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I. Macroeconomic developments: from crisis to recovery

After a severe financial crisis and deep recession in 2001, Turkey's policy goal is to enter a sustained recovery while taking measures to address the root causes of the crisis. The underlying reasons for the crisis had been building over the previous decade, notably a fragile banking system, weaknesses in the structural fiscal adjustment, as well as contagion effects from financial crises elsewhere. Against this background, a political dispute with a swelling current account deficit triggered the collapse of the three-year exchange-rate based stabilisation programme in February 2001, only 14 months after its launch. The crawling peg for the Turkish lira was abandoned and real interest rates skyrocketed, precipitating a banking crisis, which was followed by a deep recession accompanied by higher inflation and rising unemployment. A strengthened programme, backed by substantial international financial support, is intended to permit a gradual return of confidence, a sounder banking system and easing in financial market conditions, while the deep recession and a newly independent Central Bank have facilitated a rapid return to the disinflation path. Early signs of an inventory and export led recovery appeared in 2002. However, renewed political tensions in mid-2002 sparked a brief turmoil in financial markets, and may have interrupted the improving trend, while persisting market concerns about the continuity of the programme because of early elections have subsequently kept the sovereign risk premium at high levels. On the other hand, appropriate economic policies remain in place while recent political developments represent not only risks but also opportunities to show that ownership of the programme is shared by all the political parties garnering public support and that newly established institutional structures for economic management are robust to changes in government.

This chapter begins with an assessment of the overall policy framework for macroeconomic developments, from the collapse of the exchange-rate based stabilisation programme in early 2001 to the strengthened measures that followed. The following section examines the post-crisis conditions in 2001 in light of the macroeconomic programme and the beginnings of recovery in 2002. The third section discusses the short-term outlook and potential risk factors for the sustainability of the programme.

2001 and early 2002: very sharp recession giving way to recovery

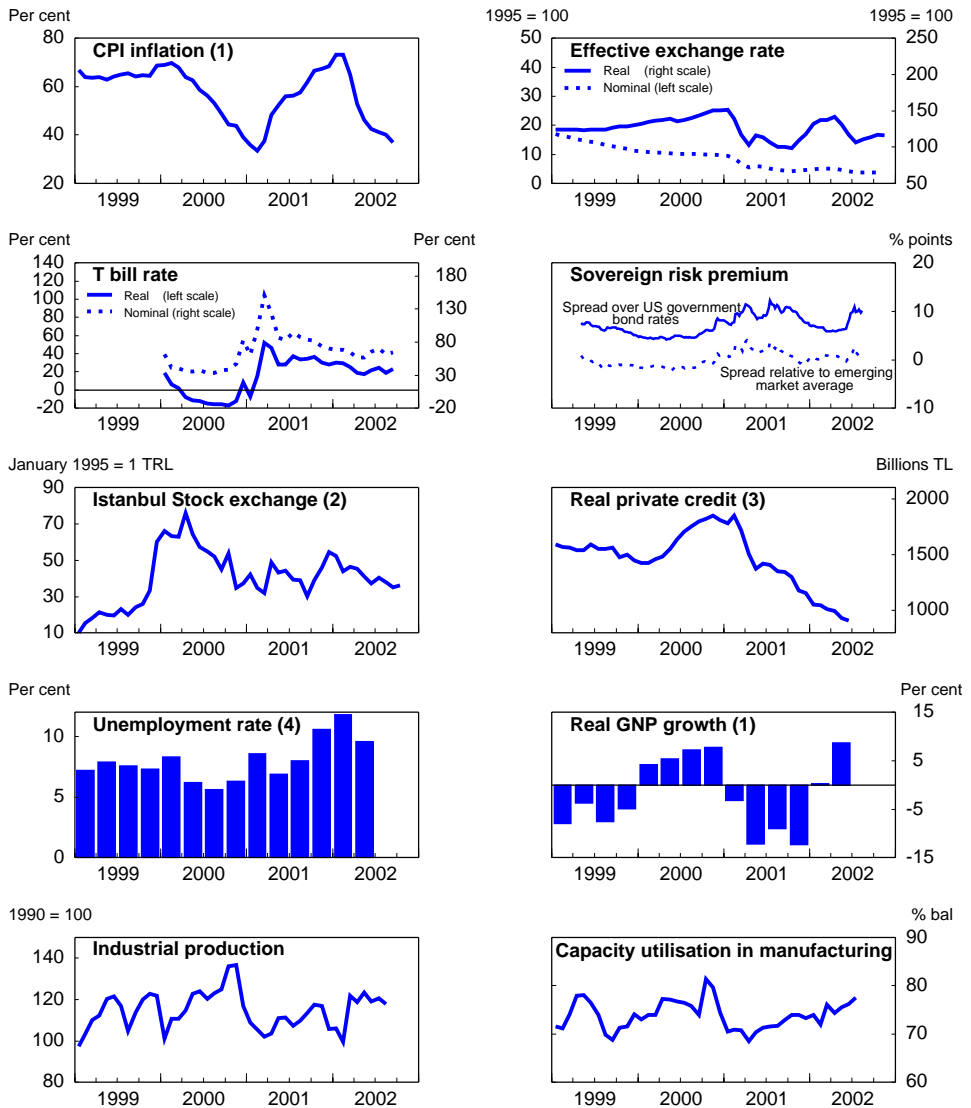
The November 2000 and February 2001 crises respectively created adverse nominal interest and exchange rate shocks of around 50 percentage points each. Real interest rates also rose sharply, and the exchange rate depreciated substantially also in real terms. These massive shocks lasted for months, destroying wealth in banking, corporate and household sectors. The fiscal tightening and banking restructuring were central features of the new programme (see Chapter II). While needed to restore confidence, they acted in a pro-cyclical way by raising taxes, disturbing lines of credit and intensifying lay-offs in the economy. The discussions on a new IMF support package at end-2001 that was later approved, provided the turning point in financial market conditions which led to the start of recovery in early 2002. With the pass-through of the depreciation into inflation, the real exchange rate reversed its initial undershooting and rose steadily throughout the year. By mid-2002, the real exchange rate had recouped all of its initial losses (Figure 1).

Interest rates came down from their crisis peaks soon after the lira was set free in early 2001, as this allowed the Central Bank to ease money market conditions. In addition, the clean-up of the state and taken-over private banks in mid-year eased the considerable pressure they had been exerting on money market and deposit rates. Nevertheless, interest rates stayed at levels significantly higher than programmed, reflecting higher-than-expected inflation and uncertainty about programme implementation (Figure 1). A jump in the fiscal debt because of the high cost of the bank clean-up, and persisting high real interest rates, entered into a self-perpetuating cycle.

In the context of the bank restructuring programme, state and SDIF banks cut their credit lines. Private banks called in their loans and restricted new credits because of growing defaults and concern about the quality of debtors, as well as efforts to meet tightened regulations on capital adequacy ratios. Hence, private credit volume contracted in real terms by almost 12 per cent in 2001 and by a further 2½ per cent by end June 2002 (Figure 1). While all banks were trying to stay as liquid as possible, given the high level of uncertainty, liquidity itself remained in short supply. Foreign capital flowed out to the tune of \$14 billion during 2001, mainly in the form of short-term capital, more than triple the amount that flowed out in the crisis of 1994 (Table 1). The Central Bank's policy remained relatively tight, as it tried to deal with the rise in inflation following the devaluation. This state of affairs only reinforced credit rationing by the banks.

The situation started to improve during the summer of 2001, but the adverse effects of the 11 September events led to discussions on a new IMF support package.¹ Markets reacted favourably to the renewed programme and announcements of the additional external support. By closing the financing gap of the Treasury for 2002, the new package eased the risk of a further rapid deteriora-

Figure 1. Crisis and recovery indicators



1. Year on year changes.
2. ISE National 100 index, based on closing values.
3. Using WPI as deflator.
4. First and third quarter are estimated for 1999.

Source: Undersecretariat of Treasury, State Institute of Statistics, OECD.

Table 1. **Balance of payments**
US\$ million

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 ¹
Merchandise exports (f.o.b)	15 611	18 390	21 975	32 446	32 647	31 220	29 325	31 667	35 258	18 412
Exports	15 345	18 106	21 636	23 225	26 261	26 973	26 587	27 775	31 340	15 962
Shuttle trade	8 842	5 849	3 689	2 255	2 946	3 039	1 852
Transit trade	266	284	339	379	537	558	483	946	879	598
Merchandise imports (f.o.b)	29 771	22 606	35 187	43 028	48 005	45 440	39 768	54 042	39 748	20 947
Trade balance	-14 160	-4 216	-13 212	-10 582	-15 358	-14 220	-10 443	-22 375	-4 490	-2 535
Other goods and services (net)	3 959	3 755	6 377	3 698	7 854	10 477	3 908	7 331	4 083	152
Private unrequited transfers (net)	3 035	2 709	3 425	3 892	4 552	5 568	4 813	5 011	3 596	1 392
Official unrequited transfers (net)	733	383	1 071	555	314	159	362	214	207	208
Invisibles balance	7 727	6 847	10 873	8 145	12 720	16 204	9 083	12 556	7 886	1 752
Current balance	-6 433	2 631	-2 339	-2 437	-2 638	1 984	-1 360	-9 819	3 396	-783
Current balance (as a percentage of GDP)	-3.6	2.2	-1.5	-1.3	-1.3	1.1	-0.9	-4.9	2.3	-0.4
Total net capital movements	8 903	-4 257	4 565	5 483	6 969	-840	4 935	9 610	-14 198	655
Direct investment	622	559	772	612	554	573	138	112	2 769	136
Portfolio investment	3 917	1 158	237	570	1 634	-6 711	3 429	1 022	-4 515	-978
Other long-term capital	1 370	-784	-79	1 636	4 788	3 985	344	4 276	-1 131	1 021
Short-term capital	2 994	-5 190	3 635	2 665	-7	1 313	1 024	4 200	-11 321	476
Net errors and omission	-2 162	1 832	2 432	1 499	-987	-697	1 631	-2 788	-2 122	-1 554
Change in reserves²	-308	-206	-4 658	-4 545	-3 344	-447	-5 206	2 997	12 924	1 682

1. Figures refer to first half and are provisional.

2. A minus sign indicates an increase in reserves.

Source: Central Bank of Turkey.

tion in Turkey's large domestic public debt burden and led to a rapid improvement in investor confidence. By October 2001, interest rates on government paper embarked on a steadily declining path in line with the new macroeconomic framework, falling to below 60 per cent by April 2002. The exchange rate stabilised at 1.3-1.4 million TL per US dollar. Spreads on dollar-denominated Turkish eurobonds fell by more than 300 basis points and the average maturity increased substantially. These favourable conditions lasted until mid-2002.

Sharp demand-led contraction followed by export-led recovery

GDP contracted by 7½ per cent in real terms in 2001, its steepest decline since World War II (Table 2). All sectors were severely hit, while agriculture suffered additionally from bad weather (Table 3). On the demand side, private consumption shrank and fixed investment expenditure collapsed, owing to the uncertain policy outlook, low consumer and business confidence, and the reduced

Table 2. **Demand and output**
Percentage changes, volume (1987 prices)

	1998		1999	2000	2001	2002 H1
	Current prices TL trillion	Per cent of GDP				
Private consumption	36 122.6	69.2	-2.6	6.2	-9.0	0.4
Public consumption	6 632.8	12.7	6.5	7.1	-8.6	2.8
Gross fixed investment	12 881.2	24.7	-15.7	16.9	-31.7	-12.0
Final domestic demand	55 594.5	106.5	-5.6	8.9	-15.0	-2.2
Stockbuilding ¹	-211.6	-0.4	2.0	1.1	-4.0	8.3
Total domestic demand	55 382.9	106.0	-3.7	9.8	-18.4	6.4
Exports of goods and services	12 713.3	24.3	-7.0	19.2	7.4	6.4
Imports of goods and services	14 573.2	27.9	-3.7	25.4	-24.8	10.0
Foreign balance ¹	-1 859.9	-3.6	-0.9	-3.0	12.4	-0.9
Statistical discrepancy ¹	-1 298.0	-2.5	-0.0	0.1	-0.0	-0.1
GDP at market prices	52 224.9	100.0	-4.7	7.4	-7.4	5.1
GDP implicit price deflator			55.6	49.9	61.7	63.0
<i>Memorandum items:</i>						
Consumer prices ²			59.0	50.0	63.5	55.5
Unemployment rate			7.5	6.6	8.5	..
Current balance (\$ billion)			-1.4	-9.8	3.4	-0.9
Current balance (per cent of GDP)			-0.9	-4.9	2.3	-0.5
Real effective exchange rate ³			4.2	9.5	-8.9	47.9

1. Change as a percentage of GDP in previous period.

2. Private consumption deflator.

3. Constant trade weights with 28 OECD partners using GDP deflator.

Source: OECD.

Table 3. **Decomposition of output growth by sector**

	1995	1996	1997	1998	1999	2000	2001	2002 ¹
Agriculture	2.0	4.4	-2.3	8.4	-5.0	3.9	-6.1	1.9
Industry	12.1	7.1	10.4	2.0	-5.0	6.0	-7.5	7.7
<i>of which:</i>								
Manufacturing	13.9	7.1	11.4	1.2	-5.7	6.4	-8.1	8.0
Services	7.3	6.8	7.4	3.2	-5.0	6.6	-6.7	5.3
Construction	4.7	5.8	5.0	0.7	-12.5	4.4	-5.9	4.2
Trade	11.5	8.9	11.7	1.4	-6.3	12.0	-9.4	6.9
Transport and Communication	5.7	7.6	7.6	4.9	-2.4	5.5	-4.9	4.0
GDP	7.2	7.0	7.5	3.1	-4.7	7.4	-7.4	5.2

1. As of first half.

Source: State Planning Organisation.

availability of bank credit combined with high real interest rates, fiscal tightening and higher import costs. The interest-rate rise caused wealth losses in the corporate sector, while the exchange-rate decline also damaged balance sheets of the firms indebted in foreign currency terms. The number of bankruptcies reached more than 16 thousand in 2001, and corporate profitability problems have continued into 2002. Firms not only cut back investments, but also significantly drew down stocks in lieu of producing to meet final demand. Households were cash-constrained because of rising unemployment and real wage losses (see below), plus sharply rising taxes. For households who had cash, savings earning high real rates of return became once again more attractive than consumption.

Export volumes grew in 2001, which alongside the collapse in imports, provided a hefty contribution from the external side to economic growth. The current external account turned around sharply, registering a surplus of 2.3 per cent of GDP (Table 1). Nevertheless, the export volume response (7½ per cent) to the large real devaluation (14 per cent) that year was relatively restrained, and export market share gains remained modest. This reflected to the lack of credit to purchase imported inputs, whose price had also risen sharply. For the same reason, tourism responded more strongly than goods to relative price shifts, and seemed to suffer very little from aftershocks of the 11 September events.²

Even though credit diffusion in the economy is relatively low, a credit crunch can have a significant negative effect on domestic demand. This suggests that domestic demand might not pick up durably as long as banking restructuring is not completed. Econometric studies have substantiated the important role of credit in the private sector.³ Many bank credits go to finance working capital, and much of the recent downturn has in fact reflected the lack of working capital. Corporate credits declined in real terms by over 13 per cent in 2001 and by a further 27 per cent by end-June 2002, which does not augur well for a recovery of invest-

ment any time soon. There is also a strong correlation between consumption and bank lending to the household sector, in particular for durable goods purchases. The overheating in 2000, which led to the demise of the stabilisation programme, had been fuelled by an unprecedented 4-fold rise in consumer credits as substitution effects from a sharp fall in interest rates boosted demand, with the reverse occurring in 2001. Credit availability to the household sector declined in real terms by almost 60 per cent in 2001, though partly offset by a 12 per cent renewed increase by end-June 2002.

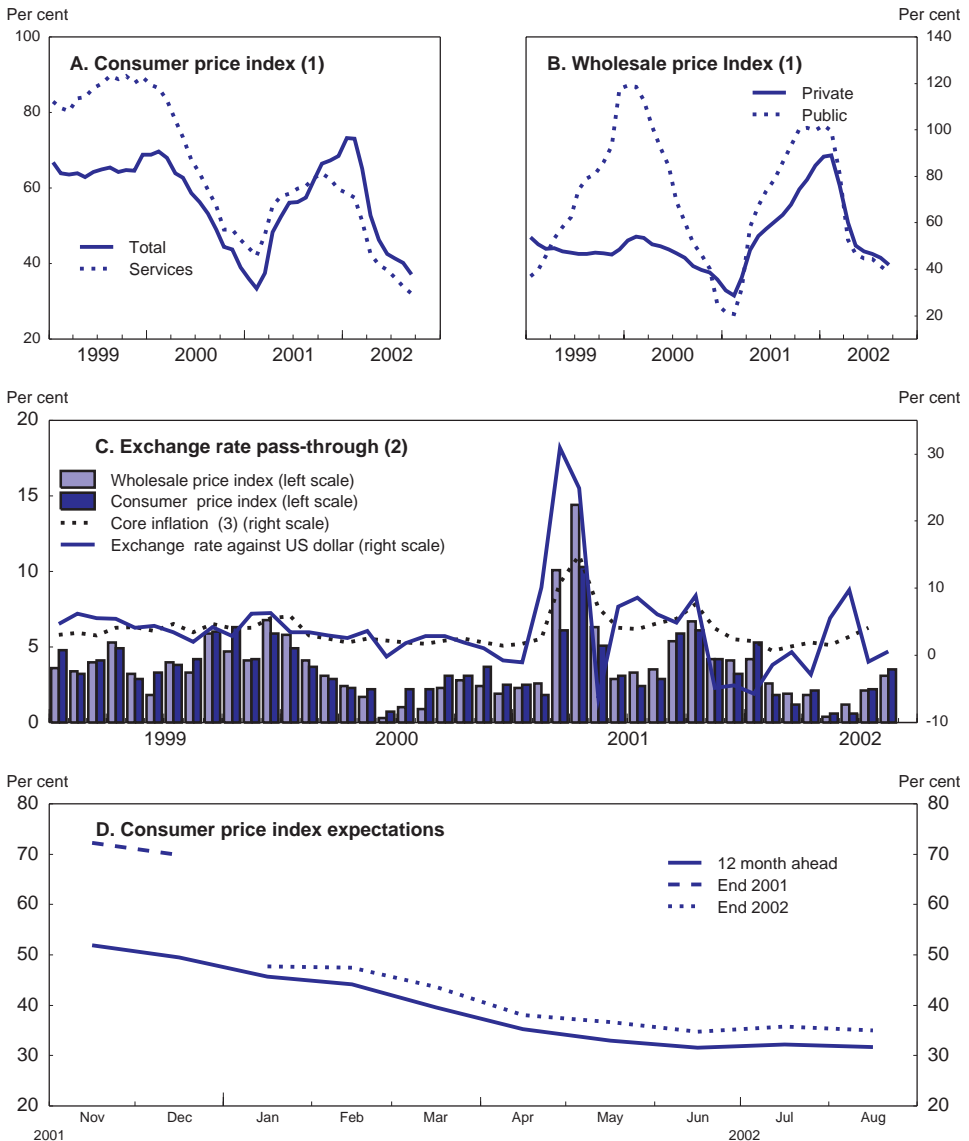
In the first half of 2002, growth performance nevertheless improved rather dramatically and unexpectedly, with a rate of growth of 5.2 per cent year-over-year, compared with -8.7 per cent in the previous half-year, the trough of the recession. Evidently, the turning point in financial market conditions in October 2001 had given rise to a turning point in real activity by the start of 2002. With the restriction in credit supply (in particular for investment), this also points to the importance of expectations in shaping demand. After four consecutive quarters of rundown of inventories, the rapid improvement in market sentiment spurred renewal of inventory build-up, making a vital contribution to growth. Another driving force was exports, assisted by world recovery and surging tourism, but the contribution of consumption also moved into positive territory. Although starting to improve by the second quarter, investment was still extremely weak.

After the initial shock, a return to disinflation

The large Turkish lira depreciation of February 2001 led to initial price hikes, but these were quickly absorbed, reflecting the impact of severe recession on the pass-through of the exchange rate shock. (Figure 2, Panel C). However, inflationary pressures remained significant: the end-2001 CPI inflation rate was 69 per cent, overshooting the target by 17 per cent. The rise in the WPI of 87 per cent was much higher: comprising mainly tradable goods, it absorbed the bulk of the exchange rate shock. The sharp increase in publicly administered prices during 2001 stands out (Figure 2, Panel B). The government pushed through price increases it had postponed the previous year in the attempt to hit the inflation target that markets had been watching closely. With the focus now on fiscal tightening, for example it allowed the price of energy to be fully passed through to final consumer prices, thus helping finances of the state energy company.

A clear turning point came in November 2001. The newly appreciating exchange rate eased energy and other imported price rises. The government also started to hold the line once again on administered prices so as to reinforce favourable inflation momentum. At the same time, it granted a temporary decrease in the VAT rate on consumer durables during November and December. Weak demand, meanwhile, was doing its part to mute price pressures, and the monthly inflation rate began to decline and considerably undershoot the market's

Figure 2. Inflation trends



1. Year on year percentage changes.
 2. Month-to-month percentage changes.
 3. Defined as private manufacturing price index.
- Source: Central Bank of Turkey.

expectations. By September 2002, the year-on-year CPI inflation rate had fallen to 37 per cent. The positive surprise in inflation had very important beneficial effects. It produced a marked turnaround in inflation sentiment with a clear break evident after October 2001, gaining momentum in early 2002 (Figure 2, Panel D). This, in turn, was essential to breaking the inflation inertia that seems to be the main determinant of endemic high inflation in Turkey (Chapter II). It allowed the Central Bank to reduce nominal interest rates in line with falling inflation, with beneficial effects on balance sheets. However, the Central Bank refrained from easing real interest rates until the trend had become well-established, in spite of calls by the government and business to the contrary, helping to reaffirm its authority as an inflation-fighter (Figure 1).

The return of market turbulence in May (see below), with renewed exchange rate weakening, may imply a slowdown in the progress on disinflation. The most recent data for private sector wholesale manufacturing prices (often regarded as a measure of core inflation by private sector financial analysts in Turkey⁴) display a sharp increase in response to the late-spring depreciation of the exchange rate (Figure 2, Panel C). Furthermore, the government was forced after mid-year to increase public sector wholesale prices in order to meet its end-year budget targets (Figure 2, Panel B). Though wholesale price changes are typically transmitted to consumer prices, the end-year target of 35 per cent remains achievable.

Weak labour markets assist the disinflation

Following adoption of the floating-rate regime, the government decided to further extend the incomes policy originally limited to civil servants, farmers and minimum wage workers. However, no concrete actions have been taken to date. Nevertheless, hourly manufacturing real wages decreased by 15 per cent during 2001 (Table 4). The incomes policy seems to have largely succeeded because the economic contraction, together with large-scale lay-offs in restructuring sectors such as banking and agriculture, lowered the demand for labour. The year-on-year decrease in manufacturing real wages continued during the first half of 2002, although at a more moderate pace.⁵ At the same time, manufacturing hourly productivity growth reached a trough in the first quarter of 2001. Since then, it has started to increase, reaching in the first half of 2002 a level 17 per cent above the trough.

Despite the large real wage adjustment, employment decreased by 1 per cent in 2001 (Table 5), with the biggest impact in the service (especially financial) and construction sectors. Employment in the industrial sector remained broadly stable whereas in agriculture it actually increased, as economic hardship caused a reverse migration to the countryside. With the labour force still increasing, the number of unemployed rose sharply, and the unemployment rate reached its

Table 4. Real wage developments
(per cent changes year over year)

	Private manufacturing ¹	Total economy ²			
		Public workers ³	Private workers ³	Civil servants	Minimum wage ⁴
1991	39.8	38.9	34.9	7.2	12.7
1992	-1.3	8.7	4.5	13.7	9.0
1993	5.0	7.6	1.0	2.0	5.6
1994	-24.3	0.0	-16.0	-21.9	-16.0
1995	-5.4	-16.9	-8.1	-4.5	-6.5
1996	3.5	-24.6	2.4	8.2	19.1
1997	1.3	19.5	-2.7	16.8	9.9
1998	-0.1	-0.8	17.6	-0.8	-4.4
1999	8.7	43.2	12.4	5.4	35.5
2000	1.6	7.6	1.7	-11.0	-14.1
2001	-14.9	-11.3	..	-3.4	-13.6

1. Hourly.

2. Real net wages.

3. Represents the wages of workers covered by collective labour agreements observed by Turkish Confederation of Employer Associations.

4. Minimum wage of industrial workers 16 and over of age.

Source: State Planning Organisation.

highest level in two decades (Figure 1). The deterioration in the labour market continued into 2002, with the year-on-year decrease in employment of almost 2.5 per cent in the first half of 2002, despite the recovery in GDP growth, and the number of unemployed persons reached a level over 2.2 million by end-June. In

Table 5. Labour market trends
Thousand persons, aged 15+

	1998	1999	2000	2001	2002 ¹
Labour force	22 399	23 187	22 031	22 269	22 008
per cent change	2.6	3.5	-5.0	1.1	0.7
Female labour force/labour force (per cent)	27.4	28.7	26.2	26.6	27.1
Employment	20 872	21 413	20 579	20 367	19 668
per cent change	2.5	2.6	-3.9	-1.0	-2.5
Female employment/employment (per cent)	27.4	28.8	26.3	26.8	27.5
Number of unemployed	1 527	1 774	1 452	1 902	2 340
Unemployment rate	6.8	8.0	6.6	8.5	10.7

1. As of first half.

Source: State Institute of Statistics.

agriculture, the adverse structural impacts of the reform evidently overpowered the positive cyclical effect (Chapter IV). On the other hand, employment in the industrial and service sectors is showing signs of recovery.

The outlook has improved, but uncertainties remain

Despite some early indications of recovery in domestic activity, political uncertainty over first the timing and then the likely outcome of an early election has become the main market driver, and since mid-2002 this uncertainty is overshadowing those favourable macroeconomic developments. The markets were nervous from the beginning of May 2002 when the Prime Minister first was hospitalised. The Treasury could auction 7-month bills only at 72 per cent compounded rates that month compared with 9-month bills auctioned at 59 per cent rates in the previous month. Nominal interest rates stayed in the 70 per cent area, while real interest rates shot up to 30 per cent in the following months. The Istanbul stock exchange index fell over 20 per cent while the Turkish lira weakened again by 16 per cent over the course of May and June. Unless soon counteracted, the renewed financial market tensions could interrupt recovery.

Even assuming that political tensions are quickly overcome, and notwithstanding first half optimism, the pick-up in real interest rates in the second half and the need to ensure a large primary surplus to manage the debt dynamics with the goal of achieving the inflation target, reduces the likelihood that the recovery in economic activity will continue at a rapid pace during the remainder of 2002. Under the OECD projections, which were prepared at end-September 2002⁶, the real exchange rate is assumed to remain stable at its level then, implying a cumulative real depreciation of around 10 per cent *vis-à-vis* February of the previous year when the currency was set free. Assuming that the government meets its budget targets for the year and thereby lowers the public debt burden, this would restore market confidence and lead to renewed reductions in real interest rates, encouraging investment and consumption. The depreciated real exchange rate and declining real interest rate would in turn boost domestic demand. World growth and real exchange rate depreciation will furthermore continue to benefit exports. Hence, a recovery of growth to close to 4 per cent and a decline of inflation to the 35 per cent targeted level are projected for 2002. Next year, these same forces should allow growth to stay at around 3½ per cent. The projections see a further decline in the inflation rate somewhat above the official target of 20 per cent by end-2003.

There are clear risks on both sides. On the upside, if confidence improves sufficiently, there is much pent-up demand in Turkey that could be suddenly unleashed, although the likelihood of a lengthy bank restructuring process puts a cap on this risk. More dangerously, as demand picks up, inflation might resurge unexpectedly. This is especially the case for services prices, especially rents,

which have been very restrained throughout the recession, suggesting large real losses of incomes in the sector. Moreover real wage losses have been large in all sectors, a necessary cost of disinflation, but as labour markets tighten there could be demands to recoup lost purchasing power, thereby threatening progress on disinflation. On the downside, non-performing loans continue to rise implying pressure on bank capital ratios and a missing credit link between banks and the corporate sector. Perhaps most seriously, the currently high sovereign risk premium can become an obstacle to the recovery of domestic demand and to the attainment of debt sustainability, if it were to fail to decline in the event of persisting domestic or geo-political risks. In this regard, fiscal policy credibility depends critically on sustained implementation of structural fiscal reforms (including privatisation, social security reform and tax reform).

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 Arıman (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 still 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

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

SEE	State Economic Enterprise
SIS	State Institute of Statistics
SME	Small and Medium Enterprises
TEAS	State electricity company (generation and transmission)
TEDAS	State electricity company (distribution)
TL	Turkish lira
TOOR	Transfer-Of-Operating-Rights
TSE	Total Support Estimate
TT	Turk Telekom
UNCITRAL	United Nations Commission on International Trade Law
VAT	Value added tax
WPI	Wholesale Price Index
YKB	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.¹ 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
Total	31 045.6

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.² 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.³ 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.⁴

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.⁵ 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 1999.⁶

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;⁷
- 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 1999.⁸ Hence, the government committed itself to the introduction of new measures to strengthen prudential regulation and tools to deal with problem banks.⁹

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.¹

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

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

where

- PD Primary deficit
- G Government expenditures
- T Taxes (and other government revenues)
- r TL real interest rate
- π Domestic inflation
- π^* 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:³

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

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

- δ 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:⁴

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

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).⁵

Table A.2. Scenarios of public debt sustainability

	<i>Baseline Scenario</i> ¹	<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								
Primary deficit	-6.5	-6.5	-6.5	-6.5	0.0	-5.0	0.0	-5.0
Debt in Turkish lira	34.0	34.0	34.0	34.0	34.0	34.0	26.0	26.0
Debt in foreign currency	48.0	48.0	48.0	48.0	48.0	48.0	38.3	38.3
Per cent values								
Domestic nominal interest rate	76.5	76.5	86.5	86.5	15.0	29.7	16.9	36.1
Real growth	3.0	3.0	3.0	3.0	5.0	5.0	5.0	5.0
Real domestic interest rate	36.5	36.5	46.5	46.5	5.0	19.7	6.9	26.1
Real world interest rate	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Real depreciation (+) or appreciation (-)	-21.6	-11.6	-21.6	-11.6	2.0	2.0	2.0	2.0
Seignorage	6.3	6.3	6.3	6.3	2.4	2.4	2.4	2.4
Change in primary balance to attain stability of debt/GNP	-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, 10th 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).*

* 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*].”¹ 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,² 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.³ 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,⁴ 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).⁵ 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.⁶

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 λ . 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

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

λ 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.⁷ 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.⁸ 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

* 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)¹

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

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**

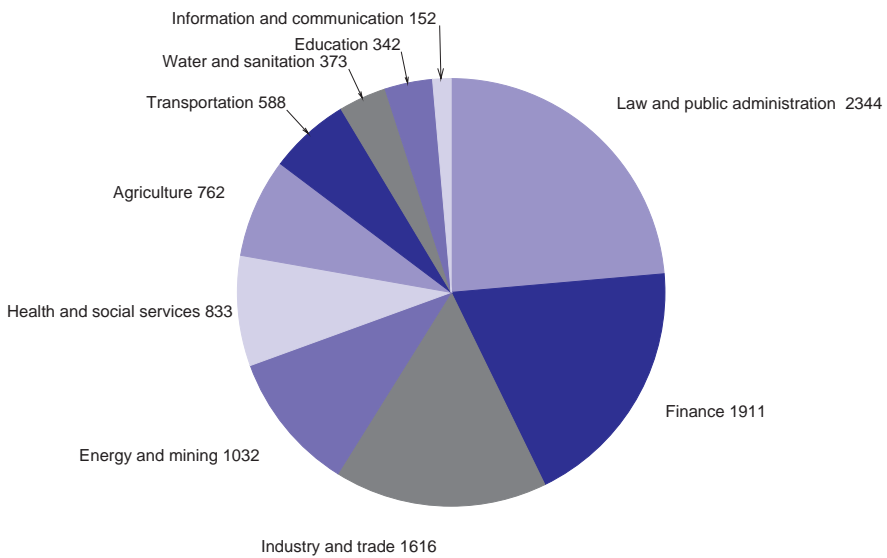
Project name	Lending instruments	Approval date	Closing date	IBRD commitments (US\$ millions)	Grants (US\$ millions)	Sector name	Project status
Phaseout of Ozone Depleting Substances Project (02)	Specific Investment Loan	05.10.1995	6/30/2004	0.0	14.0	General industry and trade sector	Active
Antalya Water 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).¹ 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,² 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.³ 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 ¹	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.⁴ 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:⁵

- *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)

1) Nominal assets	74.6		
= Total on balance sheet assets	104.1		
+ off-balance sheet securities (repos)	14.8		
– FX assets	36.8		
– Real assets	7.5		
2) Nominal liabilities	153.2		
= Total on balance sheet liabilities	104.1		
+ Contingencies + commitments	105.0		
– FX liabilities	48.7		
– Net worth	7.2		
3) Interest rate-sensitive assets	47.7		
= 0.64 * (1)			
4) Interest rate-sensitive liabilities	134.8		
= 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.⁶

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.⁷

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.⁸ 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.⁹

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.

* 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 2000,¹⁰ 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,¹¹ 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.¹² 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.¹ 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.² 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 (%) ¹	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.

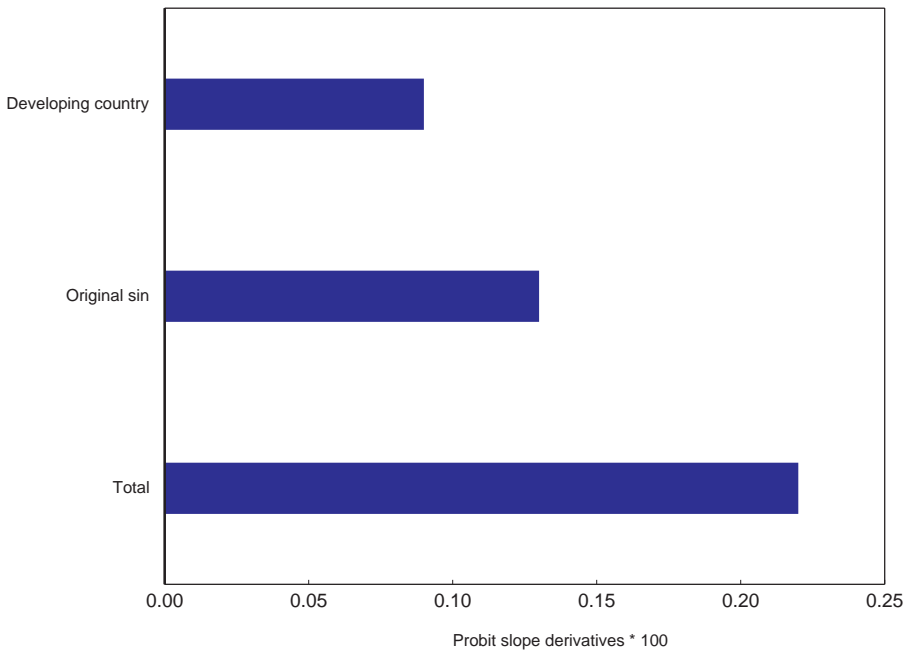
*Annex IX***A theoretical and empirical analysis of foreign direct investment, with special emphasis on Turkey**

In the current discussion of FDI, it is implicitly assumed that FDI is good for Turkey.¹ However, recent theoretical and empirical work has started to question the traditional view of FDI.² 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”.³ 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.⁴ 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*,⁵ 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



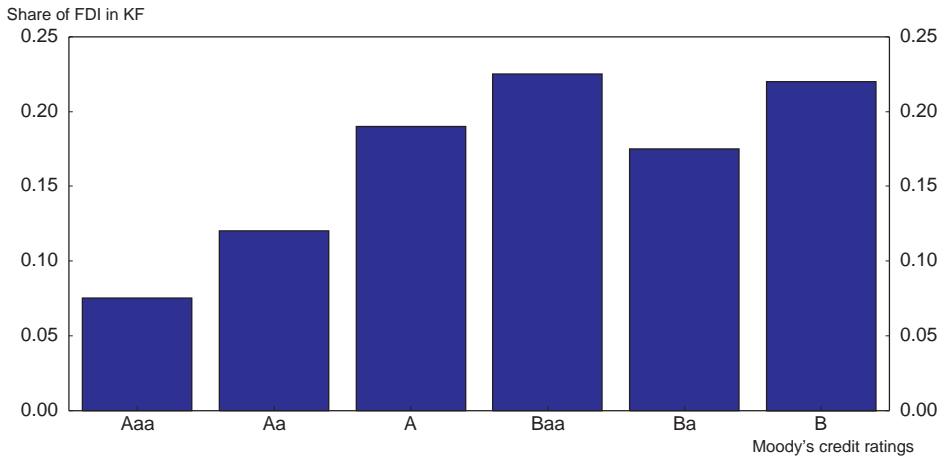
Source: Fernandez-Arias and Hausmann (2001). The model used is a probit. The independent variables included are per capita GDP, exports/GDP, original sin dummy, developing country dummy, FDI/GDP, interaction term of FDI/GDP with original sin and developing country dummies, non FDI capital flows/GDP and 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).

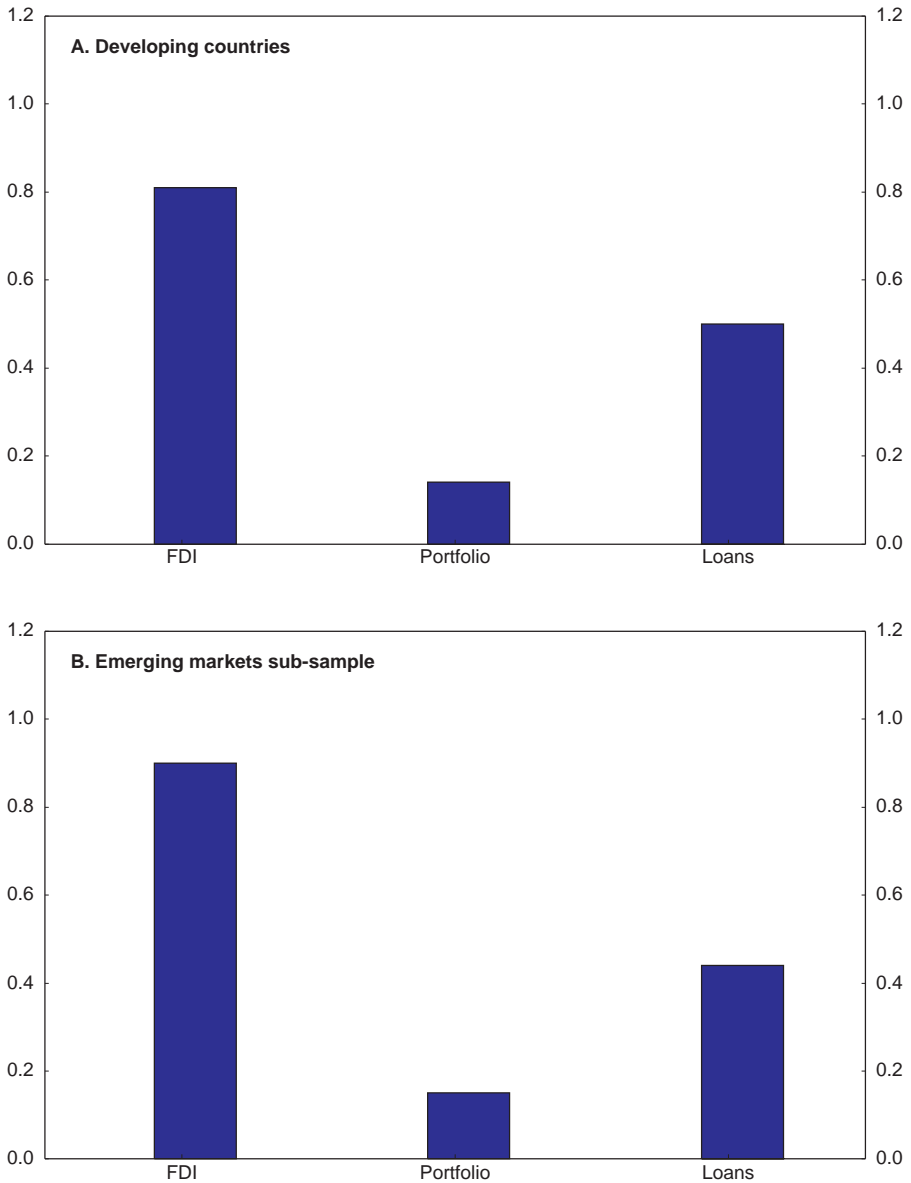
ital investment than home firms.⁶ While FDI has a higher share of capital inflows in many countries with weak institutions, it would be wrong to infer causality from this relation. It is probably the case that without FDI, these countries would have been even poorer. This so-called paradox is thus probably 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).

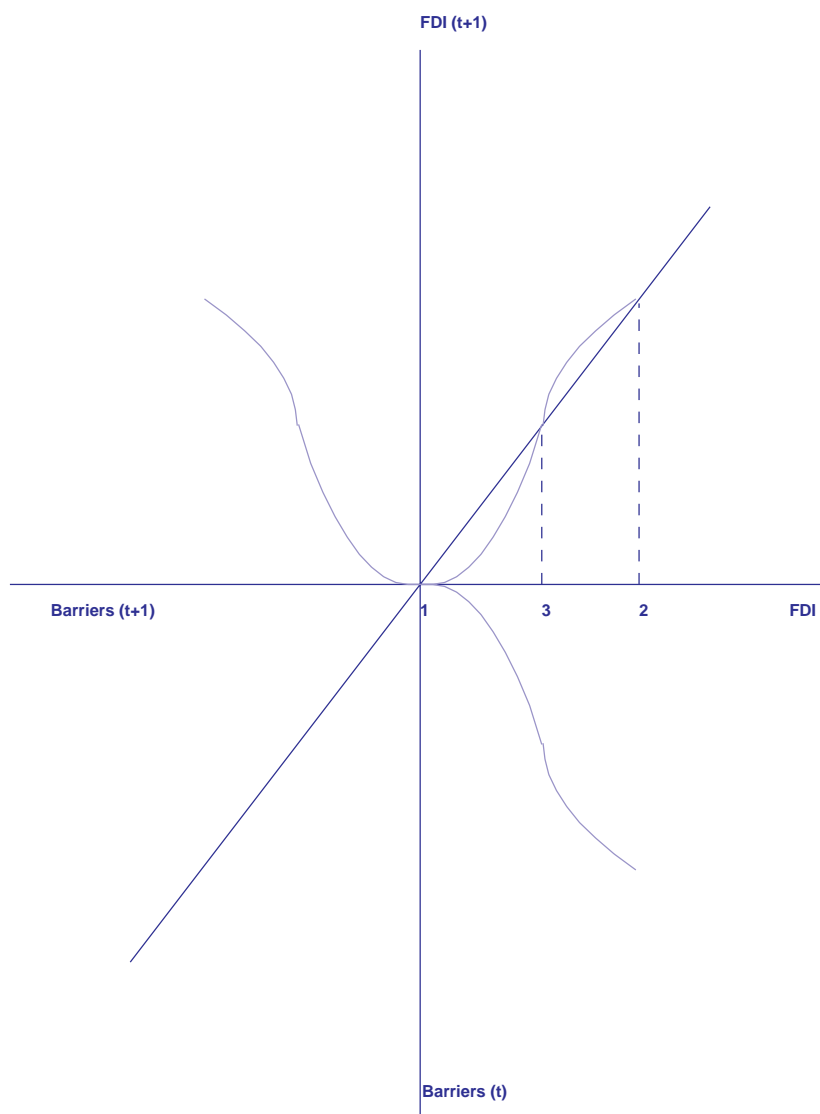
more integrated into the world, and moreover this effect has decreased somewhat in the last ten years.⁷ Although the relationship between FDI and domestic investment may still be argued, most investigators now agree that FDI increases domestic productivity and that these productivity benefits are largest in countries with a skilled labour force and well-developed infrastructure.⁸ 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).⁹

Assume that, for countries with high barriers,¹⁰ 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.¹¹ 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).¹² 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.¹³ 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 Bayindirbank.

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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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

•

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