms at a discount either because domestic investors are short of cash or because foreign investors are better informed than domestic ones, as Razin and Sadka (2002) assume in an extension of this framework. This, as Krugman (1998) notes, can increase the burden of the crisis even further. However, in OECD countries, multinationals prefer setting up subsidiaries or forming joint partnerships with local firms rather than directly acquiring domestic firms. Moreover, transfer of control to foreign ownership has increased only marginally in the Mexican, Korean and Turkish crisis, suggesting that fire sales are not a big issue, at least in the OECD.
5. Original sin is when the domestic currency is unfit for international and long-term borrowing, in other words when the currency is unsound. It can be proxied with the percentage of borrowing denominated in foreign currency.
6. The theory is also directly contradicted by the case of Turkey, where institutions are very weak yet FDI is extremely low, even in comparison to other portfolio flows.
7. Several explanations can be offered for this phenomenon: First, mergers and acquisitions are replacing direct factory construction in FDI. Moreover, the share of portfolio flows is increasing not only as countries become more globalised but also independently of the globalization process through time.
8. World Bank (2001a) notes some country studies: FDI has increased the productivity of domestic firms in Malaysia, Taiwan and southern provinces of China, while such an effect has not materialized in Morocco, Tunisia and Uruguay. The evidence in country studies is further supported by the cross-country study of Borenzstein, De Gregorio and Lee (1998), who find that FDI is more productive in countries with a more productive labour force.
9. This is a simplified version of the framework in Deliveli (2002e).
10. This analysis does not differentiate between administrative barriers specific to FDI like license of entry and more general issues like corruption and rule of law. A detailed description of barriers to domestic and foreign investment in Turkey is provided in

Chapter IV. These barriers are quantified, for Turkey as well as a sample of twenty-nine developing countries, in Morrisset and Neso (2002).

11. OECD (2001b) provides some empirical evidence for this threshold effect, although this effect has not been formally demonstrated, mostly because of difficulty of quantifying administrative barriers. Early results of Deliveli (2002d), using a new dataset on barriers to investment, show that there are indeed threshold effects on investment.
12. This assumption is relaxed in the next paragraph, making barriers dependent on past period's income and FDI.
13. Here, an intuitive argument is given. The technical details and the full model are given in Deliveli (2002e).

*Annex X***Calendar of main economic events****2000****December**

Following the financial crisis, the Government announces a full guarantee for depositors and other creditors covering all domestic deposit-taking banks including foreign branches of domestic banks for which consolidated accounts have to be submitted to the BRSA.

Demirbank, one of the medium-sized banks, is transferred to the SDIF.

The IMF Board decides to provide additional resources under the stand-by credit available under the Supplemental Reserve Facility of around \$7.5 billion, or 600 per cent of Turkey's quota in the IMF, to alleviate balance of payments difficulties stemming from the recent financial crisis.

The World Bank's Board approves a new Country Assistance Strategy for Turkey that aims to assist the country in laying the basis for reduced economic vulnerability and includes support of up to \$5 billion for the period July 2000-June 2003. As a first step in implementing the strategy, the Bank commits an additional \$1 billion for the programme in the form of a \$250 million Privatization Social Support Project (PSSP) and a \$778 million Financial Sector Adjustment Loan (FSAL).

Standard and Poor's revises its outlook on the Republic of Turkey downwards to B+/stable from B+/positive.

**2001****January**

Egebank, Yurtbank, Yasarbank and Bank Kapital are merged into Sumerbank.

**February**

IMF approves the fifth review of Turkey's economic programme, which is supported by a three-year IMF stand-by credit. The decision enables Turkey to draw up to \$1.4 billion.

There is a political dispute between the Prime Minister and the President that triggers a massive flight from the Turkish lira assets and overnight interest rates rise above 5 000 per cent.

The Government abandons the crawling peg and the Turkish lira loses one-third of its value against US dollar with the exchange rate falling from 680 thousand Turkish lira per dollar to 960 thousand.

Standard and Poor's revises its outlook on the Republic of Turkey to B/negative from B+/stable.

The framework regulation designed to furnish the legal basis for the Accession Partnership with the EU is adopted by the General Affairs Council.

Ulusalbank is transferred to the SDIF.

### March

The Government puts in place a new economic team, headed by Mr. Kemal Dervis as Minister of State for Economic Affairs in charge of an expanded economic portfolio, to strengthen policy co-ordination and implementation.

Electricity Market Law is enacted and Energy Market Regulatory Agency (EMRA) is established.

The Turkish Government announces its National Programme for the Adoption of the EU acquis and submits it to the EU Commission.

### April

The administration and management of the state banks is transferred to a Joint Board of Directors. The Board is fully authorised to oversee the restructuring programme and to prepare these banks for privatisation.

Standard and Poor's revises its outlook on the Republic of Turkey upwards to B-/stable from B/negative.

The Sugar Law is enacted which sets out the procedures and principles in production, pricing and marketing of sugar and thereby will move ahead with the privatisation of the sugar companies.

Law on Individual Retirement Schemes is adopted.

To develop consensus and collaboration among social groups in formulating economic and social policies, Economic and Social Council Law is enacted.

The new stabilisation plan called "Transition Programme for Strengthening the Turkish Economy" is initiated.

Ulusalbank is merged into Sumerbank.

### May

The Letter of Intent to the IMF describes the policies that Turkey intends to implement to overcome the financial and economic crisis and requests for timely financial support from the IMF.

The Executive Board of the IMF approves an increase of Turkey's three-year stand-by arrangement by around \$8 billion, bringing the total to almost \$19 billion and enabling an immediate access of \$3.8 billion.

The process of recapitalising the state and SDIF banks is completed, being funded through the issuance of Treasury securities totalling 44 quadrillion Turkish lira.



The new Central Bank Law is enacted with the goal of designating price stability as the primary monetary policy objective of the Bank.

The amendments to the Banking Law are approved by the parliament.

Natural Gas Law is approved by the parliament where the new law aims to liberalise the natural gas market and eliminate the BOTAS's monopoly.

The authorities agree with the labour unions on a wage contract for the public sector that sets an increase of 15 per cent on a semi-annual basis for 2001 with 80 per cent catch-up for any excess of CPI inflation. For 2002, the semi-annual increases are 10 per cent providing 80 per cent catch-up in the first half and full catch-up in the second half.

The support price for wheat is set at 63.4 per cent, much higher than the targeted inflation rate.

The Telecommunication Law accelerating the privatisation of Turk Telecom and liberalisation of the telecommunication sector is enacted.

The petroleum consumption tax rate is increased by 20 per cent, and VAT rates increase by 1 percentage point.

The minimum contribution base for social security payments is increased by 40 per cent.

## June

Sugar Board is established.

Treasury undertakes a debt swap operation with the private banks, resulting in an exchange of some \$8 billion of short-maturity Turkish lira government paper for a mix of longer-dated Turkish lira and foreign exchange indexed government paper.

The petroleum consumption tax rate is increased by 16 per cent.

Interbank and Esbank are merged into Etibank.

Bank Ekspres is sold to Tekfen Holding.

The law providing for the closure of the remaining 15 budgetary funds (except DFIF) and two extrabudgetary funds is approved by the Parliament.

The supplementary budget is approved by the Parliament, that takes into account after post-crisis measures of the strengthened programme.

## July

IMF and World Bank postpone Board meeting with Turkey that were scheduled for early July, pending fulfilment of a few prior actions mostly relating to the banking system and telecommunications sectors which form part of the government's programme.

Standard and Poor's revises its outlook on the Republic of Turkey downwards to negative from stable.

Emlak Bank is transferred to Ziraat Bank.

EGS Bank, Tarisbank, Kentbank, Sitebank and Bayindirbank are transferred to the SDIF.

The Board of Turk Telecom is renewed by appointing a new chairman and two additional members.

Following consultations with the Turkish authorities concerning their economic programme, the previously postponed Board meeting has been rescheduled for 12 July.

The Executive Board of the IMF approves the eighth review of Turkey's economic programme supported by the three-year stand-by arrangement. The Board's decision enables Turkey to draw around \$1.5 billion immediately from the IMF.

The World Bank's Board of Directors approves a \$1.1 billion Programmatic Financial and Public Sector Adjustment Loan (PFPSAL I) and a loan of \$600 million to support the Agricultural Reform Implementation Project (ARIP) for Turkey. The Board discusses the World Bank Group's Country Assistance Strategy Progress Report for Turkey, which could provide up to \$6.2 billion for Turkey over two years as the reforms are implemented.

### **August**

A withholding tax structure for deposits and repos that encourages a shift of funds towards longer-term on-balance sheet Turkish lira deposits is introduced. Additionally, 40 per cent remuneration on mandatory reserve requirements for Turkish lira deposits is introduced by the Central bank effective as of 8 August 2001 and payable as of 30 September 2001.

Türk Körfez Bank is transferred to Osmanlı Bank.

The Executive Board of the IMF completes the ninth review of Turkey's economic programme supported by the three-year stand-by arrangement. The Board's decision enables Turkey to draw \$1.5 billion immediately from the IMF.

### **September**

World Bank approves a loan of \$500 million for a Social Risk Mitigation Project (SRMP).

The implementation of a "tax identity" number on banking transactions is started.

Fertiliser support to the agricultural sector is abolished.

Demirbank is sold to HSBC.

### **October**

Turkish Electricity Generation and Transmission Company (TEAS) is separated into three companies: TEIAS (transmission), EUAS (generation), TETTAS (trading).

### **November**

Toprakbank is transferred to the SDIF.

The Executive Board of the IMF completes the tenth review of Turkey's economic programme supported by a three-year stand-by arrangement. The Board's decision enables Turkey to draw \$3 billion immediately from the IMF.

The members of the Energy Market Regulatory Board are appointed.

Standard and Poor's revises its outlook on the Republic of Turkey upwards from negative to stable.

### **December**

The BRSA issues a regulation requiring repos to be brought on balance sheet as collateralised finance transactions with applicability as of 1 February 2002.

The banking licenses of İktisat Bank, Etibank and Kentbank are revoked and these banks are put under the liquidation process.

Osmanlı Bank is transferred to Garanti Bank.

Sitebank is sold to Novabank.

Banking and deposit license of EGS bank is revoked and merged into Bayındırbank.

The budget for 2002 is approved by the Parliament.

## 2002

### January

Sale process for Toprakbank is started and scheduled to be completed by September 2002.

The “Istanbul Approach” – a voluntary market-based framework to facilitate restructuring of the debts of large borrowers – is introduced.

“Regulation on Loan Loss Provisioning” is amended where the existing procedures on the restructuring of NPLs and other claims are revised in order to improve the efficiency of the voluntary corporate debt restructuring programmes.

The Tobacco Law is enacted which eliminates support purchases and sets the stage for privatisation of TEKEL, the state tobacco company.

The new Public Procurement Law is enacted. The new law is based on the United Nations Commission on International Trade Law (UNCITRAL) model and moves Turkey towards compliance with EU requirements.

Council of Ministers approves the action plan to increase transparency and enhance good governance in the public sector and also a plan to reform the tax system.

The Treasury starts floating rate auctions.

Standard and Poor's revises its outlook on the Republic of Turkey upwards from stable to positive.

### February

The Executive Board of the IMF approves a three-year stand-by credit totalling \$16 billion for Turkey to support the government's economic programme for 2002-2004. This decision enables Turkey to draw about \$9 billion from the IMF immediately.

The BRSA issues “Regulation on the Principles and Procedures of the Banking Sector Recapitalization Scheme” specifying the principles and procedures of independent auditing to be carried out in privately owned deposit-taking banks within the context of the bank recapitalisation scheme.

The Central Bank cuts short-term interest rates at the domestic Interbank money market where the borrowing rate is decreased from 59 per cent to 57 per cent, while the lending rate is unchanged at 62 per cent.

The Council of Ministers' Decree envisaging a detailed strategic and organisational implementation plan regarding the operational restructuring of Ziraat Bank and Halk Bank is adopted and approved. The number of branches and employees of state banks will be reduced by 897 and 16 000 respectively by end-June 2002.

## March

The Central Bank cuts short-term interest rates at the domestic Interbank money market. The borrowing rate is decreased from 57 per cent to 54 per cent, and the lending rate is decreased from 62 per cent to 61 per cent.

The Central Bank announces a programme to phase out its intermediary role as a “blind broker” which will promote Interbank markets.

Public Finance and Debt Management Law aiming to bring transparency and accountability is enacted.

548 of revolving funds are closed.

## April

The Central Bank decreases the overnight borrowing rate from 54 per cent to 51 per cent, and lending rate from 61 per cent to 58 per cent.

The Executive Board of the IMF completes the first review of Turkey's economic performance under the three-year stand-by credit. The decision enables Turkey to draw up to \$1 billion immediately.

World Bank approves \$1.35 billion Programmatic Financial and Public Sector Adjustment Loan (PFPSAL II) to help Turkey implement the next phase of its reform programme and ensure that social programmes are adequately funded.

The Central Bank decreases the overnight borrowing rate from 51 per cent to 48 per cent, and the lending rate from 58 per cent to 55 per cent.

## May

To encourage development of the foreign currency market, stamp duties on forward contracts are eliminated (to be effective on June 22) and the tax on Interbank foreign exchange transactions is removed.

Prime Minister Bulent Ecevit is hospitalised. With the return of political risk, the positive domestic sentiment disappears. As a result, Turkish lira depreciates by 8 per cent in nominal terms, interest rate rise by 10 percentage points and ISE index falls by 10 per cent.

New transitional rules for the pension system reform are approved.

The Communiqués on required reserves and liquidity requirement are issued in the Official Gazette that require: *i*) an increase in the scope and the length of the averaging of reserve requirements, and *ii*) convergence of the remuneration of both Turkish lira and foreign exchange currency reserves to market rates.

## June

The BRSA takes over Pamukbank and replaces the controlling shareholders on Yapi Kredi's Board of Directors with two BRSA representatives.

The IMF's Executive Board concludes the second review of the programme and approves the release of another credit tranche of about \$1.1 billion.

Standard and Poor's revises its outlook on the Republic of Turkey downwards to stable from positive.

Special consumption tax is adopted.

The first implementations of the Istanbul Approach are carried out.

## July

The World Bank approves \$300 million for the Second Basic Education Project (APL II) in Turkey, which will focus on developing pre-school education as an integral part of basic education.

Standard and Poor's revises its outlook on the Republic of Turkey to negative from stable in light of the unfolding political crisis.

The interest rate on Turkish lira required reserves is raised by 3 percentage points to 25 per cent.

The Turkish Parliament voted in favour of holding early national elections on 3 November 2002.

## August

The 14-point reform package – abolishing the death penalty in peacetime; allowing for broadcasting and learning of local languages and dialects; giving non-Muslim community foundations in Turkey expanded rights to sell and buy property; and decriminalising criticism of the public authorities – is approved by the Parliament.

The Central Bank decreases the overnight borrowing rate from 48 per cent to 46 per cent, and the lending rate from 55 per cent to 53 per cent.

The Parliament approves a proposed budget amounting around \$100 million to cover the country's election cost.

Mr. Kemal Dervis resigns from his post of State Ministry for Economic Affairs.

The Parliament approves a Job Security Bill which foresees amendment to Labor Law and the Trade Union Law.

## September

Turkish and US officials sign an agreement for an approximately \$200 million grant which will be used for repayment of Turkey's external debt with the U.S., excluding the International Monetary Fund, World Bank and military credits.

Turkey's Eximbank secures a \$125 million syndicated loan with several foreign banks. The credit will be repayable over one year at Libor plus 135 basis points.

Turkey ranked 32nd with a \$3.2 billion foreign investment in 2001 in a Global Investment Report prepared by the UN Conference on Trade and Development (UNCTAD). Turkey ranked 123rd on a listing of 140 countries in terms of foreign investment relative to the size of its economy.

Akbank secures a one-year \$450 million syndicated loan with a group of foreign banks. 53 foreign banks took part in the deal including lead banks Citibank N.A. and Deutsche Bank AG. The deal was secured at an interest rate of Libor plus 75 basis points.

## October

The Energy Ministry cuts natural gas prices for sales to urban distribution companies by 6 per cent and for industrial customers by 5 per cent after negotiating a cut in purchase prices from Russia.

IMF officials start talks in Istanbul and Ankara as part of the fourth review of Turkey's \$16 billion stand-by deal, but at the date of publication of the present Survey it is not certain when the next tranche of the credit could be released as Turkey heads for snap polls on November 3.

The European Commission's Progress Report on Turkey is released. The Commission recommends that the EU should enhance its support for Turkey's pre-accession preparations.

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OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16

PRINTED IN FRANCE

(10 2002 19 1 P) ISBN 92-64-19963-2 – No. 52773 2002

ISSN 0376-6438

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## BASIC STATISTICS OF TURKEY

### THE LAND

Area (thousand sq.km.)	779	Major cities, 1997 (thousand inhabitants) :	
Agricultural area (thousand sq.km, 1995)	275	Istanbul	9 199
Forests (thousand sq. km, 2000)	102	Ankara	3 693
		Izmir	3 115

### THE PEOPLE

Population , 2001 (millions)	68.6	Civilian labour force, 2001, (millions)	22.6
Per sq. km, 2001	88	Civilian employment	20.2
Annual rate of change of population 1991-2001	1.8	Agriculture, forestry, fishing	7.4
		Industry	3.7
		Services	8.3

### THE PRODUCTION

Gross domestic product, 2001 (TL billions)	181 408 563	Origin of GDP , 2001 (per cent) :	
Per head (2001, US \$)	2 152	Agriculture, forestry, fishing	12.9
Gross fixed investment, 2001 (TL billions)	32 321 807	Industry	25.2
Per cent of GDP	17.8	Services	61.9
Per head (US \$)	383		

### THE GOVERNMENT

Public consumption, 2001 (per cent of GDP)	14.1	Public debt, end 2001 (per cent of GDP)	115.0
Central government current revenue, 2001 (percent of GDP)	28.6	Domestic	67.3
		Foreign	47.7

### THE FOREIGN TRADE

Commodity exports, 1999, f.o.b. (per cent of GDP)	14.0	Commodity imports, 1999, c.a.f. (per cent of GDP)	21.2
Main exports(per cent of total exports) :		Main imports(per cent of total imports) :	
Machinery and transport equipment	18.9	Machinery and transport equipment	37.8
Other manufactures	57.3	Other manufactures	22.8
Food and live animals	12.0	Chemicals and related products	15.5

### THE CURRENCY

Monetary unit: Turkish lira		Currency units per US\$, average of daily figures:	
		1997	151 595
		1998	260 473
		1999	418 984
		2000	624 325
		2001	1 228 269

*This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is in charge with the examination of the economic situation of Member countries.*

•

*The economic situation and policies of Turkey were reviewed by the Committee on 16 September 2002. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 14th October 2002.*

•

*The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee, Flavio Padrini and Gulbin Sahinbeyoglu under the supervision of Nicholas Vanston*

•

*The previous Survey of Turkey was issued in February 2001.*





**From:**  
**OECD Economic Surveys: Turkey 2002**

**Access the complete publication at:**  
[https://doi.org/10.1787/eco\\_surveys-tur-2002-en](https://doi.org/10.1787/eco_surveys-tur-2002-en)

**Please cite this chapter as:**

OECD (2002), "Banking System Restructuring in the Context of Macroeconomic Stabilisation", in *OECD Economic Surveys: Turkey 2002*, OECD Publishing, Paris.

DOI: [https://doi.org/10.1787/eco\\_surveys-tur-2002-5-en](https://doi.org/10.1787/eco_surveys-tur-2002-5-en)

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