SEQUENCING, PACE AND TIMING OF FINANCIAL LIBERALIZATION PROCESS IN TURKEY WITH IMPLICATIONS ON THE MACROECONOMIC ENVIRONMENT

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ABSTRACT

SEQUENCING, PACE AND TIMING OF FINANCIAL LIBERALIZATION PROCESS IN TURKEY WITH IMPLICATIONS ON THE MACROECONOMIC ENVIRONMENT

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This study basically analyzes timing, sequencing and pace of the financial liberalization experience of the Turkish economy in the 1980s and evaluates its implications for the crises in the Turkish economy since the 1990s. The objectives of this study are threefold: Firstly, it aims to reveal the main policy objectives and political factors pushing the government to take capital account liberalization decision in 1989. It is concluded that domestic decision makers have shaped and taken the decision of capital account liberalization in 1989, while the interaction of economic and political factors has played a major role in its timing. Secondly, it examines the extent to which economic and political institutional weaknesses in the Turkish economy, which generated inappropriate sequencing of financial liberalization policies in the 1980s, can be held responsible for the crises of 2000 and 2001 crises. It is concluded that financial liberalization policies were inappropriately sequenced, as domestic financial market and capital account liberalization were not accompanied or preceded by macroeconomic stability and financial sector institutional reforms such

as prudential regulation and supervision of the banking sector. These factors have been instrumental in the crises episodes in Turkey through contributing to an environment conducive to crises. Thirdly, it aims to analyze whether there exists a clear association between weaknesses in the regulation and supervision of the banking sector and banking crises through an empirical analysis. It is concluded that the nature of the banking crises is more associated with the institutional structure of the financial system rather than macroeconomic conditions of the economy.

Key Words: Financial Liberalization, Sequencing and Timing of Financial Liberalization, Prudential Regulation and Supervision of the Banking Sector

ÖZ

TÜRKİYE'DE FİNANSAL SERBESTLEŞME POLİTİKALARININ SIRALAMASI, ZAMANLAMASI VE HIZININ MAKROEKONOMİK ORTAM ÜZERİNE ETKİLERİ

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Bu çalışmada temel olarak, 1980'lerde Türkiye ekonomisinde uygulanan finansal serbestleşme politikalarının zamanlaması, sıralaması ve hızı incelenerek 1990 sonrasında Türkiye ekonomisinde yaşanan krizler üzerindeki etkilerinin değerlendirmesi amaçlanmaktadır. Bu çalışma üç temel amaç etrafında şekillenmektedir: İlk olarak, hükümeti 1989'da sermaye hareketlerinin serbestleştirilmesi kararının alınmasına iten temel politika amaçlarının ve politik unsurların ortaya çıkarılması amaçlanmıştır. Sermaye hareketlerinin serbestleştirilmesi kararının alınmasında yerli politika yapıcıların kararı şekillendirdiği ve aldığı düşünülmekte, ayrıca, bu kararın alınmasında ekonomik ve politik unsurların bir arada etkili olduğu düşünülmektedir. İkinci olarak, Türkiye ekonomisinde finansal serbestleşme reformlarının yanlış sıralanmasına sebep olan ekonomik ve politik kurumsal yapı zayıflıklarının ne ölçüde 2000 ve 2001 krizlerinden sorumlu tutulabileceği tartışılmaktadır. Hem yurtiçi finansal piyasaların, hem de sermaye hareketlerinin serbestleştirilmesinin, makroekonomik istikrarsızlığın ve zayıf bankacılık düzenleme ve denetleme sisteminin olduğu bir ortamda gerçekleştirilerek yanlış sıralandığı sonucuna

ulaşılmıştır. Bu unsurların Türkiye'deki kriz sürecine, krizleri tetikleyecek uygun bir ortam oluşmasına katkıda bulunarak etkisinin olduğu düşünülmektedir. Üçüncü olarak bankacılık düzenleme ve denetleme sistemindeki zayıflıklarla bankacılık krizleri arasındaki ilişki ampirik bir çalışmayla araştırılmaktadır. Yapılan çalışma sonucunda, bankacılık krizlerinin, finansal sistemin kurumsal yapısıyla, makroekonomik göstergelerle olduğundan daha fazla ilişkili olduğu bulunmuştur.

Anahtar Kelimeler: Finansal Serbestleşme, Finansal Serbestleşmenin Zamanlaması ve Sıralaması, Bankacılık Sektörü Düzenleme ve Denetlemesi

To My Mother

Ayten Ganioğlu

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LIST OF ABBREVIATIONS

BIS	Bank for International Settlements
BRSA	Banking Regulation and Supervision Agency
BWI	Bretton Woods Institutions
CAR	Capital Adequacy Requirements
CBRT	Central Bank of the Republic of Turkey
IFI	International Financial Institutions
IMF	International Monetary Fund
NPL	Non Performing Loans
SAL	Structural Adjustment Loan
SEE	State Economic Enterprises
SPO	State Planning Organization

CHAPTER 1

INTRODUCTION

1.1.Globalization and the Changing Nature of the Development Policy Analysis: Rise of Neoliberal Policies

Globalization[1] is one of the major forces affecting the world economy. Globalization implies in economic terms, the interconnection of markets of all kinds, and thus represents an evolution from the state of the closed economy, to that of the fully integrated global economy. Therefore, globalization refers to the increasing integration of economies around the world[2]. The prevailing view in G-7 capitals and multilateral lending agencies is that global integration is the key prerequisite for economic development.

From the historical perspective of development policy analysis, before the 1980s, -1950s through 1970s- economic and social trends were explained within a national framework. Key ingredients of a successful development process were identified through sequences of change within already industrialized countries. They were then applied in less developed countries without any reference to their specific circumstances. In other words, all countries were expected to go through the same patterns of development[3].

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[1] Rodrik (2000a) uses the term "international economic integration" rather than "globalization" Rodrik (2000a:184) argues "we are presently nowhere near complete international economic integration".

[2] Three important dimensions of economic integration are: 1) the expansion of international trade in goods and services, 2) movements of capital and integration of financial markets, 3) the growing significance of information technology.

[3] Gore (2000:791)

However, as a result of the inability of those policies to sustain output growth and high employment over the next decades, the mainstream perspective shifted to neo-liberalism. The neo-liberal approach, which took the center of policy stage[4], is based on general competitive equilibrium theory, which claims "competitive market forces can bring real world capitalist economies to optimal output and employment growth paths"[5]. Therefore, it is argued that development strategy should focus on maximizing market efficiency by minimizing policy-induced distortions and unexpected events. According to this approach, "the government can retard long-term growth through tariffs, taxes and controls that may permanently distort private incentives and relative prices"[6]. Therefore, it is argued that capital accumulation should be left to the market forces through elimination of capital controls and other impediments to the free flow of foreign direct investment and portfolio capital flows[7].

Under the neoliberal approach, the developmental role of the state is criticized on the basis of the proposition that "government failures" outweigh "market failures" due to corruption and rent-seeking. Therefore, minimalist state is believed to serve better the public interest. While the scope of activist state would be limited, the essential roles of the state in enforcing contracts, protecting life and property, advancing education and providing other basic public goods would be retained[8].

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[4] Taylor (1997:146)

[5] Felix (2003:3)

[6] Felix (2003:3)

[7] Felix (2003:4)

[8] Öniş (1994:122)

Consequently, there emerged a pressure on less developed countries to liberalize the current and capital accounts of their balance of payments. In the face of changing international economic environment, both low and middle-income countries experienced a massive macroeconomic adjustment[9]. However, repercussions of these transformations were observed worldwide in the form of a range of syndromes associated with macroeconomic instability —high or repressed inflation, scarcity of foreign exchange and external payments imbalances and debt crises. Felix (2003:6) asserts that the early 1980s debt crisis was the first major financial failure of neoliberalism.

On the other hand, even though neoliberal policies experienced its first major failure in Latin America and Turkey in the early 1980s, the approach followed by the Bretton Woods Institutions (BWI) has been to blame policies of the governments for the debt crisis. It is argued that "various policy errors and omissions of the debtor governments had misled the creditor banks to overlend; hailed the potential benefits to developing countries of opening up to foreign capital inflows"[10]. The BWI "urged the adoption of market-liberalizing reforms to "get prices right" and "sound" macroeconomic policies to regain the confidence of foreign lenders and investors"[11]. Afterwards,

> protecting the private foreign creditors, blaming crises on government failure and conditioning its creditors on "sound" macroeconomic policies and more market liberalizing reforms became the IMF's standard approach to future currency and financial crises in developing countries[12].

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[9] Taylor (1997:146)

[10] Felix (2003:8)

[11] Felix (2003:8)

[12] Felix (2003:8)

Therefore, it can be argued that the spread of neoliberalism as a development strategy has been fundamentally led by the self-interest of the developed countries and arranged by IFIs.

In the face of Latin American crisis in the early 1980s, what was observed is that the major creditor countries assigned the IMF with the task of "coordinating a rescue effort that would keep the Latin American debt crisis from exploding into a global banking crisis"[13]. "In coordinating the rescue, the IMF tied the bailout credits to the priorities" of the Bretton Woods Articles of Agreement[14]. Felix asserts (2003:7) that "protecting private international creditors took top priority over stabilizing the debtor economies and minimizing employment and output losses… the cost to the Latin American debtors was the "Lost Decade"…".

Therefore, it seems that "the transition to neo-liberalism was mainly impelled by political and ideological changes external to the developing world"[15]. The new policy line had been shaped by the staff of the World Bank and the IMF, and changed little over time. It is mentioned that both "the IMF and the World Bank embarked on an extensive campaign to spread the neo-liberal message."[16] Consequently, the present trend towards globalization has been the consequence of the dramatic shift in economic and social policy during the 1980s. In general terms, these policies are seen as a shift from state-led policies to market oriented policies. Ideas of the new policy approach, named "Washington Consensus" policies have spread to the developing countries through the stabilization and structural

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[13] Felix (2003:6)

[14] Felix (2003:7)

[15] Felix (2003:6)

[16] Felix (2003:7)

adjustment policies of the IMF and World Bank[17]. Taylor (1997:145) has asserted that "half the people and two-thirds of the countries in the world lack full control over their own economic policy". Rather, their macroeconomics, investment projects and social spending have been controlled or regulated by international institutions such as the IMF and World Bank.

1.2. Washington Consensus Policies

Washington Consensus has been the dominant approach to development, since the early 1980s[18]. Washington Consensus has basically insisted on trade and capital account liberalization, privatization and deregulation through which domestic product and factor markets were aimed to liberalize. Therefore, pressures on developing countries to liberalize their trade and capital accounts increased further throughout the 1980s and 1990s. According to Stiglitz (2002:102), "the IMF was not alone in pushing for liberalization". He (2002:102) argues that the US Treasury, as the IMF's largest shareholder has had an important role in determining the IMF policies.

The IMF's rationale to base its conditionality on financial liberalization, privatization and "sound" monetary and fiscal policies has been the claim that these policies allow more rapid development through attracting more private foreign capital. These capital flows are believed to supplement shortfalls in domestic savings, skills and technology, on the basis of the assumption that financial markets process information and allocate capital efficiently[19]. The IMF[20] has asserted that countries that align themselves with the forces of

[17] Gore (2000:789)

[18] Gore (2000:789)

[19] Felix (2003:28)

[20] IMF (1997:72)

globalization would benefit from trade, gain global market share and be increasingly rewarded with larger private capital flows, but those that "do not adopt such policies are likely to find themselves falling behind in relative terms". As a result, many countries have reformed their trade and capital account regimes to make the policy environment more conducive to fuller integration into the world economy.

However, when a liberalization process ends up with crisis, the IMF and the US Treasury generally claim that the liberalization itself is not at fault but the problem was that liberalization is done in the wrong way. Likewise, when there is capital outflow, the general line of the argument raised by the BWI is that the policy surprises, lack of transparency and other information flaws of the recipient country mislead the financial markets[21].

Hence, in response to financial crises, IFIs added new conditionality items to the programs to reshape the economy and make it more appealing to the financial markets. These new conditionality items are described as

> an overly ambitious agenda of "governance" reforms aimed at reducing corruption, improving the regulatory apparatus, rendering monetary and fiscal institutions independent, strengthening corporate governance, enhancing the functioning of the judiciary and so on in the policy field[22].

On the other hand, it is asserted that even in the presence of strong banks, a mature stock market and other institutions, no country could endure the sudden withdrawal of capital due to an abrupt change in investor sentiment. As an example to such large reversals, in the case of Thailand, withdrawal of capital amounted to 7.9 percent of GDP

[21] Felix (2003:28)

[22] Rodrik (2004:2)

in 1997, 12.3 percent in 1998, and 7.0 percent in the first half of 1999[23].

While new conditionality items put heavier adjustment costs on debtor country, the argument of the BWI is that improved appeal to foreign investment will bring "greater offsetting benefits over the long-run"[24]. In short, there emerged a long list of requirements that developing countries have to fulfill in order to integrate into the world economy. In other words, requirements of global economic integration begin to shape the design of development policies[25].

Rodrik (2000a:28) defines this new environment as a situation where ends and means are confused. More explicitly, this means that integration into the world economy has been viewed as an ultimate goal rather than as an instrument for achieving economic growth and development, while it should be just the opposite. "Maximizing trade and capital flows should not be the objective of development policy"[26]. Furthermore, in terms of economic development, as Rodrik (2001:29) emphasizes

> There is no single recipe for economic advancement. This does not mean that anything and everything works: market-based incentives, clear property-control rights, competition and macroeconomic stability are essential everywhere.

On the other hand, even these universal requirements can be and have been embodied in diverse institutional forms. Stiglitz (2002:33) also criticizes the IMF for not having a detailed knowledge of the

[23] Stiglitz (2002:99)

[24] Felix (2003:28)

[25] Rodrik (2000b:28)

[26] Rodrik (2000a:28)

countries and taking a "one-size-fits-all" approach on the one hand and not caring about the development and poverty issues, on the other[27].

An important message related to this issue comes from Rodrik (1998:10) who argues that

> we have to live with financial markets that are prone to herding, panics, contagion and boom-and-bust cycles. Appropriate macroeconomic policies and financial standards can reduce the risks but not eliminate them. This is as true of domestic financial markets as it is of international ones.

1.3. Interaction of Stabilization Programs and Liberalization Policies

Liberalization, in general terms, can be defined as the policies that remove or reduce price and quantity controls in a market. Liberalization attempts are more often introduced within a major stabilization program, which aimed at reducing inflation and solving a serious balance of payments crisis. Stabilization is defined as a fiscal, monetary and regulatory policy to control inflation, ensure a sustainable balance of payments position and achieve high and stable levels of capacity utilization and employment[28]. However, Chopple (1990:2) argues that stabilization is a rather short-term issue as compared to liberalization, which he simply defines as the removal of barriers to the free operation of markets.

The standard set of orthodox measures recommended by the IMF and the World Bank generally involves a mixture of short-term stabilization measures as well as medium-term adjustment and liberalization policies[29]. As an example, all three countries in the

[27] Stiglitz (2002:34)

[28] Chopple (1990:1)

[29] Taylor (1983:191, 1998:7-9,147-169)

Southern Cone –Argentina, Chile[30] and Uruguay- New Zealand, Peru and Turkey implemented their reforms as part of a larger reform and stabilization effort and began financial sector deregulation under the conditions of macroeconomic instability[31].

The question of whether stabilization and liberalization should be pursued together[32] came to the center of the debate after the economic instability in developing countries, especially the debt crisis in Latin America. Edwards (1992) argues that simultaneous stabilization and reforms seems feasible in countries of low and middle inflation level. On the other hand, Edwards (1992) and Krueger (1984) have conflicting views about liberalization in high inflation countries. As Edwards (1992) asserts that stabilization should be tackled first in these countries, Krueger (1984) believes that it may be difficult to control inflation without liberalizing the economy. Corden (1987), Krueger (1981, 1984) and Michaely (1987) are among those who favor the simultaneous implementation of trade reform and macroeconomic stabilization. Since stabilization programs generally follow a crisis period, it is asserted that after the crisis atmosphere has passed, it might be difficult to create the necessary momentum for reform, thereby arguing in favor of simultaneous approach.

On the other hand, Wolf (1986) argues that simultaneous implementation may have the disadvantage of confusing the contractionary aspects of the stabilization with the effects of the liberalization measures, as he specifically focuses on trade liberalization. Moreover, he mentions that uniting the political opposition to stabilization measures with that to trade reform is not

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[30] Liberalization measures in Chile were enacted concurrent with the stabilization program implemented between 1974 and 1981. The liberalization of interest rates had begun in 1976 in the context of an economic adjustment program in Argentina.

[31] Williamson and Mahar (1998) and McKinnon (1991:38)

[32] Edwards (1984a:2)

appropriate. He argues that the chance of sustainability of both programs is higher if they are implemented sequentially rather than simultaneously.

1.4. The Sequencing, Pace and Timing of Economic Liberalization Process

The economic liberalization process is quite complex, the success of which requires coordination with macroeconomic and structural policies as well as proper sequencing, timing and pace.

The debt crisis in the early 1980s in Latin America brought a new discussion to the literature, which questions the role of sequencing, timing and pace of liberalization process. The first significant liberalization efforts which aimed at increasing the role of market mechanism and reducing existing barriers to international trade and capital movements occurred in the Southern Cone of South America (Argentina, Chile and Uruguay) in the early and mid-1970s. These liberalization reforms included elimination of quantitative restrictions on trade, reduction in tariff levels and dispersion, developing capital markets and removing restrictions on international capital movements.

On the other hand, the pace and sequencing of the reforms differed significantly in these three countries[33]. Furthermore, those liberalization reforms were introduced without satisfying some important conditions. For example, both Argentina and Chile introduced financial sector liberalization, which involved removing controls on

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[33] Chile implemented the extensive trade liberalization first, while liberalization of the capital account took the first place in the agenda in Argentina and Uruguay (See Fischer and Reisen (1992:43, 46, 49) for details). Liberalization reforms in Chile between 1974 and 1981 included opening of the current account and a gradual liberalization of capital account between 1976 and 1982. Chile gradually reduced restrictions on international capital movements, in particular, medium-term capital flows, while maintaining restrictions on short-term capital flows until late 1981. Nevertheless, all three countries quickly liberalized their domestic financial markets, with Uruguay removing interest rate ceiling by 1974 and Argentina and Chile by 1976 (Mathieson and Rojas-Suarez, 1994: 24)

interest rates, privatization of public-sector banks and competition in the banking sector, without adequate supervisory framework during a period of macroeconomic instability[34]. Furthermore, they removed the controls on capital flows soon after domestic financial sector liberalization. Finally, these liberalization attempts ended up with crises. In the face of severe macroeconomic crises in the early 1980s, liberalization reforms had to be partially reversed in these countries, implying failure of these reforms to a large extent[35].

Although a variety of factors can lead to the emergence of a financial crisis in a country, after the debt crisis in the early 1980s in Argentina, Chile and Uruguay, i.e., a decade after these reforms were first implemented, the role of sequencing of economic liberalization in contributing to growing frequency of financial crises began to be questioned. As a result, the issue of sequencing of the liberalization process became important and a literature developed to suggest the correct sequencing of liberalization[36].

1.5. Financial Liberalization and Financial Crisis

There has been frequent financial instability in both developed[37] and developing countries accompanied by the increased global capital mobility after the collapse of the Bretton Woods system in 1971[38]. In

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[34] Williamson and Mahar (1998:25)

[35] Williamson and Mahar (1998:25); McKinnon (1991:3); Edwards (1984a:4)

[36] Edwards (1984a) and McKinnon (1982, 1991, 1994)

[37] The episodes in developed countries include the banking and real estate crises in the United States lasting more than a decade from the late 1970s, the major slumps in the global stock market in 1987 and 1989, the currency crisis of the European Monetary System (EMS) in 1992 and the ongoing instability in Japanese financial markets that started with the bursting of the bubble in the early 1990s (Akyüz and Cornford, 1999:15). See also Fourçans and Franck (2003)

[38] This classification of the crises as post-Bretton Woods crises belongs to Akyüz and Cornford (1999:15). As the literature mostly focuses on the crises of developing countries in the post-1990 period and make some conclusions regarding this period,

some cases, a severe enough financial instability even led to almost complete breakdown in the functioning of the financial markets, which is called as a financial crisis. Furthermore, in the last twenty years, financial instability[39] and financial liberalization have occurred at about the same time in almost all countries throughout the world. The episodes of crises in developing countries include the Southern Cone crisis of the late 1970s and early 1980s, the Mexican crisis of 1994-1995, the East Asian crisis beginning in 1997, the Russian crisis of 1998, Argentina crisis in 2001 and Turkish crises in 2000 and 2001[40].

There have been a number of studies[41], which specifically question whether the crises in emerging market economies in the 1990s are a direct and inevitable result of financial liberalization. The idea here is that openness of emerging markets to international capital flows, combined with a liberalized financial structure, makes them particularly vulnerable to crises. Therefore, there is a vast literature which claims that fragility induced by financial liberalization carries the risk of leading to financial crisis[42], and financial liberalization precedes crises. The crises in East Asia, Mexico, Russia, Brazil and Turkey are regarded to have emerged due to factors associated with financial and capital account liberalization.

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we will stick to classification of Akyüz and Cornford as it covers the crises of developed counties and enable to make comparison between developed and developing countries.

[39] Financial instability is characterized not only by short-term volatility in exchange rates and financial and real asset prices, but also by boom-bust cycles, which become common feature of stock and property markets together with financial liberalization Akyüz (2004:2)

[40] Akyüz and Cornford (1999:15)

[41] Williamson and Mahar (1998); Kaminsky and Reinhart (1999)

[42] Kaminsky and Reinhart (1999) and Demirgüç-Kunt and Detragiache (1998), Williamson and Mahar (1998), Glick and Hutchison (1999)

Even the IMF accepts tha the crises and volatility are associated with financial liberalization. However, the general approach of the IMF is to present the crises as the inevitable consequence that must be suffered to enjoy the long-run benefits of liberalization. Before and after the Asian crisis, the US government's approach was to push for financial liberalization for its own purposes by arguing that financial liberalization has welfare benefits for the countries involved[43].

1.6. Role of Sequencing Mistakes in Leading to Crisis

It is mostly believed that excessively rapid financial and capital account liberalization is the single most important cause of the crises, though wrong policies by individual countries themselves played a role as well[44]. Stiglitz (2002) argues that since globalization policies, i.e. liberalization policies have been implemented too fast, in the wrong-order and not designed according to the specific characteristics of countries; they increased instability, vulnerability to shocks and poverty, besides reducing growth.

In the aftermath of the East Asian crises, one of the lessons drawn is that improperly sequenced financial liberalization

> -forcing liberalization before safety nets were put in place, before there was an adequate regulatory framework, before the countries could withstand the adverse consequences of the sudden changes in market sentiment that are part and parcel of modern capitalism[45]-

raises vulnerability to speculative attacks. Stiglitz (2002:73) states that the underlying factor behind these sequencing mistakes is the misunderstandings of economic and political processes by those who believed in market fundamentalism. According to free market ideology,

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[43] US Treasury (2000)

[44] Stiglitz (2002:89) and Williamson (1999:9)

[45] Stiglitz (2002:73)

market forces drive the economy to efficient outcomes as if by an invisible hand. Accordingly, under perfect information, there would be little role for financial markets and financial market regulation. Nevertheless, "whenever information is imperfect and markets incomplete, which is to say always, and especially in developing countries, then invisible hand works most imperfectly"[46].

Financial liberalization undertaken in the context of inadequate supervision and prudential regulation raises the risk of vulnerability to short-term and potentially reversible capital flows, as economic agents tend to borrow abroad at low interest rates and to lend at home at high interest rates. Moreover, strong macroeconomic fundamentals are essential to avoid crises, while not sufficient. Hence, rapid and poorly coordinated financial liberalization before ensuring macroeconomic stability and strong financial system has been blamed for enhancing the vulnerability of financial markets to unstable international capital flows.

1.7. Financial Crisis and Prudential Regulation and Supervision

Lack of banking regulation and supervision emerges as a major component of vulnerability to crisis. Financial crises have features in common, particularly the insolvency of a number of financial institutions that were involved in lending to interrelated entities and rapid growth of bank credit following liberalization.

It is argued that in the case of capital account liberalization, badly regulated and supervised banks, get access to new sources of funding and open positions often emerge and get larger as capital flows in, creating a situation of high vulnerability[47]. In the case of domestic

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[46] Stiglitz (2002:73)

[47] Demirguc-Kunt and Detragiache (1998), Edwards (2000), Rossi(1999), Mehrez and Kaufmann(2000), and Kaminsky and Schmukler, (2003)

financial liberalization, banking and financial sectors began to take more risk and in the absence of adequate supervision and regulation, risk-taking may easily become excessive[48]. Therefore, rapid credit growth that follows financial liberalization itself strains the credit approval process and often results in an increase in lending to more high-risk projects. When this is combined with extensive lending to interrelated entities and the lack of rules regarding classification and provisioning for bad debts, the result is banking insolvency.

The early literature barely mentions the role of prudential regulation and supervision of the domestic banking system. For instance, Diaz-Alejandro (1985) argued that the Chilean crisis of the early 1980s was due to a combination of premature financial liberalization and lax prudential regulation. Only in the aftermath of the serious crises in the 1990s, prudential regulation and supervision was recognized as an important remedy to prevent crises.

The IMF strongly suggests prudential regulation and supervision to the countries to which they are engaged with a program as a way of protecting against crisis. They also support this view through empirical and theoretical studies done by the IMF staff.

The evidence for emerging markets regarding the timing of financial liberalization and institutional reforms displays that reforms to institutions occur mostly after liberalization is completed[49]. Hence, the general argument is that adverse effects of financial liberalization occur mainly in countries with poor institutions, characterized by the

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[48] Eichengreen (1999:40) argues that in many emerging markets, the stage has been set for banking crises by financial liberalization that creates opportunities for banks to expand their risky activities without concurrent supervision and regulation. He further argues that the higher the capital mobility, the greater the scope for banks to expand their risky activities by funding themselves abroad.

[49] Kaminsky and Schmukler (2003:22)

absence of proper banking regulation and supervision and widespread corruption[50].

Since the Asian crises, the BWI have begun to highlight the importance of establishing properly functioning financial institutions and banking regulation and supervision before liberalizing domestic financial and capital account. However, weaknesses in financial institutions do not seem to present an impediment to openness from the side of the IMF. The general approach of the IMF can easily be captured from the IMF Working Paper prepared by Johnston and Tamirisa (1998) which indicates that the adoption of prudential regulations based on generally accepted best practices will not normally entail restrictions on capital flows and will support the move toward capital account convertibility.

1.8. The Main Objectives and Conclusions of the Study

The degree of openness of the Turkish economy to the outside world has been a major decision, which was shaped mostly through the liberalization policies pursued in the 1980s. Among these liberalization polices, the decision of full-scale opening up of the capital account has a critical place in that it created a radically different environment in the context of the 1990s. In this perspective, we suggest that even though the capital account liberalization in Turkey in 1989 has helped Turkey's integration to the world economy, the vast amount of literature holds capital account liberalization in 1989 responsible for crises since the 1990s. Hence, the rationale behind its timing should be questioned, which has not been tackled specifically in the literature yet.

[50] Demirgüç-Kunt and Detragiache (1998), Edwards (2000), Rossi(1999), Mehrez and Kaufmann(2000)

The standard approach aimed to explain the crises in Turkey has blamed bad macroeconomic policies and its outcomes such as high inflation, large fiscal deficits and high current account deficit. Although there is partial truth in these explanations, the real explanation goes far beyond them. In other words, although the crises of 1994, 2000 and 2001 in Turkey can be explained by worsening macroeconomic conditions, it can also be argued that even without them, economic crises might have occurred.

A more satisfactory account of the cyclical nature of unsustainable and poor macroeconomic policies in Turkey lies in the institutional characteristics of the society as well as its implications on politicians[51]. What makes us to think about the role played by economic and political institutional structure is the fact that almost the same set of macroeconomic policies continually re-emerges and then collapse, ensuring successive crises in Turkey.

Economic and political institutional weaknesses, at the same time, constitute the basis of disorderly sequencing of financial liberalization process. Hence, an analysis of the Turkish crises should be traced back to the whole financial liberalization process that took place in the post-1980 period, taking into account the evolution of the domestic institutional and political framework as well as the implementation failures of institutional reforms[52].

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[51] See Acemoğlu et al. (2002) for detailed discussion of this approach and characteristics of institutionally-weak societies. Furthermore, Alper and Öniş (2001) follow a similar approach to explain crises in Turkey. They analyze the role of institutional and political forces in explaining the degree of implementation failures of the banking sector regulations in the aftermath of capital account liberalization with the purpose of explaining their relation to 2000 and 2001 crises.

[52] Alper and Öniş (2001) seem to follow a similar approach. However, the difference of our approach to crises of 2000 and 2001 derives from following an approach which takes whole financial liberalization into account with a specific concern on sequencing and timing issues as well as not taking capital account liberalization in 1989 as milestone in the Turkish experience.

Parallel to this approach aimed to explain crises, there are strong arguments, which view weaknesses in the prudential regulation and supervision of the financial system as a major factor that contributed to the emergence of bank failures[53] and financial crises. It is argued that if financial liberalization is accompanied with weak prudential supervision of the banking sector, then it will result in excessive risk taking by financial intermediaries and a subsequent crisis[54]. Hence, within this framework, reforms proposed to help preventing crisis mostly include changes in existing financial regulations and supervisory standards. The underlying phenomenon is the belief that if only policymakers in countries around the world would implement particular regulatory and supervisory practices, then banks would be sound and strong, which would prevent banking crises to a great extent. Hence, the World Bank and the IMF being the leading ones, almost all international financial institutions (IFIs) began to urge countries to adopt and implement appropriate regulations and supervisory practices for their financial systems. Hence, the validity of these assertions and beliefs should be questioned, as there is little empirical evidence that supports advices related to regulatory and supervisory reforms.

Furthermore, contrary to the recent suggestions of the international institutions and economists towards ensuring strong prudential regulation and supervision prior to financial liberalization, the evidence indicates that in many countries, prudential regulation and supervision seem to seriously lag the process of financial liberalization in practice. In other words, reforms to institutions occur mostly after liberalization is completed[55]. In the literature, the reason why in practice so many countries diverged from optimal sequencing is

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[53] Fischer and Reisen (1992:103), Noy (2004:341), Mishkin (2001:8)

[54] Demirgüç-Kunt and Detragiache (1998), Edwards (2000), Rossi(1999), Mehrez and Kaufmann(2000)

[55] Kaminsky and Schmukler (2003:22)

a rarely mentioned issue. What is more striking for our purposes is that although many countries seem to have established the legal framework, banking regulation and supervision remains weak due to implementation failures, which end up with severe financial crises. We believe that the reasons behind lack of proper implementation of banking sector regulations, specifically for the Turkish, case need to be paid more attention[56].

The objectives of this study are threefold: Firstly, it aims to shed some light on the reasons behind the timing of capital account liberalization in Turkey and in this perspective, reveal the main policy objectives and political factors pushing the government to take capital account liberalization decision in 1989. To this aim, interviews have been carried out with the people who held critical positions in the decision making process at that time in Turkey.

Secondly, this study examines the extent to which economic and political institutional weaknesses in the Turkish economy, which generated inappropriate sequencing of financial liberalization policies in the 1980s, can be held responsible for the crises in the post-1990 period in Turkey, specifically 2000 and 2001 crises. To this aim, firstly, we intend to assess the sequencing of the financial liberalization policies in Turkey and evaluate the compatibility of the sequencing pursued in Turkey with the form of sequencing we propose. While sequencing accounts for the degree of success in the aftermath of liberalization reforms, institutional characteristics and the policy environment of the country in which the reforms are introduced also have a crucial importance in terms of the nature of adjustment process and the subsequent economic performance. Hence, secondly, we aim to make a critical assessment of the political conjecture at the time when the liberalization reforms were introduced in Turkey with the aim of

[56] This issue has been examined by Alper and Öniş (2001).

revealing which policy objectives and political factors had pushed the government towards taking these decisions. Furthermore, the reason why in practice Turkey has diverged from optimal sequencing is analyzed through focusing on weak institutional structure in the form of weak banking regulation and supervision as well as populist policies of the state. In this perspective, the role of political and institutional forces behind implementation failures of banking sector reforms within the Turkish context is analyzed. These analyses are supported by a survey aimed to consult opinions of the academicians, high-level bureaucrats and senior economist related to the issues mentioned above. Furthermore, these issues are also examined through consulting to the views of the people interviewed.

These analyses are aimed to reveal the root causes of crises in the post-1990 period in Turkey. Hence, the Turkish crises of 2000 and 2001 are not directly and specifically linked to capital account liberalization decision in 1989, as in the "crisis literature".

Thirdly, this study aims to analyze whether really there exists a clear association between weaknesses in the regulation and supervision of the banking sector and financial crises through an empirical analysis. Furthermore, respective role of macroeconomic variables and their interaction with the regulatory and supervisory framework in the generation of crises are questioned through an empirical analysis.

Throughout the thesis, policies pursued are evaluated within the specific characteristics of the time period under analysis. In other words, we do not follow an approach, which criticizes past from today's perspective. Rather, we choose an approach, which evaluates the period under analysis within its specific characteristics.

Main conclusions of the study are as follows: As regards to capital account liberalization decision in 1989, it is concluded that capital

account liberalization was a final destination, which was projected since the first days of the Özal government. It seems that domestic decision makers have shaped and taken the decision of capital account liberalization, while the interaction of economic and political factors has played a major role in its timing.

Furthermore, it is concluded on the basis of the analyses that financial liberalization policies were inappropriately sequenced, as the domestic financial market and capital account liberalization were not accompanied or preceded by macroeconomic stability and financial sector institutional reforms such as prudential regulation and supervision of the banking sector. This structure was backed by populist policies of the state and lax supervision and fraud.

Furthermore, it is important to note that early exposure to financial globalization i.e., the financial liberalization process started in an environment of poor public sector management and rent seeking behavior of politicians, has been instrumental in the crises episodes in Turkey through contributing to an environment conducive to crises. The views expressed by the respondents to the survey and interview are on the whole in line with these findings.

Empirical findings suggest that the nature of the banking crises is more associated with the institutional structure of the financial system rather than macroeconomic conditions of the economy. It is concluded that once a solid institutional structure of the banking system is established, worsening macroeconomic conditions need not lead to a banking crisis. Thus, in order to prevent banking crises, the policy-makers should focus more on the institutional factors, such as moral hazard problem, capital regulations and restrictions on bank activities. On the other hand, if these conditions are not met, then worsening macroeconomic conditions most probably lead to a banking crisis. In this empirical analysis, only institutional factors related to the banking

sector are taken into consideration, due to difficulty of obtaining cross country data concerning political institutional factors.

In this study, while we pay attention to the importance of banking regulation and supervision, we do not claim that it would have been possible to prevent crises in Turkey through proper implementation of prudential banking regulation and supervision.

1.9. Specific Research Questions

1) Sequencing, Timing and Pace of Financial Liberalization in Turkey

First of all, we intend to assess the sequencing and pace of the liberalization policies in Turkey and evaluate the compatibility of the sequencing pursued with the form of sequencing we propose. Although the importance of sequencing has been mentioned in some instances[57] for the Turkish economy, none of the previous studies has concentrated on this issue specifically and subjected it to detailed examination.

We specifically ask the following questions: Was there any concern or discussion as regards to sequencing and timing in Turkey at the time liberalization reforms were implemented? Is financial liberalization process in Turkey properly sequenced? Was sequencing of the liberalization policies put on the table as a major issue by the BWI any time the 1980s, in particular in 1989?

Particularly, we question the timing of the capital account liberalization in 1989 in Turkey. Timing is not independent of the structural characteristics of the economy. We believe that timing of capital account liberalization has a critical importance in terms of determining the dynamics of the Turkish economy in the post-1990

[57] Altınkemer and Ekinci (1992)

period. We ask the following specific questions: Was capital account liberalization planned in any economic program of the government, for example at the beginning of 1989 or before? Which policy objectives and political factors had pushed the government towards taking these decisions? Which factors was the overriding factor for the decision of the government, economic or political? Why was the government so determined in implementing the capital account liberalization in 1989? Was the decision discussed within the government bureaucracy? If yes, who were involved? If yes, what was the approach of the bureaucrats? Was the capital account liberalization decision based on a consensus or one-man decision? Was there any serious concern expressed in the Turkish bureaucracy as regards capital account liberalization being undertaken in an environment of macroeconomic instability and fragility of the banking sector? If yes, by whom? If yes, did issues about banking regulation and supervision come on to the agenda when the 1989 decision was made? If no, why do you think that the macroeconomic instability -high inflation and budget deficit- and weaknesses in the banking sector in that period were not seen as major impediments to capital account liberalization? Was there any dialogue on the subject with the World Bank and the IMF? If yes, was this at the initiative of the government or the BWI? If yes, what was the approach of the World Bank and the IMF? Did they advise against it? Did they question its timing? Did they encourage or urge to implement the decision gradually? What was the reaction of the Turkish public opinion to the 1989 decision? Was there any serious opposition from politicians or business environment or any other major segments of society?

Finally, the pace of financial liberalization is evaluated. Although the liberalization process in Turkey is often portrayed as being gradual, we believe that there appears a need for a more specific and careful analysis. Gradualism or abruptness of reforms can not be evaluated on the basis of their duration. As long as reforms are introduced without

establishing the necessary framework, reforms can be evaluated as abrupt. Hence, we will assess the pace of capital account liberalization and the question why capital account liberalization was undertaken in just one step rather than a phased approach.

2) Political and Institutional Framework, Financial Liberalization and Financial Crisis:

Although, in the literature, a strong link between financial liberalization and financial crises is established, we are aware of the fact that not all financial liberalization experiences end up with financial crisis. Therefore, a more specific analysis is needed rather than generalizing the case to an association between financial liberalization and financial crises.

Hence, we suggest that focus should be directed to deeper fundamentals in explaining the impact of financial liberalization on financial crisis. In other words, the effects of financial liberalization hinge to a great extent on the way it is sequenced with other policy reforms. To this aim, we intend to assess the political and institutional framework during which financial liberalization was undertaken. Therefore, we intend to analyze the period preceding the 2000 and 2001 crises with an approach, which is somewhat different from the prevailing "crisis literature". Unlike the standard explanations, we attach utmost importance to the role of sequencing errors in the emergence of the crises of 2000 and 2001.

Turning our attention specifically to the impact of the institutional characteristics on the subsequent performance of liberalization reforms, we examine the framework of prudential regulation and supervision in Turkey. Then, we discuss the implementation failures of banking sector reforms. To this end, we examine the characteristics of political and institutional forces at work

in the 1980s and 1990s in Turkey with the purpose of explaining why domestic financial liberalization and capital account liberalization preceded prudential regulation. Furthermore, we examine the role of external anchors such as the IMF in pushing for regulatory reforms in Turkey? In that context, we try to find out whether the domestic political and institutional factors outweigh the role of external actors.

To this end, we ask the following questions:

What has been the result of the financial liberalization under the circumstances of large fiscal deficit and high inflation? What is the interaction of financial opening with fiscal dynamics? What have been the repercussions of fiscal imbalances on the economy in the era of large capital flows? What has been the impact of this overall macroeconomic scheme on the financial system? What are the risks facing the Turkish banking system that raise vulnerability to shifts in the market sentiment? What has been the implication of ineffective prudential regulation and supervision as well as moral hazard created by government guarantees on banks? What has been the role of deficiencies in the regulatory and supervisory framework of the banking system in raising vulnerability of the financial system to shocks?

However, our approach again being different from the "crisis literature", does not take weak prudential regulation and supervision as the sole factor leading to crises by itself.

3) Prudential Regulation and Supervision and Financial Crisis

A variety of factors and forces can lead to the emergence of a financial crisis[58] in a country. For instance, one of the striking

[58] On the basis of the review of the case studies in the literature, Denizer et al. (2000:7) conclude that "A currency crisis tends to be preceded by an overvaluation of the real exchange rate, rapid domestic credit growth, expansion of credit to the public sector, a rise in the ratio of broad money to foreign exchange reserves, an increase in the domestic inflation rate, a decline of FDI flows, and an increase in

characteristics of the crises (the Mexican, Asian and Russian crises) in the latter part of the 1990s was that an initial country-specific event was rapidly transmitted to markets of very different sizes and structures around the globe, i.e. contagion[59].

On the other hand, the common expression is that in most of the countries that have experienced financial crises, prudential regulation and supervision is weak during and in the aftermath of financial liberalization. According to the theoretical model of Dekle and Kletzer (2001), banking and currency crises coincide and inevitably occur in the absence of effective prudential regulation. Furthermore, it is even asserted that it would have been possible to avoid the Asian crisis if banks had been well supervised[60].

We question the following questions through an empirical analysis: Is the weak banking sector supervision and regulation a major contributor to financial crisis? What is the relative role of macroeconomic deterioration in the generation of the crisis, especially when examined together with variables related to the supervisory and regulatory framework.

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industrial country interest rates." "Banking crises are often preceded by large inflows of short-term capital, rapid expansion of domestic credit (which may result from inadequately sequenced and/or supervised) financial liberalization, recessions, and declines in asset prices such as stocks and real estate. The various case studies suggest that often financial sector liberalization without adequate prior strengthening of the regulatory structure not only sets the stage for a banking crisis but also makes it more difficult to cope with it if one erupts".

[59] The definition of "contagion" has varied considerably throughout the studies. Kaminsky and Reinhart (1999) argue about this "definition conflict" in the literature and accept the definition made by Eichengreen et al. (1996) that a crisis elsewhere increases the probability of a crisis at home. Edwards and Susmel (1999) defines contagion as a short-lived and unusual change in volatility induced by an exogenous shock, while Hernandez and Valdes (2000) give a simple definition of contagion as "country A gets into trouble, because country B gets into trouble. Trouble, in this case, refers to a devaluation, a moratorium or other traumatic regime changes, or milder problems, such as entering into a stage in which capital inflows turn scarce".

[60] Williamson (1999:10), Intal et al. (2001:43)

We also aim to discuss the following questions: How does financial liberalization lead to the banking sector problems and financial crisis and under what conditions? Why is there a need for a strong regulatory and supervisory framework for the banking system? In that context, what is the function of regulation and supervision of the banking sector in terms of preventing the generation of the problems in the banking sector led by financial liberalization? What is the framework of the prudential regulation and supervision of the banking sector currently proposed by international agencies?

1.10. Methodology

Survey

Our survey includes 33 questions in 4 parts. The survey questions are given in Appendix B at the end of the study. Questions included in the questionnaire fall broadly under the following categories: 1) sequencing and pace of financial liberalization policies, 2) impact of financial liberalization on the financial system, 3) efficiency of financial institutions in risk assessment and management, 4) government insurance and moral hazard, 5) role of financial liberalization policies and existing regulatory and supervisory framework in leading to crises in the post-1990 period, 6) assessment of prudential regulation and supervision in the 1990s and at present, and 7) policies of the international financial institutions. The questionnaire was sent to 78 people, who are selected from academicians, high-level bureaucrats and senior economist. Sampling method is non-probabilistic purposive sampling method. As 43 responses are obtained, the response rate is 55 percent.

Interview

The interview included 21 questions in 3 parts. Interview questions are given in Appendix A at the end of the study. Questions are broadly related to the issues of capital account liberalization in 1989, sequencing of financial liberalization reforms as well as financial liberalization and crises.

Interviews have been conducted with Mahfi Eğilmez, Selçuk Demiralp on November 24, 2005; with Ercan Kumcu on November 25, 2005 in İstanbul; with Faik Öztrak on November 21, 2005 in Ankara; and with Işın Çelebi on January 16, 2006 in Ankara.

Empirical Analysis

The relationship between banking crises and regulatory and supervisory environment are examined using both simple correlations and logit regressions.

The main challenge of finding regulatory and supervisory data on cross country basis has been solved by using the database collected by Barth, Caprio and Levine (1999a, 1999b) through a survey on the different financial regulatory and supervisory environments that exist in 104 countries throughout the world. Indices used in the empirical analysis were provided by Barth, Caprio and Levine on our request. Basically, these aggregate indices are obtained by incorporating the answers to many questions. The entire database embraces 5 qualitative and 2 quantitative variables. Quantitative variables are control variables, which are inflation and current account balance as a percentage of GDP as the macroeconomic factors likely to lead to a financial crisis.

The sample covers both developing and developed countries. The 40 countries included in the sample are as follows: Developing countries

are Argentine, Brazil, Chile, China, Czech Republic, Greece, Hungary, Indonesia, India, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Thailand, Turkey and Venezuela. Developed countries are Austria, Australia, Belgium, Canada, Denmark, France, Finland, Germany, Ireland, Israel, Italy, Japan, Spain, Switzerland, Sweden, Netherlands, New Zeland, United Kingdom and United States.

1.11. The Sequence of Presentation

In Chapter 2, the literature on sequencing of the liberalization reforms will be discussed to propose a general guideline of sequencing in the evaluations of country experiences. Furthermore, approach of the BWI to sequencing issue will be examined, as their renewed interest on this issue in the aftermath of the Asian crisis is questioned.

In Chapter 3, the sequencing and pace of the Turkish liberalization experience in the post-1980 period will be evaluated, as the compatibility of the sequencing pursued in Turkey with the form of sequencing we proposed is questioned. Furthermore, a critical assessment of political conjecture and the approach of international lending institutions at the time when the liberalization reforms were introduced in Turkey is examined.

In Chapter 4, we intend to reveal the rationale behind the introduction of full capital account liberalization in 1989 into the Turkish economy through interviews conducted with the people who held critical positions in the decision making process at that time in Turkey.

In chapter 5, a group of countries is examined so as to understand whether they put into place the legal framework of banking sector supervision and regulation before financial liberalization.

Secondly, we examine country experiences as regards to the timing of effective implementation of banking regulation and supervision with respect to both financial liberalization reforms and financial crisis. The purpose, here, is also to see whether there exist implementation failures, although legal framework is ready. These analyses would also enable us to make a comparison with the Turkish experience.

In chapter 6, turning our particular attention to the case of the Turkish banking sector, our aim is to discuss the reasons behind lack of proper implementation of regulatory and supervisory reforms. We will discuss the role of political and institutional forces behind implementation failures of banking sector reforms with particular attention to the Turkish experience. To this end, we will examine the characteristics of political and institutional forces at work in the 1980s and 1990s in Turkey. The main purpose in the discussions of these political and institutional factors is to explain why financial liberalization precedes prudential regulation, being quite contrary to what is suggested. We also ask whether domestic actors remain indifferent to the importance of this issue.

In chapter 7, our aim, first of all, is to see whether there really exists a clear association between weaknesses in the regulation and supervision of the banking sector and financial crisis through an empirical analysis. We specifically ask the following question: Is the weak banking sector supervision and regulation a major contributor to financial crisis?

In Chapter 8, first of all, the types of crises and the factors leading to them are discussed. Our explanation of crises takes institutional weaknesses and the failure to democratize polity successfully, i.e. poor governance, as the root causes of the crises in the post-1990 period in emerging market countries.

In chapter 9, we aim to question the role of institutional weaknesses in Turkey in leading to financial crises in the post-1990 period. We aim to identify what exactly was lacking in the institutional framework in Turkey before, during and after the liberalization process in terms of evaluating its implication on the economy.

In chapter 10, the analysis of the results of the survey, which has been implemented to senior economists, high level bureaucrats and academicians will be provided. This analysis is supported with the views of some high level bureaucrats expressed in the interviews, some part of which is discussed in Chapter 4. In this chapter, the remaining part of the interview will be examined in terms of its exact match with the questionnaire.

Finally in the last chapter, our conclusions and recommendations for policy and further research will be presented.

CHAPTER 2

SEQUENCING AND PACE OF THE LIBERALIZATION POLICIES

2.1. Introduction

In the aftermath of the crises in the Southern Cone countries in the early 1980s, there emerged a belief that it was liberalization strategies followed in these countries, which were responsible for macroeconomic instability and crises. Later, financial crises in the 1990s in emerging market countries namely, Mexico, East Asia and Russia, have reinforced these views. Especially after the Asian crisis, the importance of sequencing has been more widely recognized. In response to the Asian crisis, even the IMF[61] has altered its policy recommendations toward advocating a sequencing of reforms with domestic financial reform preceding capital account liberalization. On the other hand, the IMF has not changed its policy line regarding capital account liberalization and continued to push for capital account openness[62]. Hence, as all markets cannot be liberalized or at least should not be liberalized simultaneously, sequencing and pace of the liberalization process has become the common problems of all liberalizing countries.

The discussions regarding the pace and sequencing of liberalizations were aimed to minimize the risks of the liberalizations, while maximizing their net benefits. Thereby, these discussions intend to find out an optimal order of economic liberalization, which may, of course, vary for different liberalizing economies depending on their initial conditions. When theories of the sequencing of liberalization are

[61] Johnston (1998)

[62] Johnston (1998); Eichengreen and Mussa (1998)

considered, they usually focus on the liberalization of the three markets in the following order: the goods market (current account of the balance of payments), the domestic financial system and the capital account of the balance of payments[63]. The pace of liberalization process, i.e, how fast a liberalization should proceed, generally takes two forms[64], one being a gradual process of liberalization and the other being a rapid liberalization.

On the other hand, there is a factor that can not be ignored: i.e., all countries are different in terms of their levels of economic and financial development, their existing institutional structures, their legal systems and legal practices and their capacity to manage the liberalization process. Hence, as the discussions regarding sequencing of liberalization on the basis of country experiences have revealed, there is no single rule for devising a plan for sequencing and coordinating liberalization with other policies and no single guideline for how the process should take place. There is no optimal speed either[65].

Hence, it is argued that the pace and sequencing need to be decided in the context of country-specific circumstances and institutional characteristics. In that context, countries are suggested to change their sequencing plans in the face of changing macroeconomic conditions or emerging signs of vulnerabilities. It is also reminded that recommendations as regards to sequencing should be updated from time to time in the light of new developments[66].

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[63] Chopple (1990:3)

[64] Wyplosz (2001:3)

[65] IMF (2002:4) and Karacadağ et al. (2003:4)

[66] IMF (2002:4) and Karacadağ et al. (2003:4)

Being aware of the fact that there is no single prescription for the correct sequencing of liberalization reforms, there have been different views and suggestions about the correct sequencing. While some believe that capital account should be liberalized following the liberalization of current account and the domestic financial system, others hold the view that there should be simultaneous liberalization of the current and capital accounts. McKinnon (1982, 1991) being the original contributor to financial liberalization argument advocates to start with liberalization of the domestic goods market, then to open up trade, and then to proceed to domestic financial liberalization, before finally setting free the capital account –possibly starting with long-term assets and keeping short-term assets for the last step.

Despite these different views in the economics literature, there is a general consensus on the claim that economic liberalization should be implemented in the "right" sequence and at the "right" speed, of course, which is determined according to the specific needs of the country under consideration. It should be reminded that the word "right" does not imply a specific sequencing and speed that should be applied to all countries. Rather, sequencing and speed should be "right" in terms of country-specifics. McKinnon (1991:4) also argues that optimal sequencing of economic liberalization may vary for different countries depending on their initial conditions. Therefore, there can only be some recommendations regarding sequencing and pace derived from country experiences. On the other hand, in practice, many countries have also diverged to a large extent from these recommendations on optimal sequencing.

In this chapter, after deriving a general guideline of sequencing of financial liberalization policies on the basis of discussions in the literature, we intend to question the approach of the BWI to this issue in philosophy and practice. This chapter is organized as follows: Section

2 gives a brief explanation of the concepts of financial repression and liberalization. Section 3 discusses the importance of credibility of reforms and consistency of policies in terms of sequencing. The general trends of liberalization policies implemented by world economies are reviewed in section 4. In section 5, there will be literature review of the discussions on sequencing of financial liberalization, which provides useful points for generalized assessments and driving a guideline that would be the most appropriate approach for the Turkish financial liberalization experience as well. Section 6 focuses on sequencing of capital account liberalization, whether full or gradual. In section 7, the discussions as regards to the pace of liberalization reforms are reviewed. In section 8, the approach of the BWI to the sequencing and pace of financial liberalization reforms is explored. Section 9 gives the criticisms towards the BWI as well as the IMF's reaction to these criticisms. Final section gives conclusion.

2.2. Financial Repression and Financial Liberalization

2.2.1. Financial Repression

McKinnon (1973) and Shaw (1973) presented the first systematic attempts to explain some specific characteristics of financial markets in developing countries. According to McKinnon (1991:11), if the government tax or otherwise distort their domestic capital markets through a variety of measures, such as ceilings on interest rates, high reserve requirements and overall and selective credit ceilings, then the economy is said to be financially repressed. McKinnon (1973) and Shaw (1973) believe that these government interventions to the financial system have the effect of keeping real deposit and lending interest rates at very low and often negative levels. This is considered to have

adverse effects in terms of the development of financial system, savings and investment[67].

The government plays an important role in a financially repressed system. The motivation for the interventions of the government, to a large extent, arises from fiscal concerns. Since the government does not have direct fiscal means to promote development, due to either a lack of political will or administrative constraints, the government uses the financial system to finance development spending. One of the ways to do so is to impose large reserve and liquidity requirements on banks and to create a demand for the government's non-interest bearing and interest bearing instruments respectively. Thereby, the government can finance its own spending through issuing debt[68].

Secondly, lending interest rates are kept low through imposition of ceilings, which creates an excess demand for credit. The government determines who gets and gives the credit as well as the price of it. The government exercises this control through determining the financial institutions, which are allowed to operate and the conditions under which they can do business[69]. Furthermore, the government can own banks as well as other financial intermediaries. For example, mostly state-owned banks imposed loan-rate ceilings. Under this framework[70], "banks are required to allocate minimum percentages of their asset portfolios for loans to priority sectors of the economy at subsidized loan rate of interest."[71] In this scheme, credit is allocated according to

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[67] McKinnon (1991:11)

[68] McKinnon (1973) and Shaw (1973), Agenor and Montiel (1996:152)

[69] McKinnon (1973) and Shaw (1973), Agenor and Montiel (1996:152)

[70] Both loan interest rate ceilings and selective credit policies.

[71] Fry (1988:18)

transaction costs and perceived risks of default rather than expected productivity of investment projects. Therefore, a large proportion of potentially high-yielding investments is rationed out in this situation[72].

Thus, in a financially repressed economy, financial institutions and financial instruments, which supply significant seignorage revenue to the government, are encouraged while the others are discouraged. Since private bond and equity markets cannot provide seignorage so easily, they are suppressed through various means[73]. One of the purposes for the use of interest rate ceilings was to repress competition arising from the private sector to the public sector funding[74].

To sum up, measures such as the controls on foreign exchange, interest rate ceilings, high reserve requirements and suppression of private capital markets were all parts of the objective aimed to increase the flow of domestic resources to the public sector without having higher tax, inflation or interest rates. Thereby, this scheme permits a greater public sector deficit to be financed at a given inflation rate and given nominal interest rates [75].

2.2.2. McKinnon-Shaw Hypothesis of Financial Liberalization

McKinnon (1973) and Shaw (1973) challenge the case of controlled low rates of interest and financial repression. The main argument put forward by McKinnon (1973) and Shaw (1973) was that government intervention itself distorts the determination of the price of loans, thereby adversely affects not only the allocation of loans but also savings. In other words, this produces lower savings and thus lower

[72] Fry (1988:18)

[73] See Fry (1988:14) for detail.

[74] Fry (1988:14)

[75] Fry (1988:14)

growth rates than otherwise. Therefore, it was argued that in the absence of intervention, market forces would determine the interest rate, which in turn would manage the allocation of loans. The presumption was that interest rate plays a crucial linking and casual role amongst savings, investment and growth.

McKinnon (1973) and Shaw (1973), therefore, suggested positive high real rates of interest of bank deposits and loans

> by eliminating onerous reserve requirements, interest ceilings and mandated allocations of cheap credit on the one hand, while stabilizing the price level through appropriate macroeconomic measures on the other[76].

In other words, they propose financial liberalization[77] and development as growth-enhancing economic policies. This happens as "domestic savers and investors would "see" the true scarcity price of capital and thus reduce the great dispersion in the profitability of investing in different sectors of the economy"[78].

The crucial message of the financial liberalization argument is that it is the lack of competition, which brings inefficiency to the financial sector. Interest rate liberalization was the first step, but it was recognized that this alone is not likely to generate competition in the financial market, in view of its oligopolistic nature. "The general objective of financial liberalization policy was to mobilize domestic

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[76] McKinnon (1991:12)

[77] According to Williamson and Mahar (1998:2), there are six dimensions of financial liberalization: the elimination of credit controls; the deregulation of interest rates; free entry into the banking sector or, more generally the financial services industry; bank autonomy; private ownership of banks; liberalization of international capital flows.

[78] McKinnon (1991:12)

savings, attract foreign capital and improve efficiency in the use of financial resources"[79].

According to the McKinnon-Shaw model[80], saving is a positive function of the real interest rates. Therefore, in this model, real interest rate (the rate of return to savers) is the determining factor to reach a higher level of investment. Furthermore, increased investment will push up economic growth.

This model reveals that in financially repressed economies, economic growth is constrained by the level of saving, which is suppressed by the low levels of real rate of interest. Therefore, McKinnon (1973) and Shaw (1973) advise raising institutional interest rates or reducing inflation rate for financially repressed economies. They believe that removal of interest rate ceilings altogether yield the optimal result of maximizing investment and raising further the average efficiency of investment. Moreover, Shaw (1973:11) asserts that financial liberalization and deepening of finance also contribute to the stability of growth in output and employment.

According to early financial liberalization literature, one of the most important objectives of the financial liberalization reforms was to generate, among other things, a considerable increase in savings. Financial liberalization is said to raise ratios of private domestic savings to income through higher real rates of interest and opportunities for diversifying savers' portfolios of domestic assets[81]. Shaw (1973:10) argues that liberalization allows savings to be allocated in superior way through widening and diversifying financial markets on which investment opportunities compete for the savings flow. The market for

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[79] Villanueva and Mirakhor (1990:509)

[80] Fry (1988:16)

[81] Shaw (1973:9)

savings widens, as broader range of selection in terms of scale, maturity and risk becomes available. In other words, savers are offered a wider menu of portfolio choice, in contrast to repressed financial economies where savers mainly use their own savings to finance their investments[82].

Shaw (1973:9) also argues that as a result of financial liberalization, there can be a shift in savers' planning horizon to more distant future. Improvement in income expectations may reduce current consumption relatively. According to Shaw (1973:9), savings of the government sector tends to increase as well, while it is low in financially repressed economies. Furthermore, capital flight of domestic funds is also expected to be reversed, while access to foreign capital markets becomes easier.

There have been many theoretical extensions to and empirical tests of the McKinnon-Shaw model over developing countries. One of the critiques advanced against this model was by a group of neo-structuralists[83] led by Lance Taylor (1983). They have argued that increases in interest rates stimulate inflation in the short-run through a cost-push effect as well as lowering economic growth rate through reducing the supply of credit in real terms available for investment finance.

The main belief behind financial liberalization in developing countries was that "interventionist financial policies were one of the main causes of the crisis of the 1980s"[84]. However, on the basis of failure of the financial liberalization experience in Latin America, in the early 1980s, McKinnon (1986, 1988) modified his earlier position and

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[82] Shaw (1973:10)

[83] Taylor, van Wijnbergen, Giovannini, Cavallo, Buffie.

[84] Akyüz (1993:1)

suggested that "the government should probably impose a ceiling on standard loan (and deposit) rates of interest" to overcome the bank's moral hazard, which arise when risky loans are provided at high rates in the expectation that large losses will be covered by deposit insurance, explicitly or implicitly provided by the government[85].

2.3. Credibility of Reforms and Consistency of Policies

In many countries, especially in the Southern Cone countries in the 1980s, credibility of reforms was low particularly in those, which experienced some reversals in reforms. It is argued that in Latin America, the real problem behind the failures of liberalization attempts in the 1980s was the lack of credibility of the authorities[86]. Hence, designing liberalization policy packages in a way that reforms will not be reversed has gained importance together with the issue of sequencing. It was even asserted that it is more important to define consistent and credible policy packages that will support any particular sequencing of liberalization that is chosen than determining the correct sequencing of liberalization[87].

The degree of credibility is also critical in terms of the analysis of the sequencing of liberalization[88]. The program may fail due to lack of credibility alone[89]. On the other hand, credible reforms attract additional resources from abroad, which raise confidence and let the program to continue. Since one of the most important determinants of the degree of credibility is the perceived consistency of the proposed policies, people must believe that policy regime is permanently

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[85] McKinnon (1988:408)

[86] Lal (1986:218)

[87] Stockman (1982:188) and Edwards (1984a:84)

[88]Edwards (1984a:23, 1986b:210), Stockman (1982:187) and the World Bank (1991:116)

[89] The World Bank (1991:116)

changed so that credibility of reforms is high. If the credibility of the economic reforms is low, this means that these policies are perceived as inconsistent and there are expectations of policy reversal. Then, agents will not make the required adjustments and the likelihood of failure of the reform will be high. Politicians are, therefore, suggested for not to promise too much. Hence, the pace and sequencing of the liberalization should be set in a way that expectations of policy reversals will be low.

Furthermore, Mathieson and Rojas-Suarez (1994:345) suggest that consistency of macroeconomic, financial and exchange rate policies is much more important for sustaining an open capital account than sequencing of the removal of capital controls. Consistent monetary and fiscal policies with the choice of exchange rate regime are stressed as an important precondition for liberalization of capital account by the IMF (1998:82) as well.

2.4. Liberalization Trends in Some Selected Economies

Besides differences in the approach to the sequencing of liberalization in the literature, country experiences also vary to a major extent. For instance, the pattern of financial liberalization[90] varies across developing and developed countries as revealed by the analysis of Kaminsky and Schmukler (2003) on 28 countries. In developed countries, the liberalization of domestic financial sector occurs before the opening of capital account. As almost all developed countries liberalized at least partially their domestic financial sector by the mid 1980s, capital account liberalization occurred widely only in the late 1980s and the beginning of the 1990s in these countries[91]. USA and Canada had completed the most important liberalizing reforms in the

[90] Liberalization of domestic financial market, capital account and stock market.

[91] Kaminsky and Schmukler (2003:9)

1960s, while Western European countries had much more closed capital accounts than North America until the mid-1980s.

On the other hand, liberalization experience of the developing countries followed a different path with mainly two episodes[92]. Liberalization of the domestic financial sector and capital account occurred in the first episode, in the late 1970s. However, these countries experienced liberalization reversals in the early 1980s, following the debt crisis. In the second episode of liberalization for developing countries in the late 1980s, both the domestic financial sector and the stock market are jointly deregulated before capital account liberalization, which started mainly in the early 1990s.

Striking factors in terms of regional liberalization experiences are that: first of all, capital account liberalization is mostly introduced at a later stage in all Asian countries[93]; secondly, many countries have undergone several liberalization reversals especially as a result of currency crises[94]. For instance, many of the Latin American countries introduced restrictions in the face of the debt crisis in the early 1980s, which remained until the early 1990s. Argentina in 1982 and 2001, Chile in the mid-1990s introduced some controls and restrictions to restrict the extent of financial liberalization[95]. On the other hand, China and India maintained restrictions throughout the 1990s on every type of capital account transaction monitored by the IMF.

Cross-national trends in capital account openness from the early 1970s to the late 1990s on the basis of the capital account openness index developed by Brune et al. (2001:12) reveals that richer countries

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[92] Kaminsky and Schmukler (2003)

[93] Kaminsky and Schmukler (2003:8)

[94] These countries are listed by Kaminsky and Schmukler (2003:5)

[95] Kaminsky and Schmukler (2003:5)

have always had more open capital accounts, and there is no evidence of convergence over time among the country groupings of high income, middle income and low-income countries. Furthermore, they assert that although there has been a gradual but accelerating trend towards capital account liberalization from the early 1970s to the present among the high income countries, there were no aggregate increases in capital account openness in the low and middle income group of countries until 1991- when a period of rapid and dramatic liberalization began.

2.5. Sequencing and Pace of Financial[96] Liberalization Reforms

Although significantly different initial economic and financial conditions across countries are viewed as a factor explaining different subsequent performance to financial liberalization[97], successful cases of financial liberalization are said to share some common patterns. These patterns are summarized as the establishment of a stable macroeconomic environment with a priority given to fiscal discipline and prudential supervision and regulation of the banking system and institutional reforms. IMF (1998:82) lists the preconditions of financial[98] liberalization as follows:

1. a sound macroeconomic policy framework; in particular, monetary and fiscal policies that are consistent with the choice of exchange rate regime;

2. a strong domestic financial system, including improved supervision and prudential regulations covering capital adequacy, lending standards, asset valuation, effective loan recovery mechanisms,

[96] Financial liberalization term refers to domestic financial and capital account liberalization unless otherwise indicated throughout the thesis.

[97] Villanueva and Mirakhor (1990:509)

[98] Particularly capital account liberalization

transparency, disclosure, and accountability standards, and provisions ensuring that insolvent institutions are dealt with promptly;

3. a strong and autonomous central bank; and timely, accurate, and comprehensive data disclosure, including information on central bank reserves and forward operations.

While these conditions are generally accepted as preconditions of financial liberalization, as will be discussed in this section, our categorization places these conditions within sequencing of financial liberalization reforms. In other words, throughout the thesis, macroeconomic stability and institutional reforms with a particular emphasis on prudential regulation and supervision of the banking system are regarded as part of sequencing of financial liberalization policies.

As will be explained below, while macroeconomic stability and strong financial system should precede financial liberalization, i.e. domestic financial market and capital account liberalization, sequencing of financial liberalization with respect to trade liberalization will be discussed on the basis of the arguments in the literature.

2.5.1. Macroeconomic Stabilization

Despite the tendency among developing countries to introduce liberalization policies within a stabilization program, ensuring macroeconomic stability prior to reform period carries vital importance especially in terms of the success of liberalization efforts. A general consensus[99] in the literature is that macroeconomic stability[100] is an

[99] Fischer (1986,1987); McKinnon (1991); Sachs (1987), Williamson and Mahar (1998), the World Bank (1989, 1991)

[100] Williamson and Mahar (1998:26) define stable macroeconomic environment as fiscal deficit below 5 percent of GDP and inflation below 10 percent.

important condition for the liberalization policies, especially for the financial liberalization[101]. McKinnon (1982) also stresses the importance of "stabilization first" condition before the introduction of liberalization reforms.

Financial liberalization in an unstable environment may make things worse, especially as macroeconomic instability[102] carries the risk of exacerbating financial sector weaknesses. Furthermore, macroeconomic instability may raise the financial system's vulnerability to shocks through leading to an increased probability of default and an accelerated financial collapse[103]. On the other side, capital account liberalization can further raise macroeconomic instability especially when it results in large destabilizing capital flows in the short-run[104].

Moreover, macroeconomic stability is important for the success of financial liberalization. One of the aims of the domestic financial liberalization is to achieve positive real interest rates to raise savings. On the other hand, in the presence of macroeconomic instability, i.e., "inflation expectations, exchange rate devaluation or government borrowing may push real interest rates too high, increasing the fiscal deficit and contributing to further macroeconomic instability"[105]. In other words, complete liberalization of the interest rates in a macroeconomic environment with high and unstable inflation rates may result in high and unstable real rates of interest and wide spreads

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[101] Edwards (1984a), McKinnon (1991), Hanson (1996:336)

[102] Villavueva and Mirakhor (1990:514) defines macroeconomic instability as "a situation where large changes in the prices of goods and factors of production lead to increased variance and positive covariances in returns on investment projects; that is, many or all investment projects would be affected adversely by poor macroeconomic performance."

[103] Villanueva and Mirakhor (1990:520)

[104] Edwards (1984a:7)

[105] The World Bank (1991:116)

between lending and deposit rates. McKinnon (1988:388) argues that "macroeconomic instability reduces the socially desirable level of real interest rates in the banking sector and makes financial liberalization more difficult."

On the basis of a number of successful liberalization experiences, it is argued that fiscal discipline should have the priority in the macroeconomic stabilization measures and even should come before disinflation efforts[106]. For instance, McKinnon (1982) suggests that trade restrictions, capital controls and domestic financial regulations should be maintained until the government has reduced its fiscal deficit first. Only after that, gradual removal of controls in a particular order is recommended. Hence, while the issue of whether fiscal reform should precede liberalization reforms or be implemented simultaneously was questioned in the mid-1980s, there emerged an agreement by the late 1980s such that in countries with serious macroeconomic imbalances, the most appropriate sequencing requires to take early and decisive action on solving the public sector's debt problem[107]. Because, if there is a large fiscal deficit that is financed by an inflation tax, reserve requirements must be kept high and deposit interest rates low to prevent erosion of the stock of high-powered money on which the inflation tax is collected[108]. Therefore, it is suggested that in an inflationary environment, domestic financial market liberalization should follow the control of fiscal deficit[109]. It is argued that fiscal reform is necessary as an important precondition of capital account liberalization, even when a large fiscal deficit is financed by bond

[106] McKinnon (1991:4), Williamson and Mahar (1998:26)

[107]Edwards (1994:3) and Hanson (1996:336)

[108]McKinnon (1982:161). If financial liberalization occurs, it will erode the base, forcing the government to accelerate inflation to collect the same real revenue, raising the real exchange rate.

[109] Edwards (1984a:7) and Hanson (1996:336)

issuance, because a rising stock of external and internal debt leads to doubts about a country's ability to service these debts and thereby its creditworthiness[110].

Only after the public finances are brought under control, it is argued that inflation can be reduced, since inflation heavily depends on the control of fiscal deficit[111]. Price stability is important in terms of achieving successful deregulation of banks and other financial institutions. Otherwise, under the conditions of macroeconomic instability -such as high inflation- tight monitoring and regulation of deposit-taking commercial banks become particularly important[112]. Moreover, unless price stability is achieved, unpredictable volatility in real interest rates or exchange rates makes unrestricted domestic borrowing and lending by deposit-taking banks too risky[113]. Furthermore, trying to offset high inflation with high nominal interest rates can be very risky, particularly when interest rates are completely decontrolled and bank supervision is loose. However, under price stability, higher real deposit interest rates can be sustained with minimal risk[114].

2.5.2. Prudential Regulation and Supervision of the Banking System

Prudential regulation and supervision is regarded as a major condition for successful financial liberalization, besides macroeconomic stability. While, for instance, strong regulatory and supervisory policies

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[110] Mathieson and Rojas-Suarez (1994:343)

[111] McKinnon (1982:162)

[112] McKinnon (1991:41)

[113] McKinnon (1991:6)

[114] McKinnon (1991:31;41)

make interest rate liberalization more effective[115], weakness of the prudential regulation and supervision of the financial system is seen as one of the major reasons for the failure of financial reforms. Villanueva and Mirakhor (1990:520) even assert that inadequate prudential regulation and supervision of the banking system, especially in the presence of moral hazard is the most crucial element among the reasons of liberalization failure, rather than macroeconomic instability.

It is argued that strong financial system is necessary for the banking system to stand firm to the wind of liberalization. Kaminsky and Reinhart (1999:496) argue that strong banking regulation and supervision is necessary for countries to be on the safe side after financial liberalization. McKinnon (1998:57) claims that a deregulated financial system may need more supervision than the one that is subject to extensive administrative controls and government intervention.

Financial market liberalization unaccompanied by an appropriate regulatory structure tends to generate economic instability. McKinnon (1991:7) argued that an effective prudential regulation framework is especially crucial in countries experiencing macroeconomic instability, since macroeconomic instability has the ability to aggravate the prevailing distortions in the banking sector, making the relationship between distorted banking sector development and macroeconomic stability a two-directional phenomenon[116]. McKinnon (1991:7) also believes that effective prudential supervision is necessary even in a stable macroeconomic environment, as weak prudential regulations may create a suitable environment for banks who want to exploit the existence of moral hazard and can lead to financial breakdown.[117]

[115] Fischer and Reisen (1992:128)

[116] Alper and Öniş (2002:8)

[117] Villanueva and Mirakhor (1990:520)

Consequently, it is widely recognized that it is necessary to make financial liberalization contingent upon the prior establishment of appropriate prudential regulation and supervision. Thus, the appropriate sequencing of banking restructuring and supervision policies becomes a pressing issue especially for developing countries. This also means that financial liberalization should take place only after the achievement of macroeconomic stability and a strong financial system.

2.5.3. Sequencing of the Domestic Financial Market versus Trade Liberalization

There are different views as regards to the sequencing of trade liberalization with respect to domestic financial liberalization. Williamson and Mahar (1998:26) suggest the trade reform to take place before financial sector reform by arguing that "a deregulated financial system will channel funds to the most profitable industries and that these will be the most socially desirable industries only when the price system conveys accurate information about scarcity, rather than the distorted incentives associated with heavy protection". Williamson and Mahar (1998:26) have listed the countries that began financial sector reforms more than three years after trade reform[118] as Japan, Korea, Morocco, Sri Lanka and Thailand.

On the other hand, McKinnon (1982:163, 1991:8) asserts that complete trade liberalization should take place after the improvement in fiscal policy and domestic financial liberalization.

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[118] Their definition of the conventional sequencing is that financial sector reform comes more than three years after trade reform. For more detail of other country experiences, see Williamson and Mahar (1998)

2.5.4. Sequencing of the Capital Account Liberalization versus Domestic Financial Market Liberalization

The general consensus[119] is that capital account liberalization should follow the liberalization of the domestic financial system. The idea is that if capital account liberalization precedes domestic financial market liberalization, massive capital outflows will take place in an environment of artificially low levels of interest rates. Therefore, it is strongly suggested that capital account liberalization should follow domestic financial liberalization, after which interest rates are higher compared to the repressed financial market period[120].

2.5.5. Sequencing of the Capital Account Liberalization versus Trade Liberalization

There are different approaches as regards to the sequencing of the liberalization of trade and capital account. While the literature does not yield a strong sequence regarding the appropriate order for liberalizing the current and capital accounts of balance of payments, both the historical evidence and the orthodox theoretical considerations point strongly toward liberalizing the current account first.

The early view suggested by McKinnon (1973) and then followed by others[121] proposes that capital account liberalization should come after trade liberalization, because opening of the capital account

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[119] Dornbusch (1983), Edwards (1984b, 1986b), Fischer and Reisen (1992), Frenkel (1982), McKinnon (1982)

[120] McKinnon (1982:163); Frenkel (1982); Hanson (1996:337); Edwards (1984b:3); Edwards (1986b:209); Williamson and Mahar (1998:26) mention that conventional wisdom is interpreted as the maintenance of capital controls until at least two years after financial liberalization has been initiated.

[121] For a detailed discussion, see McKinnon (1982), Frenkel (1982), Krueger (1986:25), Edwards (1986b:209), Dornbusch (1983), Fischer and Reisen (1992)

results in large capital inflows, which leads to real appreciation of the domestic currency. On the other hand, successful liberalization of the trade account requires real depreciation of the domestic currency[122]. Therefore, as capital account liberalization automatically excludes this devaluation, the transition in the tradable goods sector from a protective to a free environment will become more difficult. At the time tradable goods sector is going through a costly adjustment, appreciation brought about by the capital account liberalization will tend to squeeze profitability in this sector by inducing production factors to move towards the non-tradable sector of the economy[123]. Therefore, real appreciation of the currency led by capital inflows may result in failure of the liberalization experience.

Another factor raised by McKinnon (1982:163) to advise the tight control of capital flows throughout trade liberalization period is that short-term capital flows are not sustainable in the long run and provide incorrect signals to the private sector. It is also asserted that the volatile nature of capital flows after capital account liberalization will generate volatility in the real exchange rate. Advocates of this view also argue that capital account should be opened slowly, so as to reduce the degree of real appreciation[124].

Frenkel (1982:200, 1983) advises trade liberalization first approach in that it is easier and less costly to reverse wrong portfolio decisions than wrong investment decisions. The idea is that if the capital account is liberalized first, then portfolio decisions will be taken under less distorted prices, while investment decisions will be taken under very distorted ones. Therefore, since it is cheaper and faster to

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[122] Edwards (1984a:8) and Edwards (1984b:4)

[123] Edwards (1984a:9)

[124] For a detailed discussion on that issue, see Edwards (1984a) and Frenkel (1982). They are more focused on the behavior of the exchange rate in examining the appropriate sequencing of liberalization.

reserve the portfolio decisions, trade account liberalization is recommended to take the first place in sequencing.

Another reason why capital inflows should be controlled during the transition period of trade liberalization is related to adjustment costs[125]. Furthermore, adjustment costs also explain why trade and capital account balances should not be liberalized simultaneously. Since financial markets tend to adjust more quickly than the goods markets, then the simultaneous[126] opening of both accounts will result resources moving first into the nontradables sector and out of exportables and importables, suggesting that in the short run, the capital account effects tend to dominate. Hence, Edwards (1986b:208) argues that since capital account adjusts faster, the avoidance of adjustment costs call for trade liberalization first which will be followed by capital account liberalization. Edwards (1986b:208) asserts that in a world of adjustment costs, market imperfections and externalities, sequencing of the capital and trade account liberalizations is more relevant rather than simultaneous and instantaneous liberalization.

Kaminsky and Schmukler (2003:20) found that crashes in the economy seem to be larger in emerging markets if the capital account opens up first, providing support to the usual claim that the capital account should be opened last.

On the other side, those in favor of early capital account liberalization argue that it can push towards broader economic reforms before political resistance builds up and can help overcome vested

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[125] Frenkel (1982:199)

[126] Some authors who argues for earlier liberalization of the capital account as well as the simultaneous liberalization of the trade and capital account balances to get rid of problems of short-run adjustment costs and the opposition to reforms are Krueger (1981), (1984), (1986:29) and Michaely (1986). For example, Krueger (1986:29) is in favor of rapid liberalization, basing the decision on the credibility issue.

interests that otherwise postpone necessary reforms[127], which mostly reflects views of the BWI.

Among the proponents of early capital account liberalization, Lal (1982) claims that during the transition from a protected to a liberalized trade account, the government should not be allowed to manipulate the exchange rate, since this has resulted in failure of the liberalization process in many cases, as in Argentina in 1982. Therefore, in order to avoid this factor and undesired real exchange rate movements, Lal (1982) proposes free floating exchange rate system with full currency convertibility before the trade reform, which means that capital account liberalization should precede trade liberalization. However, Lal (1982) does not specify the way to handle the appreciation problem led by capital account liberalization and also how much in advance of trade liberalization should the capital account be opened.

2.6. Sequencing of the Capital Account Liberalization: Gradual or Full Capital Account Liberalization?

Although the discussions in the literature about capital account liberalization is generally focused on having the capital account to be either completely open or completely closed, especially in the aftermath of the Asian crisis, some authors[128] and the IMF (2002:14) begin to argue that capital account liberalization is not an "all or nothing" issue and individual components of the capital account can be liberalized selectively. For instance, Williamson (1999:6) argues that there is no need to liberalize the capital account completely to reap the benefits of capital account liberalization. He (1999:12) claims that "since it is the last step which seems to present big risks of crisis, it

[127] Johnston (1998:19) is an IMF document; Dornbusch (1998:22)

[128] Johnston (1998:4), Williamson (1999:6), Fischer and Reisen (1992), Reisen (2000)

makes sense to stop one step short." Williamson (1999:6) believes that one country can still have large inflows of capital, while keeping some controls on short-term capital movements.

There are different suggestions about sequencing of the capital account liberalization. It is argued that risks most commonly associated with each type of flow needs to be evaluated in deciding when to liberalize a particular category of capital flows[129]. For example, Carlos Massad, President of the Central Bank of Chile, has argued that the capital account should be opened gradually, to protect the economy especially from short-term capital because they are quickly reversible and can seriously dislocate the economy[130]. Furthermore, he has argued that the exposure of developing countries to short-term, speculative capital flows is much greater than that of developed countries, while their ability to influence capital flows through monetary policy is much more limited.

Therefore, there is a general consensus toward liberalizing the long-term capital flows ahead of short-term capital flows[131] and foreign direct investments before portfolio capital flows[132]. Immediate liberalization of foreign direct investment and trade related finance are suggested because they are seen as a significant part of the real sector reforms and important for growth as well as the factor that they have little adverse impact on macroeconomic management and financial sector stability[133]. Liberalization of portfolio investment flows is suggested to be coordinated with financial sector reforms and the

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[129] IMF (2002:14)

[130] IMF (1998:83)

[131] IMF (2002:18)

[132] Reisen (2000)

[133] Reisen (2000)

development of financial markets and instruments. Nevertheless, liberalization of short-term bank lending and other volatile short-term flows is suggested to be deferred until strong prudential regulation and supervision is established and the domestic financial sector is deep enough.

2.6.1. Liberalization of Capital Inflows

Williamson (1993) describes preconditions for liberalization of capital inflows as the establishment of nontraditional export industries, fiscal discipline, a liberalized import regime and a liberalized and healthy domestic financial system, which are not different from the general line of the preconditions for the liberalization of capital account.

Fischer and Reisen[134] (1992:131) suggest liberalization of long-term[135] capital inflows and trade-related flows immediately, considering their benefits in the earliest stages of development. On the other hand, liberalization of short-term capital inflows is not recommended until a sufficient level of competition is present in the banking sector and a sound system of banking regulation and supervision is in place[136].

The analysis of Williamson and Mahar (1998:33) on the capital account liberalization experience of twenty-nine countries has revealed that most of the countries had restored fiscal discipline and initiated trade and domestic financial liberalization before removing controls on short-term capital inflows. On the other hand, fewer countries

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[134] Fischer and Reisen (1992:131) classify capital flows as inward and outward flows, long-term and short-term flows, and bank and nonblank flows.

[135] Williamson and Mahar (1998:32) define long-term inflows as comprising both foreign direct and portfolio investment as well as borrowing using long-term bonds.

[136] Fischer and Reisen (1992)

introduced competition or prudential regulation of the banking system before liberalizing short-term capital inflows. Chile is said to be the only country that had a well-developed system of prudential regulation and supervision in its second attempt at liberalization before opening short-term capital inflows.

2.6.2. Liberalization of Capital Outflows

The preconditions[137] for the liberalization of capital outflows are considered to be: i) liberalization of domestic interest rates ii) a policy regime regarded as permanent[138] iii) establishing sound government finances, i.e., fiscal discipline, defined as a fiscal deficit of less than 5 percent of GDP in three years prior to the removal of controls iv) arrangements to limit erosion of the tax base and v) resolving bad loan problems.

2.7. Pace of the Liberalization Reforms

Pace of the liberalization, i.e, how fast a liberalization should proceed is discussed under two main categories, short-term adjustment costs and political economy dimension.

1) Short-run adjustment costs: This approach is related to pure welfare aspects while externalities and adjustment costs play an important role under this issue. It is argued that foreign funds can be used to reduce or offset the costs of these frictions. Therefore, simultaneous opening of capital and current account is suggested for reducing adjustment costs[139]. In other words, the suggestion that

[137] Fischer and Reisen (1992) and Williamson (1993)

[138] Williamson and Mahar (1998:34) measure this in their analysis by the absence of a significant policy reversal within four years of the lifting of controls.

[139] See also Bhattacharya (1997:1046)

markets should be liberalized very quickly relies on the purpose of maximizing the present value of welfare gains.

However, the proposition of simultaneous opening of both capital and current accounts implicitly assumes that the adjustment process following the opening of these accounts is equally fast and the market imperfections and externalities do not exist[140]. On the other hand, in a world of adjustment costs, market imperfections, and externalities, capital account adjusts faster as discussed before. Hence, sequencing of the capital and trade account liberalizations is more relevant rather than simultaneous and instantaneous liberalization. In other words, under these circumstances, a gradual liberalization is suggested[141].

2) Political economy dimension: The second line of arguments concerning pace of reforms is related to the political economy, which deals with the issues of *credibility* and *opposition to reforms*.

i) Credibility: If the reforms go slowly, there is a risk that people may not believe reform program will go through to its end. Stockman (1982:188) argues that gradualism may invite speculation about future policy reversals. In such a case, people will not make necessary adjustments. However, for the success of structural reforms, economic agents should believe that reforms will be lasting and not reverted. Therefore, rapid reforms, i.e., decisive policy actions towards quick and deep changes may add to credibility if the results achieved in the short run are sufficiently favorable to support reforms and ensure against reversibility[142]. It is asserted that gradualist approach hinders progress by making credibility more difficult to achieve. On the other hand, Bhattacharya (1997:1047) says "a gradualist approach may create

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[140] Edwards (1986b:207)

[141] Edwards (1984a:80); Edwards (1986a:33); McKinnon (1982); Frenkel (1982)

[142] Edwards (1986a:33); Bhattacharya (1997:1046); Stockman (1982:188)

greater credibility, if it avoids unnecessary disruption in the short run and allows time for beneficiaries of reforms to emerge with a clear vested interest in their continuation".

ii) Opposition to Reforms: In this line of argument, it is emphasized that countries generally have little incentive to reform themselves without pressures from outside. Because even when governments are committed to the reform process, the public may oppose considerably the reforms, which could lead governments to backtrack on the liberalization measures or to slow down the pace of reform[143]. All structural reforms involve some distributional changes in favor of some groups and against others. Opposition to the reforms are usually led by the sectors that lose, even if the whole economy would benefit from the liberalization process. If those sectors are politically powerful, then they may disrupt these liberalization efforts.

Likewise, it is argued that financial liberalization involves transfer of wealth and income. In this framework, creditors gain from higher interest rates and debtors lose. As "financial institutions with long-term loans and short-term deposits can be adversely affected by interest rate deregulation that results in higher rates", "firms with foreign exchange debt can suffer huge losses when currency is devalued"[144]. In the face of these drawbacks, it is argued that the losses can be a political and economic obstacle to needed reforms in the short-run. To tackle the problem of opposition, politicians are first suggested to anticipate how reforms will change relative prices and how these changes will affect different groups. Secondly, it is argued that it

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[143] Bhattacharya (1997:1046)

[144] The World Bank (1989)

may be necessary to provide transitional compensation to those most adversely affected[145].

Hence, as an overall solution to the problem of opposition, it is believed that a more rapid implementation of reforms does not allow time for opposition to build up and for interest groups to get together and increase their lobbying activities against the reforms. Dornbusch (1998:22) also asserts that since protectionism wastes resources, the sooner is better for both.

Despite these views, the recommended approach for financial liberalization, especially for the capital account liberalization in the literature is to follow a gradual approach, but it is reminded that a gradual approach does not guarantee an orderly liberalization itself.

Consequently, the general argument in the literature is that liberalization should be gradual due to the presence of adjustment costs and the opposition of those who have vested interests in the controlled markets. One of the earliest writers who recommend a gradualist approach to structural reforms was Little et al. (1970) arguing that gradualism may minimize adjustment costs and limit the distributional burdens on particular groups in the initial years and also ensure that reforms are allowed to proceed at a politically acceptable pace.

Since the learning process by financial intermediaries, depositors and the authorities is not instantaneous, it is argued that financial liberalization process should be gradual to allow financial intermediaries enough time to learn managing risks; depositors to use new information channels; and the authorities how to supervise the

[145] The World Bank (1989)

system more strictly and how to modify prudential regulations and reporting requirements on the basis of accumulated experience[146].

Bhattacharya (1997:1047) argues that in practice, optimal pace of reform depends on the initial economic and political conditions of the reforming economy and is likely to be dictated by the amount of funds, including foreign funds, available to the authorities to help finance the reform process. Furthermore, Mathieson and Rojas-Suarez (1994:344) assert that the pace of full capital account liberalization depends both on how far a country has proceeded in implementing the policies that are preconditions for such convertibility and on its willingness to take further policy measures. Mathieson and Rojas-Suarez (1994:344) argue that although New Zeland and the United Kingdom followed a rapid removal of capital controls early in the reform process, they have successfully sustained an open capital account.

Kaminsky and Schmukler assert that (2003) the pace of liberalization of developed markets was gradual and uninterrupted, while that of emerging markets was gradual, but has some reversals in which capital controls and restrictions are reintroduced. Liberalization reforms have been completed over a longer span of time in Asia than in Latin America[147]. In terms of regional comparisons, while Latin America is said to be faster as compared to other developing countries, reform in East and South Asia is evaluated as gradual[148].

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[146] Ocampo (2000:32)

[147] Duration of liberalization reforms is measured as the number of months between the partial opening of the first sector and partial opening of third sector. This duration is 108 months for Asia, 61 months for G-7, 55 months for Europe and 38 months for Latin America (Kaminsky and Schmukler, 2003).

[148] See Williamson and Mahar (1998) for individual country experiences of financial liberalization

2.8. Approach of the Bretton Woods Institutes to Sequencing and Pace of Financial Liberalization

Approach of the BWI to the issue of sequencing and pace of financial liberalization reforms in the late 1980s and early 1990s can be followed from their reports. For instance, in the World Development Report of 1989 by the World Bank, it is suggested that in the light of country experiences, reforms undertaken in the presence of macroeconomic instability have the potential of making that instability worse. Furthermore, in the World Development Report of 1991, it is argued that while the scope of the economic reforms widely differs among the developing countries, everywhere, reforms need to be grounded in macroeconomic stability. Critical importance of macroeconomic stability in establishing credibility is also emphasized in this report. It is claimed that "the longer the history of high inflation and unsuccessful remedies, the harder the task"[149]. More strikingly, it is asserted that for financial liberalization to succeed, both macroeconomic stability and strong bank supervision need to be in place.

The World Bank (1989) suggested the move from a regulated to a more liberal financial system as follows:

First step involves control of fiscal deficit and establishment of macroeconomic stability. In this stage, the government is suggested to reduce its directed credit programs and adjust the level and pattern of interest rates to bring them into line with inflation and market forces. Furthermore, it is argued that the government should improve the accounting and legal systems, procedures for the enforcement of contracts as well as the structure of the prudential regulation and supervision. In case of widespread institutional insolvency, it is urged

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[149] The World Bank (1991:116)

that the government may need to restructure some financial institutions in the early stages of the reform. It is also argued that liberalization of trade and industry should take place before financial liberalization[150]. The World Bank urges the countries to implement reforms in trade and public enterprise policy before, or at least along with, financial liberalization.

In the second stage, development of markets and institutions as well as competition is encouraged. It is argued that broader ranges for deposit and lending rates should be introduced. Entry of foreign institutions into the domestic market is suggested to increase competition, "but perhaps with restrictions until domestic institutions are able to compete fully" [151]. An important message from the World Bank is that "until such reforms are well under way, it will probably be necessary to maintain controls on the movement of capital" [152].

It is argued that the government should move to the final stage after substantial progress in reform. This stage involves full liberalization of the interest rates, elimination of the remaining directed credit programs, removal of capital controls and restrictions on foreign institutions. Furthermore, it is reminded that capital account liberalization should follow trade liberalization since the speed of adjustment in the capital market is faster than in the goods market, which is in line with the general argument in the literature. Furthermore, it is argued that

> ….external reform should wait until internal reform and the recovery of domestic markets are under way. When macroeconomic stability has been established and the domestic financial system has been liberalized and deepened, it will be

[150] The World Bank (1989:127)

[151] The World Bank (1989:128)

[152] The World Bank (1989:128)

safe to allow greater freedom for foreign institutions and capital flows, to link the domestic and international financial markets[153].

All these recommendations seem quite sensible and in line with the general consensus in the literature. Furthermore, these reports give the cases in Argentina, Chile, the Philippines, Turkey and Uruguay in the early 1980s as the examples of the failure of rapid interest rate liberalization which were implemented under the conditions of macroeconomic instability and inadequate bank supervision and ended up with financial crises. As regards to the pace of liberalization process, the World Bank seems to suggest gradual liberalization as revealed by the argument that "it will allow firms time to adjust and financial institutions time to develop the new skills they will need" [154], while not forgetting to remind the losses it might impose.

On the other hand, the World Bank also emphasizes the possibility of success even in an unstable macroeconomic environment by reflecting the standard approach of the BWI. After commenting on the pitfalls of financial liberalization in an unstable macroeconomic environment, the World Bank argue about the possibility of avoiding serious disruption and achieving rapid growth in financial sectors for countries with considerable macroeconomic instability but gradual liberalization. This reflects the view that countries with an unstable macroeconomic environment should not be discouraged towards implementing financial liberalization reforms. In other words, they always keep the door open.

Furthermore, it is argued that undue delay carries the cost of perpetuating the inefficiencies of financial repression. Therefore, while on the one side, quick liberalization is not suggested so that it might impose heavy losses, on the other side, gradualism is suggested with a

[153] The World Bank (1989:128)

[154] The World Bank (1989:128)

"cautious" approach. In other words, they suggest gradual liberalization but urge for not to be too "gradual". It is even claimed in the World Development Report (1991) that in order to establish credibility, it may be necessary for policy to "overshoot", giving the example of Poland's currency devaluation in January 1990 to prove the decisiveness of politicians.

The idea behind these arguments is that developing countries should not give up financial liberalization but accompany it with reforms that deliver the institutional quality needed to realize the relationship between financial liberalization and economic performance.

2.9. Criticism of BWI for Pushing Liberalization

Edwards (2002: 254) criticizes the IMF and the World Bank in that even though the World Bank and the IMF had already reached a consensus regarding sequencing and pace of liberalization in the organizations and conferences led by the World Bank in the early 1980s, they then forgot to transfer these issues to the programs they suggested to developing countries. The views on which there appeared a general consensus in these conferences are summarized by Edwards (2002) as follows:

- ✓ trade liberalization should be gradual and buttressed with substantial foreign aid;
- ✓ in countries with very high inflation, fiscal imbalances should be dealt with very early on the reform process;
- ✓ financial reform requires the creation of modern supervisory and regulatory agencies; and
- ✓ the capital account should be liberalized at the very end of the process, and only once the economy has been able to expand successfully its export sector.

However, the BWI continued to advocate the simultaneous and very fast reforms and to push the developing countries to open their capital accounts, as they declared that politically, this was the only way to move forward[155]. On the other hand, expression of these policies has been adorned with other notions such as in an "orderly and progressive manner" and "supported by enhanced prudential regulation of financial practices". In pushing the developing countries to liberalize their capital account, the idea generally expressed by the IMF was that capital account convertibility has beneficial effects in countries with strong institutions.

Hence, although the World Bank and the IMF accepted the appropriate sequencing of liberalization as macroeconomic stabilization and enhanced prudential regulation first and only then, capital account liberalization as mentioned above, these recommendations were not reflected to the programs until late 1990s. Thus, on the basis of this ignorance of sequencing issues by the IMF, the IMF is criticized in that it has been pushing for financial liberalization.

The IMF began to be widely criticized in the aftermath of the Asian crisis. For instance, Stiglitz (2002:104) blames the IMF, the World Bank and the US Treasury for policies that encourages and sometimes insists on rapid pace of financial and capital market liberalization, which finally contributed to an environment that enhanced the likelihood of a crisis. He (2002) particularly believes that opening the capital account too soon is a huge mistake. Stiglitz (2002:73) also blames "the IMF for forcing liberalization before safety nets were put in place, before there was an adequate regulatory framework and before the countries could withstand the adverse consequences of the sudden changes in market sentiment.."

[155] Edwards (2002:254)

Stiglitz (2002:100) points to an unbelievable paradox that the IMF was advocating capital market liberalization to East Asian countries in that it would enhance economic stability in the region, while being very aware of the fact that capital flows are pro-cyclical[156]. Stiglitz (2002:105) says that the vulnerability of East Asian countries was newly acquired as a result of the capital and financial market liberalization that the IMF was responsible for.

Rodrik (2003:2), asserts that

> …I think without question, East Asian countries would have been far worse off if they had encountered something like the "neoliberal consensus" or the Washington Consensus. China would have been far worse off if it had had no choice but to start its growth process through a structural adjustment loan from the World Bank, as opposed to having the relative luxury of being able to develop it on its own.

Furthermore, the experiences of India and China since the early 1980s are suggestive of the benefits of a gradual, sequenced approach of opening up to imports and foreign investment[157].

Despite these criticisms, Öniş (2002:20) argues that since "the IMF has been involved with problematic countries rather than successful cases", "it would be misleading to attribute to the IMF all the responsibility for the outbreak of the recent crises" in Turkey and for other crises. The underlying phenomenon is that "these problematic countries have been characterized by deep deficiencies in their domestic political and institutional environments"[158].

The main point of all these criticisms is that the IMF programs can indirectly contribute to greater crisis risks by promoting capital

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[156] Procyclical capital inflows are defined by Kaminsky, Reinhart and Vegh (2004) as "external borrowing increases in good times and falls in bad times".

[157] Rodrik (2001); Stiglitz (2002); McKinnon (1994)

[158] Öniş (2002:20)

account liberalization inappropriately and prematurely. These views support the general consensus in the economics literature that appropriate sequencing is vital for the success of liberalization and a premature opening of the capital account could entail serious dangers for the country in question.

The IMF's Response to these Criticisms

In the face of all these criticisms, the IMF does not deny the volatility, crises and the adverse consequences associated with financial liberalization after all as can be observed from the staff papers recently originating from the IMF. Therefore, the IMF seems to recommend capital account liberalization to developing countries with greater caution. This attitude change can be clearly observed in one of the recent studies at the IMF, "Volatility and Comovement in a Globalized World Economy: An Empirical Exploration", by Köse et al. (2003a), which has reached the conclusion that financial globalization has been associated with increased macroeconomic volatility in emerging market countries.

Another recent study at the IMF, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence" by Prasad et al. (2003) also asserts that despite the vast research, there is no strong, robust and uniform support for the theoretical argument that financial globalization delivers a higher rate of economic growth. It is also claimed that even though the theory suggests that the volatility of consumption relative to that of output should go down as the degree of financial integration increases, in practice "the volatility of consumption growth relative to that of income growth has on average increased for the emerging market economies in the 1990s, which was precisely the period of a rapid increase in financial globalization". This paper divides countries into those that are more or less financially liberalized according to volume of capital inflows and outflows relative

to GDP. Therefore, a country that received large capital inflows is treated as a more liberalized financial market.

The effort to divide countries as more or less liberalized ones amounts to manipulating the evidence to yield results that defend liberalization in the long term, even though its consequences are obviously adverse. All these evaluations were aimed at reinforcing the conclusion that financial crises are a natural consequence of financial globalization, a "pain" that has to be endured in order to reap the "gains" of liberalization[159]. The IMF tends to view crises as inevitable consequences of the process to enjoy the long-run benefits of liberalization.

Another study by Köse, et al. (2003b)[160] again concludes that financial openness, as measured by gross capital flows as a ratio to GDP, is associated with an increase in the ratio of consumption volatility to income volatility, contrary to the notions of improved international risk sharing opportunities through financial integration[161]. On the basis of empirical evidence, they believe that increased financial integration do not lead to macroeconomic volatility and developing countries need to be more, not less, integrated into the world financial markets to be able to reap the benefits of financial integration in terms of improved risk sharing. It is further argued that since international financial integration is associated with a variety of risks, developing countries would need to implement sound

[159] The wordings of "gain" and "pain" belongs to Schmukler (2003)

[160] They analyzed the developing countries in two groups: More Financially Integrated Economies (MFIEs) and Less Financially Integrated Economies (LFIEs).

[161] Once the level of gross capital flows crosses a particular threshold, it appears to have a negative effect on this ratio. Industrial economies, which typically have much larger gross capital flows (as a share of GDP) appear to have benefited the most from this form of financial integration, at least in terms of the relative volatility of consumption (Köse, et.al. 2003b).

macroeconomic[162] and structural frameworks to minimize these risks. As regards to structural reforms, their results suggest that development of the domestic financial sector is critical as a high degree of financial sector development is associated with lower macroeconomic volatility.

The study conducted by Kaminsky and Schmukler (2003) also supports the ideas of the IMF by arguing that financial liberalization is more destabilizing in developing countries than in developed countries, while this divergence exists only in the short-run[163]. On the other side, analysis of Kaminsky and Schmukler (2003:24) showed that in the long run, stock market booms and busts have not intensified after financial liberalization. In other words, they conclude that financial liberalization leads to more stable markets in the long run. In the mature markets, on the contrary, liberalization appears to be beneficial in the short run as well. The authors argue that the difference between developing and developed counties arises from the fact that institutional reforms aimed at increasing transparency and appropriate regulation of markets do not predate liberalization. They claim that vulnerability of developing countries to the risk factors associated with financial liberalization is mainly dependent on the quality of macroeconomic policies and governance. Since these factors are put into effect only after liberalization, beneficial effects associated with it are realized with a lag. According to their analysis, this leads to contrast between the short run adverse and long-run beneficial effects of financial liberalization. It is implicitly argued that developed countries do not have these shortcomings of institutional features that generate the vicious circle between financial liberalization and volatility. Therefore, they are not exposed to same cycle of crisis events that developing countries are very often exposed to.

[162] For example, their findings emphasize the role of fiscal and monetary policies in driving macroeconomic volatility.

[163] Short-term is defined as the four years after the opening of the first sector and the four years after the opening of the second sector.

2.10. Conclusion

There are different views as regards to the sequencing of the liberalization reforms, especially sequencing of financial liberalization with respect to other liberalization reforms. The general consensus in the literature advocates that the priority should be given to macroeconomic stability, as fiscal discipline is ensured first. At the same time institutional reforms should be undertaken before implementation of liberalization reforms. For the success of financial liberalization, strong banking regulation and supervision is necessary. Then, domestic financial liberalization should take place before capital account liberalization and trade liberalization. As regards to the sequencing of the trade and capital account liberalization reforms, it is suggested that capital account liberalization should be left to the last step.

Furthermore, it is argued that capital account liberalization is not an end in itself, but can be phased. While preconditions of capital outflows and inflows are different, it is recommended that long-term capital flows, such as foreign direct investment should be liberalized first. On the other hand, short-term capital flows and portfolio flows are suggested to be left to the final stage.

While the literature has been mostly focused on the sequence of trade and capital account liberalizations with respect to each other, the initial steps, which are macroeconomic stability and prudential regulation and supervision, have not received adequate attention. This has even occurred despite the importance of these issues had already been mentioned in the World Bank Reports published in the late 1980s. The BWI continued to push developing countries for financial liberalization reforms, being aware of the inadequacies in these countries and possible failure of the reforms. As they began to give more emphasis in the aftermath of the Asian crisis to the issues of

prudential regulation and supervision as well as institutional reforms, they continued to insist on financial liberalization reforms to be undertaken by developing countries by emphasizing their long-term benefits. Even when they seemed to accept the adverse consequences of financial liberalization, they have not given up advocating them the countries as an ultimate objective that needs to be reached.

Consequently, on the basis of the discussions in this chapter, our recommendation is that success or failure of the financial liberalization reforms should be evaluated without neglecting the very first steps of sequencing, which are macroeconomic stability and prudential regulation and supervision.

CHAPTER 3

SEQUENCING, PACE & TIMING OF LIBERALIZATION REFORMS IN TURKEY WITH SPECIAL EMPHASIS ON FINANCIAL LIBERALIZATION

3.1. Introduction

Turkey experienced a major crisis in the late 1970s as a result of a combination of domestic and external forces and their interaction. Import substitution strategy of the 1960s and 1970s led to dependence on imports and foreign borrowing, while failing to increase capacity to export. In the aftermath of the debt crisis in 1977, foreign lenders had cut off credit to Turkey. As the second oil shock hit the country in 1979, other foreign exchange inflows such as workers' remittances, exports were also declining. Therefore, the government did not have the foreign exchange to meet its external obligations. Then, the ensuing severe balance of payments crisis in 1979 forced the country to restrain imports and produced shortages of essentials.

The late 1970s was also accompanied by a political crisis. In the aftermath of elections in 1977, the Republican People's Party (RPP) under Ecevit's leadership and Demirel's Justice Party formed a coalition government, which resulted in political instability as well as mounting levels of terrorism and violence. As the economy's performance continued to worsen in the second half of 1979, as a result of the parliamentary elections in October, the Ecevit administration was replaced by the sixth Demirel administration in November 1979[164].

The period of late 1970s also witnessed negotiations with the IMF. It had been started under the fifth Demirel administration (July-

[164] Öniş and Kirkpatrick (1998:126-127)

December 1977) and concluded with a two-year Standby agreement in April 1978 under Ecevit's administration. On the one hand, Ecevit's government had no inclination to possess the stabilization program, but presented the program as being imposed on it against its will. On the other hand, the external donors as well had little confidence in the commitment of the government and its ability to implement the program[165]. Hence, the IMF agreement failed to stop the deterioration in the economy. Only after the Demirel's administration took office in November 1979, informal meetings had restarted with the IMF. Özal took the leading role and became the main negotiator of the January 1980 program[166]. It was the economic team under Özal that persuaded Demirel's government to introduce comprehensive policy measures on January 24, 1980.

The orthodox stabilization program introduced in January 1980 represents a major turning point for the break away from inward oriented strategy based on import substitution towards a market-oriented economy. The neo-liberal policies introduced in 1980 aimed at short-term stabilization and long-term structural adjustment. Hence, liberalization process in Turkey was initiated with the stabilization program in 1980. While the priority of the stabilization program was not liberalization at the beginning of 1980s, in the post-1983 period, liberalization took the leading role in the program parallel to the trend in other developing countries mostly with the impact of proposals of Washington Consensus policies.

This program received strong support from the OECD governments and international agencies. The program is identified as the one which is "based on close collaboration between the IMF and the World Bank and involving the application of cross-conditionality", as

[165] Okyar (1983:540), Öniş and Kirkpatrick (1998:126-127)

[166] Okyar (1983:543), Öniş and Kirkpatrick (1998:128-129)

well as being radical and far-reaching[167]. Furthermore, the transitional military regime from September 1980 to November 1983 had ensured the continuity in the policy implementation through establishing political stability and eliminating the right to opposition.

Another striking characteristic of this period is that "the character and unity of the technocratic elite with clear ties to international lending agencies"[168], has been a key factor in determining the success of the adjustment program. Hence, "elusive triangle"[169], that is, "the relationship between the state, society and the international system and the precise nature of their interaction at a particular point in time" [170] characterizes the Turkish experience in the 1980s.

Briefly, liberalization measures in Turkey, which will be examined in detail later in the chapter, were sequenced as follows: First, domestic financial markets were liberalized, as interest rates were to a large extent deregulated in mid-1980. Secondly, a preliminary step in import liberalization came in mid-1981 in the form of removal of the quota list from the import regime, while the import policy relied on licensing and prohibited imports as restrictive devices until 1984. Hence, domestic financial liberalization had started earlier than trade liberalization process. In the post-1983 period, liberalization policies gained momentum. Thirdly, the import regime was further liberalized and a partial decontrol of external financial flows was undertaken through liberalization of foreign exchange regulations in one unified major step at the end of 1983 and early 1984. Then, full capital account liberalization had been taken at one step in 1989.

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[167] Öniş (2003:6)

[168] Öniş (1998a:246)

[169] ibid.

[170] ibid.

In this chapter, we will take a closer look at the pattern and content of these policy measures in the pre-1980 period and thereafter, as well as the political environment they were introduced and the rationale behind them. Then, Turkish liberalization experience will be evaluated in terms of the extent to which they fit to the sequencing that we proposed in the previous chapter. For instance, at the time when domestic financial liberalization and capital account liberalization had been introduced to the Turkish economy, macroeconomic stability was not sustained and safety and integrity of the Turkish financial system was not satisfied.

The line of argument we would like to pursue in this chapter is that while sequencing mistakes account for the degree of success in the aftermath of liberalization reforms, institutional characteristics and policy environment of the country also have crucial importance in terms of the nature of adjustment process and the subsequent economic performance. Hence, in this chapter, we aim to make a critical assessment of political conjecture and the approach of international lending institutions at the time when the liberalization reforms were introduced in Turkey. Furthermore, the impact of the policy environment on the subsequent performance of liberalization reforms will be evaluated as well. We believe that political dimension should not be neglected, since "Turkey's economic performance and political realm is heavily interrelated"[171].

Our main argument in this chapter develops around the idea that policymakers need to overview a wide spectrum of conditions before introducing economic reforms, even when the country's conjecture necessitates its implementation. In analyzing the introduction of liberalization reforms to the Turkish economy, besides the question of

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[171] Öniş (2003:2)

"when"[172], the questions of "how" and "by whom" gain importance and need to be answered.

In this chapter, first, a brief summary of the policies in the pre-1980 period will be provided to give a picture of the Turkish economy before the liberalization process began. Then, in section 3, stabilization attempts in the aftermath of the debt crisis in 1977 and role of domestic and external actors in development of new stabilization program of 1980 are discussed. Sequencing of liberalization policies in the post-1980 period will be examined in detail in section 4, with a critical evaluation of policy environment. An assessment of this sequencing is provided in section 5. Then, section 6 follows with examination of the pace of reforms. Finally, section 7 concludes.

3.2. Policies in the Pre-1980 Period

3.2.1. The Main Policy Framework: Import Substitution Industrialization Regime

During 1960s and 1970s, the main development strategy in Turkey was import-substitution-industrialization (ISI). Under ISI, Turkey was implementing an inward-oriented development strategy with high protection of the industry maintained through foreign exchange restrictions, tariffs, quotas and overvalued exchange rates. The main

[172] Timing of capital account liberalization is examined in chapter 4.

pillar of this regime was to restrict imports[173] through a set of complex and highly restrictive rules and regulations[174].

There were some attempts towards export-promotion during this period. Export incentive schemes in the form of tax rebates, preferential export credits and foreign exchange allocations were in operation. However, they were not effective on exports and export performance of the manufacturing sector remained sluggish due to an overvalued TL, high costs and overall inefficiency resulting from heavy and indiscriminate protection brought about by a highly restrictive import regime[175]. Hence, trade and industrialization policies remained inward-oriented and highly biased against exports. However, by the late 1960s, rapid growth of the demand for imports put pressure on the balance of payments. Even though these problems were the result of the trade and industrialization policies applied, the focus was not directed towards changing them under the illusion of high growth performance[176] of annual average growth rate of 5.7% during 1960-1970 periods.

The exchange rate regime was fixed in that period, as it was adjusted at long intervals with the changing economic conditions. However, lags in the adjustment often resulted in overvaluation, which later required significant devaluations. The 1970s started with a major

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[173] Licensing was required for all imported goods, i.e., importers were required to have an "importer's certificate". From 1964 to 1980, imports were classified basically in three lists: Quota List, Liberalized List 1, and Liberalized List 2. Imports of goods that did not appear in any of the three lists were prohibited. In the pre-1980 period, importers were also required to place an advance deposit guarantee with the Central Bank for import activities. Moreover, tariffs and non-tariff charges –municipality tax, stamp duty, wharf charge and production tax- were also imposed on imports. Togan (1996:11)

[174] Like tariffs, surcharges, multiple exchange rates as well as exchange control, quantitative restrictions and outright prohibition and strict licensing of imports (Şenses, 1984: 287)

[175] Togan (1996:19)

[176] Şenses (1981, 1984), Togan (1996)

devaluation[177] of the Turkish Lira (TL), which resulted in an improvement in current account balance through rapid growth in exports. Also, during the same period, the sharp increase in workers' remittances temporarily relieved foreign exchange needs of the country. Nevertheless, planners, encouraged by the improvements in external payments situation, gave greater emphasis on creating domestic production capacity in intermediate and capital goods, instead of an export-oriented policy framework[178]. While ISI strategy partly achieved creating an industrial base in consumption goods, it failed to extend import-substitution into intermediate and capital goods, as further growth of manufacturing sector became increasingly more dependent on imports of raw materials and capital goods. Therefore, the 1972-79 period, which is often called as the second phase of the import substitution period, was characterized by the deepening of the industrialization strategy based on ISI[179].

3.2.2. Financial and Capital Markets

Before the reform period in the 1980s, since 1950s, the development and evolution of the financial system in Turkey were shaped by macroeconomic imbalances and the requirements of the public sector financing. Budget deficit were largely financed by monetization. In other words, the Central Bank credit[180] was an important source for the public sector financing requirements.

Capital markets were underdeveloped with a very limited set of financial instruments, while banks were the main financial institutions in the financial markets. The money market and government securities

[177] 20.3% nominal devaluation in 1970 and 38.6% in 1971.

[178] Şenses (1981:412-13)

[179] Boratav and Yeldan (2001:4)

[180] Share of Central Bank credit in financing of consolidated budget deficit rose from 43.5% in 1975 to 67.6% in 1980.

markets were not developed. Therefore, bank loans were the primary source of financing for domestic enterprises. Furthermore, as corporate sector were heavily dependent on bank credits, there was a high degree of interlocking relations between banks and industrial holding companies.

Throughout the 1970s, deposit and lending interest rates were under the control of the government and rarely changed. Real interest rates became increasingly negative as inflation rate peaked up toward the end of the decade (See Table 3.1). Real deposit rates of interest were almost minus 27 percent in the late 1970s. The M2/GDP ratio declined from 29 percent in 1970 to 17.4 percent in 1980. This meant the financial system to shrink in real terms. Holdings of foreign assets were severely restricted as well.

This scheme resulted in a highly repressed and segmented financial structure and a very distorted economic environment[181] under which reforms of the 1980s began. At that time, there were no effective institutional safeguards against unsound financial practices and to protect bank deposits. Moreover, there were no adequate supervision and regulation of the financial markets. Before 1980, capital flows were also controlled through foreign exchange regulations.

Table 3.1: Real Rate of Return, 1973-1980

%	1973	1974	1975	1976	1977	1978	1979	1980
Inflation Rate (WPI)	20.5	29.9	10.1	15.6	24.1	52.6	63.9	107.2
Nominal Interest Rate *	7	9	9	9	9	12	20	33
Real Interest Rate	-11.2	-16.1	-1	-5.7	-12.2	-26.6	-26.8	-35.8

* Interest rate of the 1-year time deposit account

Source: State Planning Organization (1990:11)

[181] Denizer et al. (2000:2)

3.2.3. Macroeconomic Performance

The first oil shock in 1973-74 led to a sharp deterioration in the terms of trade, putting a huge burden on the balance of payments during 1974-77. Furthermore, the economic difficulties of European economies led to a decline in workers' remittances. Despite these problems and severe international recession, Turkey managed to sustain an average annual growth rate of 7.2% during 1973-76 by basically relying on short-term external borrowing and rapid reserve erosion.

However, as successive governments pursued expansionary policies; and public investments grew sharply with total investment/GNP ratio increasing from 19.1 percent in 1973 to 25.8 percent in 1977, public finances deteriorated sharply with public sector borrowing requirement reaching 8.1 percent of GNP in 1977. In the face of rapid monetary expansion fuelled by large fiscal deficits, domestic demand boom and rising costs of imported materials, inflation rose from 15.6% in 1976 to 63.9% in 1979 (See Table 3.2). In order to keep inflation from rising, the government continued to apply the fixed-exchange rate system. Although there had been a series of minor adjustments in exchange rate, the real exchange rate appreciated. In order to avoid adverse impacts of exchange rate appreciation, the government increased export rebate rates and control on foreign capital movements. However, the policies implemented resulted in increases in imports as exports stagnated. Consequently, the widening current account deficit and the sharp increase in external debt ended in payments crisis in 1977[182].

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[182] Şenses, (1981:415-417), Togan, (1996:5-6)

Table 3.2: Selected Macroeconomic Indicators of Turkey, 1960-1979

	Average Exchange Rate (TL/US $)	Export (mio US $)	Import (mio US $)	Foreign Trade Balance (mio US $)	Export/GNP	Import/GNP	Foreign Trade/GNP	Current Account Balance (mio US $)	GNP Growth Rate (%)	Budget Revenue (mio TL)	Budget Expenditure (mio TL)	Budget Balance (mio TL)	Budget Rev./GNP	Budget Exp./GNP	Budget Bal./GNP	WPI (%)
1960	9.00	321	-468	-147	3.3	4.7	-1.5	-139	3.4	6933.3	7320.3	-387	14.9	15.7	-0.8	5.3
1961	9.00	347	-510	-163	6.3	9.3	-2.9	-170	2.0	10933.9	11382.5	-448.6	22.1	23.0	-0.9	2.9
1962	9.00	381	-622	-241	6.0	9.7	-3.7	-242	6.2	9017.8	9118.1	-100.3	15.7	15.8	-0.2	5.6
1963	9.00	368	-688	-320	5.0	9.3	-4.3	-300	9.7	11370.8	11725.6	-354.8	17.0	17.5	-0.5	4.3
1964	9.00	411	-537	-126	5.2	6.8	-1.6	-109	4.1	12920.2	13533.6	-613.4	18.1	19.0	-0.9	1.2
1965	9.00	464	-572	-108	5.5	6.8	-1.3	-78	3.1	13587.9	14487.9	-900	17.7	18.9	-1.2	8.1
1966	9.00	490	-718	-228	4.9	7.1	-2.3	-164	12.0	16557.5	17248.3	-690.8	18.1	18.9	-0.8	4.8
1967	9.00	523	-685	-162	4.7	6.1	-1.5	-115	4.2	20386.7	20288	98.7	20.1	20.0	0.1	7.6
1968	9.00	496	-764	-268	2.8	4.2	-1.5	-224	6.7	20630.2	21322.1	-691.9	12.6	13.0	-0.4	3.2
1969	9.00	537	-801	-264	2.7	4.0	-1.3	-220	4.3*	23561	25386.9	-1825.9	12.8	13.8	-1.0	7.2
1970	11.34	588	-948	-360	3.1	5.0	-1.9	-171	4.4	33120.3	32865.8	254.5	15.9	15.8	0.1	6.7
1971	14.98	677	-1171	-494	3.9	6.8	-2.9	-109	7.0	40632.8	46269.9	-5637.1	15.6	17.7	-2.2	15.9
1972	14.00	885	-1563	-678	4.0	7.1	-3.1	-8	9.2	50952.2	50921.2	31	16.2	16.2	0.0	18.0
1973	14.00	1317	-2086	-769	4.7	7.5	-2.8	484	4.9	61433.7	64287.4	-2853.7	15.4	16.1	-0.7	20.5
1974	13.74	1532	-3778	-2246	4.0	9.9	-5.9	-719	3.3	73575.7	77776.8	-4201.1	13.7	14.5	-0.8	29.9
1975	14.31	1401	-4502	-3101	3.0	10.0	-7.0	-1648	6.1	112828	114228.2	-1400.2	16.3	16.5	-0.2	10.1
1976	15.86	1960	-4872	-2912	3.7	9.6	-5.9	-2029	9.0	150716.3	155028.3	-4312	17.4	17.9	-0.5	15.6
1977	17.83	1753	-5506	-3753	2.9	9.5	-6.6	-3140	3.0	196171.5	240200.7	-44029.2	17.7	21.7	-4.0	24.1
1978	24.07	2288	-4369	-2081	3.4	6.9	-3.5	-1265	1.2	323605.1	347703.4	-24098.3	19.7	21.1	-1.5	52.6
1979	37.55	2261	-4815	-2554	2.8	6.2	-3.4	-1413	-0.5	545192.6	611411.8	-66219.2	19.0	21.3	-2.3	63.9

Source: State Planning Organization, Ekonomik ve Sosyal Göstergeler http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

* Based on new GNP series after 1969.

3.3. Aftermath of the Debt Crisis in 1977: Period without Adjustment (1978-79)

3.3.1. Relations with the International Financial Institutions and the IMF Standby Agreements

Turkey entered its debt crisis in 1977 and then was effectively almost cut off from private capital markets. Hence, the debt crisis was followed immediately by a foreign exchange shortage. As the government was not able to meet its commitments, in the face of erosion in reserves, the only alternative left to finance current account deficits was official flows[183]. A complicated series of negotiations[184] and initiatives occurred between Turkey and its creditors after 1977.

Two sets of stabilization programs with the IMF were announced in the 1978-79 era, one being in April 1978 and the other in July 1979. Discussions with the Fund had been initiated by the fifth Demirel administration (July-December 1977), as "the cabinet failed to agree on the preconditions of an 18 percent devaluation and reduction in government spending."[185] Then, a two-year Stand-by agreement involving SDR 300 million was reached by the Ecevit administration with commitments of restrictive monetary and fiscal policies, devaluation - 23 percent devaluation of the Turkish lira on March 1, 1978[186]- and better debt management.

Nevertheless, developments in the Turkish economy between March and September 1978 diverged from the expectations and

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[183] Celasun and Rodrik (1989:750)

[184] These negotiations involved a wide circle of concerned parties: commercial banks, creditor governments, foreign export suppliers, the IMF and the World Bank (Celasun and Rodrik, 1989:753).

[185] Öniş and Kirkpatrick (1998:127)

[186] Okyar (1983:534)

projections of the stand-by agreement[187]. Hence, the program failed in late 1978 (See Table 3.5). As the negotiations with the Fund were restarted in April 1979, there were also pressures from the commercial banks which were a party to debt rescheduling negotiations. The striking point is that commercial banks insisted on a new agreement between the IMF and Turkey to replace the earlier one (April 1978) before they would reschedule the debt. Moreover, the OECD arrangement was also conditional to the IMF program. Western leaders who met at a summit meeting in January 1979 to contribute joint economic help of around $1 billion in 1979, also made this aid dependent upon a new agreement with the IMF[188]. Only after a new one-year stand-by arrangement came into effect in July 1979, the banks signed the agreement[189] and the OECD fund amounting to $ 225 million was released[190] besides various World Bank project credits and a program credit of $150 million[191]. In addition to the IMF agreement, arrangement with the OECD also played a major role in triggering an additional flow of resources from official creditors to Turkey[192].

While American and European governments initially showed little interest in the Turkish economic crisis, Turkey's geopolitical role in the

[187] See Okyar (1983:535-36) for details.

[188] Okyar (1983:536)

[189] Celasun and Rodrik (1989:753). During the 1978–1982 period, Turkey rescheduled both its long-term and short-term debt in a series of debt negotiations, which was the largest undertaken to date by the international financial community. By year-end 1981, no less than 70 percent of Turkey's total debt had been rescheduled. "By March 1982, practically all short-term debt had been consolidated and transformed into long-term debt." Celasun and Rodrik (1989:784) See also Baysan and Blitzer (1990) and Okyar (1983:536)

[190] The impact of the OECD program was reflected most heavily in 1980 when $1 billion flowed in. (Celasun and Rodrik, 1989:757)

[191] Okyar (1983:538)

[192] Celasun and Rodrik (1989:752) and Öniş (1998a:246)

Middle East and as a NATO member bordering on the Soviet Union[193], this interest increased over time, ending in a major rescue operation initiated in early January 1979 by the Big Four (USA, West Germany, France and Great Britain). It is argued that concern of the Western countries for the economy was fundamentally strategic[194]. Furthermore, it is asserted that mainly due to this strategic importance, "in 1980, Turkey emerged as the test case for the newly instituted World Bank-IMF joint programs involving "cross-conditionality""[195].

The letter of Intent dated July, 1979[196], approved a one-year stand-by agreement amounting to SDR 250 million (see Table 5). As the government was committed to further stabilization measures, Turkish lira was devalued by a 43.7 percent[197] in June, 1979. In the stabilization efforts during 1978-79, Turkey attempted to tackle basically the major problems of public sector deficits, balance of payments difficulties and inflation. However, measures taken to overcome the crisis were inadequate and ended up with severely negative interest rates, highly overvalued domestic currency, widespread shortages of imported materials and black market activity on a wide scale[198]. Furthermore, the second oil shock in 1979 deepened the crisis as the social and political conflict heightened[199]. While shortages in commodity supplies

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[193] For further details, see Celasun and Rodrik (1989:756) and Öniş (1998a:246), and Öniş and Kirkpatrick (1998:128)

[194] For detailed information about Turkey-USA relations and Turkey' strategic role, see Arıcanlı (1990: 239-244). Also see Celasun and Rodrik (1989:761)

[195] Öniş (1998a:246)

[196] Celasun and Rodrik (1989:757); Okyar (1983:537)

[197] Turkish lira was devalued from 26.5 TL=$1 to 47.1 TL=$1

[198] Exports increased sharply with a shift in composition towards manufactures, owing much to sluggish domestic demand together with exchange rate flexibility and other export promotion schemes. Inflation and external debt situation were kept under control. See Şenses (1984) and Celasun and Rodrik (1989) for a detailed discussion.

[199] Şenses, (1981:417).

led to wide public discontent, implementation failures of the IMF Stand-by arrangements also damaged relations with the IMF and the International Financial Institutions (IFIs)[200].

Many interrelated factors had been instrumental in leading to failure of the IMF agreements. First of all, the Ecevit government perceived the agreements as short-run remedy to deal with the balance of payments crisis. Secondly, there was no inclination of the government towards changing the long-term development strategy of ISI regime. Furthermore, the government had a tendency to reflect the program as dictated by external donors against their will. On the side of IFIs, they had little confidence in the commitment of the Ecevit administration to implement measures[201]. Okyar (1983:539-40) describes the divergence of approaches between the IMF and Ecevit government as follows:

> … it appears that the political views and the ideological complexion of the left-of-center Ecevit government created almost insurmountable barriers in the way of arriving at a correct diagnosis of the situation, let alone taking decisive measures to counter it…….The necessity of resorting to IMF cooperation and advice when the Party assumed power early in 1978 made the Ecevit government extremely uneasy and unhappy, since this went against its own convictions and embarrassed it in the eyes of its supporters….In view of such a fundamental divergence of views, it is not surprising that the stand-by agreements of 1978 and 1979 failed.

Thereby, external funds promised by the IMF and bilateral donors had been of negligible amounts as compared to the period in the aftermath of 1980[202].

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[200] Celasun and Rodrik (1989:663)

[201] Öniș and Kirkpatrick (1998:127)

[202] Öniș and Kirkpatrick (1998:127)

3.3.2. Role of Domestic and External Actors in the Stabilization Program of 1980

On the basis of deteriorating economic performance and increasing social and political tensions, parliamentary elections in October 1979 concluded with resignation of the Ecevit's cabinet and the formation of Demirel's minority government in November 1979[203].

Although the International Organizations such as the OECD, the IMF, and the World Bank, had played a major role in the adjustment program of 1980, Öniş and Webb (1998:345) assert that they did not dictate most of its content. On the other hand, the IMF and World Bank were the key players in the development of the policy packages in the early 1980s and influenced both the evolution of economic philosophy in Turkey and the short-term policy choice[204]. The striking point is that although informal talks between the government and the international organizations had begun in December 1979[205], the first structural adjustment loan was not signed until April and the new IMF standby loan was not signed until June 1980. Therefore, the measures had begun before formal agreements. Intention of the government was to present the January policy reforms as an internally formulated program, being independent from external pressure of the IMF. This reflected the intention of the government to be seen publicly as taking the initiative[206].

Shift to neo-liberal model of development in Turkey did not take place through voluntary choice but as an inevitable outcome of a major balance of payments crisis associated with the exhaustion of the

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[203] Celasun and Rodrik (1989:663)

[204] Öniş and Webb (1998:346)

[205] It is argued that formal negotiations with the IMF began in March 1980 (Öniş and Kirkpatrick, 1998:129).

[206] Yalman (1997: 11); Öniş and Webb (1998:346) and Öniş and Kirkpatrick (1998:129)

import-substitution model of industrialization. Hence, in such a situation, leadership becomes very important in terms of gaining support of the international institutions and broad segments of the public, which would ensure the long-term success of a reform program. It is asserted that Özal had the necessary virtues of leadership[207] and a major impact in the multilateral flows through signaling his seriousness about economic reforms[208]. These signals were sent by Özal as the main negotiator with donor organizations during the late 1970s, when he was Demirel's deputy in charge of economic affairs. For instance, Özal, in his visit to Washington for negotiations, mentioned the government's intention to carry out a large devaluation[209].

Soon after Demirel took office in November 1979, he made contact with the IMF and his officials met with an IMF team during a routine visit to Turkey in early December. Okyar (1983:541) claims that Demirel understood the dependence of economic recovery to gaining the confidence of Western economic institutions. He (1983:542) further adds that "good relations with the IMF were crucial because the first step toward recovery lay in financing the minimum level of activity in Turkey."

Nevertheless, the problem was that relations with the IMF were sensitive with a segment of Turkish public opinion, as Ecevit exploited this issue after his return to opposition. Thus, psychologically and politically, the government took the option of taking drastic economic decisions required independently of the IMF, and subsequently signing a new stand-by agreement with the IMF. It was to the government's

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[207] See Öniş (2004) for a detailed analysis of Özal's leadership properties.

[208] Celasun and Rodrik (1989:758)

[209] Okyar (1983:543)

political advantage if stabilization policy were regarded to be decided upon independently by the Turkish government[210].

Hence, Özal was sent to discuss the outline of the proposed stabilization measures. Then, the informal contact with the IMF was maintained. It is argued that Özal[211] was the driving force behind these measures and policy formulation[212]. Hence, the leading role of Özal can not be ignored. Öniş and Kirkpatrick (1998:146) claim that "the character and unity of the bureaucratic elite is a critical factor in determining the success of an adjustment program". Furthermore, it is argued that presence of a charismatic leader played a key role "in terms of legitimizing and generating broad public support for the program as well as overcoming resistance from key elements of the anti-reform coalition"[213].

The distinguishing characteristic of the new period, being different from the period of 1972-9, was that the views of the Turkish government under Özal's leadership were almost analogous to the type of program advocated by the World Bank and the IMF. Furthermore, the staff of the World Bank and the IMF was also in close collaboration with many of the staff at the Central Bank, State Planning Organization and Treasury[214]. The striking point is that the program was no longer presented as dictated by external donors. Rather, the Turkish

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[210] Okyar (1983:542)

[211] "Özal worked at the World Bank in the 1970s, where he was impressed with the arguments in favor of more open trade regimes." (Öniş and Webb, 1998:345)

[212] Öniş (1998a:245); Öniş and Kirkpatrick (1998:129)

[213] Öniş (2002:14)

[214] Öniş and Webb (1998:346)

authorities introduced the program as formulated by themselves, assisted by the World Bank[215].

In June 1980, a three-year standby arrangement, amounting to SDR 1200 million (625 percent of quota) was signed with the IMF[216]. An important characteristic of the Turkish economy is that

> major policy changes in Turkey have not been initiated on the basis of a broad social consensus. Rather, such changes have taken place in a top-down fashion, often in response to influences originating from the international economy. The adoption of the neo-liberal model in 1980 is a striking example of this pattern of top-down and externally induced restructuring[217].

Consequently, while the external factors seem to be in dominant position, parallel views of the Turkish authorities to that of the external actors were instrumental in the adoption and subsequent performance of the policies proposed by the IMF and World Bank. Furthermore, there was a general tendency of the government in the early 1980s to pretend that the measures agreed with the international organizations were its own policies.

3.3.3. Liberalization Policies in the Post-1980 Period

On January 24, 1980, Demirel's minority government introduced an orthodox stabilization program under the IMF support. Celasun and Rodrik (1989:666) assert that these measures went further than the proposals and requirements of the IMF. It was even rumored that the

[215] As Yalman (1997:11) argues "…there was the tendency to play down the role of the IMF and/or the World Bank in the policymaking process so as to drive home the point that nitty-gritty of the market reforms were "home grown".

[216] The Standby arrangement signed in June 1980 was for a total of SDR 1.25 billion, which "amounted to 625 percent of Turkey's IMF quota at the time, and together with previous purchases brought total IMF commitments to Turkey to 870 percent of quota, the largest multiple awarded by the IMF until then" (Celasun and Rodrik, 1989:758)

[217] Öniş (2003:3)

devaluation and price hikes announced on January 24, 1980 had been in excess of what the IMF was willing to settle for[218].

Liberalization process in Turkey has started with the stabilization program of 1980, which initially emerged as a response to the macroeconomic difficulties of the Turkish economy at the end of the 1970s. The whole reform process represented the "most significant break away from Turkey's inward-looking and interventionist trade and industrialization strategy"[219] and "incorporated the first structural steps towards a market-based mode of regulation"[220]. Therefore, the distinguishing characteristic of the 1980 program was that Turkey, for the first time, initiated a set of policies aimed at a permanent transformation of the economy.

It is argued that although the stabilization program of 1980 was specific on policy measures, it was not so explicit for the magnitude and sequence of objectives sought in the future performance of the economy[221]. The measures introduced were a series of packages[222], aimed at coping with the severe problems of inflation and balance of payments in the short-term i.e. stabilization, and export-led growth, as well as achieving outward-orientation of the economy in the long-term through a sequential liberalization and structural adjustment in the economy[223]. The leading role in this restructuring process would be taken by the private sector rather than the government as used to be in

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[218] See Celasun and Rodrik (1989:759) for details of the story.

[219] Şenses (1984:273)

[220] Boratav and Yeldan (2001: 4)

[221] Celasun and Rodrik (1989:666)

[222] Measures included a wide range from fiscal and monetary ones to a radical shift in foreign trade regime and financial system. See Baysan and Blitzer (1990:10) for full list of policy objectives.

[223] Celasun and Rodrik (1989:666), Sak (1995:55), Togan (1996:6)

previous periods. Therefore, the policy makers focused on the task of designing the necessary framework to encourage the private sector[224].

At the outset, stabilization objective dominated the liberalization objective. The 1980-82 period could be named as the first phase[225] of the reform process which started with January 24, 1980 measures until Özal's resignation in July 1982. From this time until November 1983, although there were minor reversals in reform[226], most of the reforms were sustained. The decisive shift in the direction of liberalization took place in December 1983 and January 1984, together with the newly elected administration. Therefore, the Turkish liberalization experience that took place in the 1980s will be examined in two phases; the first being during 1980-1982 period and the second phase that started in 1983 soon after the elections in November of 1983.

3.4. The First Phase of the Reform Period: 1980-82

3.4.1. Trade Liberalization

The policy objectives of the 1980 program related to trade policy included the adoption of a flexible exchange rate regime; more effective export promotion measures to encourage rapid export growth; and gradual import liberalization.

Policymakers' preference was to pursue macroeconomic stabilization and export-led recovery simultaneously. While in the early

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[224] Altınkemer and Ekinci (1992:1)

[225] Sak (1995:55); Altınkemer and Ekinci (1992:2) named 1980-83 period as the first phase being different from our classification.

[226] "After Özal's departure from the government in 1982, along with the core of his economic team, the military government reversed the real depreciation that had been launched with maximum devaluation in 1980; some real appreciation of Turkish Lira took place in 1982". Öniş and Webb (1998:353)

stage, achieving a rapid disinflation was the primary motive, policymakers also desired to abstain from the potentially adverse consequences of a prolonged recession in the Turkish economy. Therefore, "an early success in export promotion was perceived to be essential to restore creditworthiness, establish the credibility of liberalization measures and extend penetration in foreign markets for a sustained export drive in the future"[227].

Hence, after reducing inflation from over 100 percent in mid-1980 to around 30 percent in mid-1981, policymakers started to emphasize export-led growth. Then, export promotion has become a crucial element of the trade strategy in terms of its role in improving international creditworthiness and current account balance; compensating for the depressed domestic demand as well as maintaining sustainability of import liberalization[228]. Export promotion policy relied on three instruments: exchange rate policy, credit policy and fiscal incentives[229].

Export promotion measures of the government were in the form of export tax rebates, preferential export credits[230], foreign exchange allocations, duty free importation, and the foreign exchange retention scheme during the 1980s.

Exchange rate policy constituted one of the main pillars of trade liberalization. The purpose was twofold: one being to restrict domestic demand, and the other being to increase the external competitiveness

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[227] Celasun and Rodrik (1989:667)

[228] Baysan and Blitzer (1990:13)

[229] See for details of fiscal incentives, Togan (1996:22)

[230] During the first half of the 1980s, a substantial difference occurred between the general lending rate and the rate of interest applied to export credits.

of the Turkish economy[231]. In that sense, depreciation was important in terms of both export growth and import restriction in the face of import liberalization.

In January 1980, Turkish lira was substantially devalued by 136.6 percent, amounting to 30 percent real devaluation. This large devaluation was followed by frequent small devaluations through May 1981. From May 1981 onward till the end of 1983, the Central Bank adjusted exchange rates daily against a currency basket and banks were allowed to fix their own rates around a narrow band of the Central Bank rate.

Policy reform in import regime was gradual, as significant import liberalization measures were delayed until the end of 1983. In 1980, cost of importation was reduced as the stamp duty on imports was lowered from 25 % to 1% and import regulations were simplified. In 1981, the Quota List was partly phased out and many items were transferred from Liberalized List 2 to the less restrictive Liberalized List 1. Furthermore, guarantee deposit rates were reduced from 25-40% range in 1979 to 7.5-15 % range in 1983[232].

3.4.2. Domestic Financial Liberalization and the Financial Crisis of 1982

Domestic financial liberalization began before trade liberalization. The first step towards financial deregulation had been taken in July 1980, as the government deregulated deposit rates and freed non-preferential lending rates. The aim was to attract savings into the financial system and encourage competition among financial institutions in order to deepen the financial sector. Secondly, banks

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[231] Sak (1995:58)

[232] Şenses (1984:291), World Bank (1982:99), Günaydın (1990: 49), Togan (1996:11), Baysan and Blitzer (1990:15).

were allowed to issue negotiable certificates of deposits (CDs). Hence, certificates of Deposits (CDs) were added to the financial regulatory framework as a new instrument[233].

The Turkish financial system was dominated by commercial banks. Most of the private banks, with the major exception of İşbank, were owned or controlled by industrial conglomerates. While new entry into the banking system was subject to the permission of the government, prior to deregulation, the governments were conservative in granting the permission. In this structure, as "some of the private banks were established by industrial groups controlled by individual families", "small banks and provincial banks were established by local businessmen and later acquired by industrial groups and transformed into nation-wide banks"[234].

The other set of players in the Turkish financial system were brokerage houses. Most of the brokerage houses were established in 1979 together when industrial groups started to issue bonds. Hence, industrial groups that did not have banks started to establish their own brokerage houses[235].

Following deregulation of interest rates, "larger banks encouraged members of the banking system to form a cartel and set deposit interest rates collusively, at a rate higher than the pre-liberalization level (30 percent on annual deposits)"[236]. After a brief period of interest rate competition among the commercial banks, a "gentlemen's agreement", which put a ceiling on the nominal rates, was set among major banks and all banks agreed to comply with the

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[233] Atiyas (1990:134); Sak (1995:64)

[234] Atiyas (1990:134)

[235] Atiyas (1990:134)

[236] ibid.

rates set by the agreement. Nevertheless, the agreement did not settle the competition, as small commercial banks had continued interest rate competition to attract more funds. While a new gentlemen's agreement was signed in February 1981, and the rate of interest on one-year deposit was increased to 50 percent, this agreement was also broken. The real net interest rate on decontrolled deposits went up from an average of minus 35.8 percent in 1980 to an average of 18 percent in 1982 (Table 3.3). On the other side, large banks with high levels of deposits were faced to operate under the conditions of increasing costs[237].

Table 3.3: Turkey: Real Rate of Return, 1980-1989

%	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Inflation Rate (WPI)	107.2	36.8	25.2	30.8	62	40	26.7	39	70.5	64
Nominal Interest Rate *	33	45	50	45	45	55	48	58	83.9	66.6
Real Interest Rate	-35.8	6	18	11.1	-3.5	8.2	14.2	19.7	9.3	-1.8

* Interest rate of the 1-year time deposit account

Source: State Planning Organization (1990:31)

Furthermore, high deposit interest rates accompanied by the tight monetary policy led to high lending rates, in both nominal and real terms, which in turn meant increased non-performing loans of the banking sector. "Lending rates for non-preferential credits reached unsustainable levels of 25-30 percent in real terms in 1981-82"[238]. Firms were heavily dependent on the banking sector in terms of meeting their financing needs. Therefore, in the face of rising interest rates, most firms found themselves in a situation of having to service sizable debts, which in turn meant increased default on bank credit. It is argued that a significant part, of around 40-60 percent, of the nominal credit

[237] Sak (1995:64); Atiyas (1990:135)

[238] Celasun and Rodrik (1989:676)

expansion, during 1981-82 period, was directed toward refinancing the interest payments connected with non-performing loans[239].

Banks had attempted to increase their share of deposit market. Bound by the "gentleman's agreement", small banks continued competition by issuing CDs and marketing them mostly through unlicensed money brokers (called bankers) besides brokerage houses that were subsidiaries of banks and holding companies. The bankers were a group of money brokers who offered ever-increasing rates of return to deposits in order to raise more funds[240]. They also bought corporate bonds at a discount and sold them to investors promising attractive interest yields. They lent heavily to the private corporate sector without bank financing at rates higher than non-preferential bank lending rates. Bankers used CDs and bonds as collateral for their operations, while the secondary market for these CDs and bonds were absent. Only the brokerage houses, bankers and banks issuing the CDs were able to buy them back[241].

This process was analogous to Ponzi scheme of the 1920s. The idea is to collect funds by offering high rates of return and make interest payments of yesterday's investor through the deposits of newcomers today. The rate of interest has to be at an increasing pace to collect the same volume of funds. However, the system eventually collapses.

Things began to getting out of hand, in November 1981, monetary authorities prohibited banks from marketing CDs through brokers. However, this did not prevent some brokerage houses to continue with the practice, one of which was Banker Kastelli, the

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[239] Altınkemer and Ekinci (1992:4)

[240] Sak (1995:64) and see also Akyüz (1990:2), Denizer et al. (2000:6).

[241] Sak (1995:64)

largest brokerage house in the market. Kastelli mainly marketed bonds of private sector companies at the beginning, i.e. until the end of 1980. Later, as it fell into difficulty of finding a steady supply of securities, Kastelli went into the CD business in early 1981[242]. Atiyas (1990:136) asserts that while in the early stages, Kastelli had chosen its client banks with caution and avoided marketing the CDs of risky banks. He adds that later, after the ban on issuing CDs through bankers in 1982, due to illiquidity problems, Kastelli issued CDs of those risky banks that the banker had earlier tried to avoid.

The scheme in Turkey collapsed in 1982 after the collapse of the Kastelli, which was followed by the collapse of nearly all money brokers and a number of small banks[243]. In June 1982, during a meeting of banks, the monetary authorities became aware of the extent and gravity of the problem. In the face of the fact that several banks were insolvent and unable to meet their payments on CDs they had issued, the Central Bank initially provided liquidity to banks and monitored them closely. As some of the bureaucrats resigned in July, the new team changed the policy framework. The government had taken over the liabilities of five banks[244], amounting to a cost of 2.5 percent of GDP[245]. Each of these banks were either controlled or owned by holding companies, while three of them had their own brokerage houses. Moreover, several major brokerage houses also went bankrupt. The Central Bank was reauthorized to set ceilings on deposit rates at the end of 1982[246].

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[242] Atiyas (1990:136)

[243] See Atiyas (1990:136-144), for details of the crisis evolved.

[244] İstanbul Bankası, Hisarbank, Odibank, İşçi Kredi Bank and Bağbank

[245] Denizer et al. (2000:7)

[246] Celasun and Rodrik (1989:677)

3.4.3. An Evaluation of the Liberalization Policies in terms of Sequencing and Lessons from the Crisis of 1982

The ensuing financial crisis revealed the fact that interest rate liberalization by itself could not be taken as an automatic device that adjust the financial sector to new conditions.

In terms of sequencing of the liberalization measures, domestic financial markets were liberalized first. Trade liberalization process came after, while a major part of trade liberalization and capital account liberalization were left to the second stage of the liberalization reforms. When compared to "McKinnon's recipe"[247], at first sight, the Turkish liberalization experience seems to have followed the right course of action in terms of sequencing. In the literature, many authors[248] declared their view as "the sequencing of the Turkish liberalization process is in accordance with the pattern prescribed in the literature".

On the other hand, we believe that there is a misinterpretation of the "McKinnon's recipe". McKinnon (1982) stresses the importance of the "stabilization first" condition before implementing liberalization reforms. In other words, McKinnon (1982) suggests the maintenance of trade restrictions, capital controls and domestic financial regulations until the government has first reduced its fiscal deficit and then gradual removal of controls in a particular order. The main criticism directed to Argentina's sequencing of liberalization reforms during late 1970s was the inability of the government to bring public sector deficit under sufficient control[249]. Therefore, an evaluation that takes into account

[247] Frenkel (1982) shares the same views with McKinnon.

[248] Uygur (1993:9)

[249] McKinnon (1982:193)

just the plain order of liberalization reforms without considering the satisfaction of the major preconditions will be misleading.

Lack of Macroeconomic Stability

Therefore, before turning our attention specifically to the order of liberalization reforms, we first need to evaluate the macroeconomic environment under which the liberalization reforms were initiated. When Turkey liberalized its foreign trade regime and deregulated its financial sector, economic stability had not been attained. Public sector borrowing requirement was quite high with 8.8 percent of GNP in 1980. Following an initial fall in 1981 and 1982, it went up again in 1983 to almost 5 percent of GNP (Table 3.4).

Table 3.4: Selected Macroeconomic Indicators of Turkey, 1980-1983

Percent	1980	1981	1982	1983
Inflation (WPI)	107.2	36.8	25.2	30.8
Current Account/GNP	-4.7	-2.5	-1.4	-3.1
GNP Growth rate	-2.8	4.8	3.1	4.2
PSBR/GNP	8.8	4	3.5	4.9

Source:SPO

Hence, Turkey, first of all, had to bring under control its fiscal deficits before proceeding with the liberalization reforms. McKinnon (1982) argues that only after fiscal deficits are eliminated, a country should proceed to eliminate interest ceilings on demand deposits and various domestic financial controls and to liberalize trade.

Hence, along with persistent and large fiscal imbalances, the need for stabilization was apparent before the liberalization process had started. However, the whole liberalization process had taken place under an unstable economic environment. Financial liberalization had aggravated these imbalances to some degree rather than eliminating

them. Hence, the liberalization and stabilization policies in Turkey were attempted simultaneously.

Weak Regulatory and Supervisory Framework of the Banking System

Furthermore, the legal and institutional framework was not adequate for supervising and regulating such an abrupt move towards domestic financial liberalization. Therefore, the first phase of financial sector reforms in the early 1980s (1980-1982) was undertaken in the presence of a weak regulatory framework of the financial sector. Some features[250] of the financial markets of that period can be summarized as follows:

i) There was no national agency responsible for the supervision of the activities of non-bank financial intermediaries. They were licensed by city governors without any concern for their specific operations.

ii) There were no prudential rules and requirements. Prudential control was also weak in the case of banks.

iii) While there were no accounting standards for non-bank financial intermediaries, the accounting standards for banks were not reflecting the changing conditions.

iv) There were no collective markets for securities and Certificates of Deposits.

Since there was no regulatory structure to oversee the players in the market when financial liberalization reforms began, risky behavior of banks and brokers could not be controlled. Moreover, there were no insurance mechanisms to build confidence towards banks and the system and to safeguard against bank runs.

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[250] Sak (1995:65)

The financial crisis of 1982 represents the turning point in terms of the policies designed to change the Turkish financial system. The crisis in 1982 provided important lessons in terms of prudential regulation and supervision of the financial institutions. The financial crisis in 1982 brought the issues related to banking regulation and supervision to the forefront and only after that, in the second phase of the reform process starting in 1983, the structural and institutional characteristics of the Turkish financial system began to be discussed[251]. As a result, importance of the sequencing of the reforms and the need for appropriate regulatory and supervisory legal and institutional framework were also recognized.

Most importantly, it revealed the fact that timing and pace of reforms should be given utmost importance. However, reflection of this fact to the implementation of reforms in the aftermath of 1982 is questionable.

3.4.4. Policy Environment in the 1980-82 Period

Despite ineffective policy trails in the period preceding 1980, the 1980 stabilization program started with an initial strength and then implementation was sustained. Interaction of certain specific factors had been instrumental in the continuity and relative success of liberalization reforms in the early 1980s.

3.4.4.1. Relations with the BWI

One of the factors was the role of the World Bank and the IMF. Turkey received exceptional capital flows from the IMF and World Bank from 1980 on. The post-1980 period was characterized by debt relief, balance of payments assistance and policy support of the major bilateral creditors (mainly the OECD countries) and multilateral

[251] Sak (1995:60)

institutions. Celasun and Rodrik (1989:751) made a comparison of Turkey against seventeen highly indebted less-developed countries in terms of net capital inflows in the post-crisis period[252]. They (1989:752) concluded that "the net resource transfers to Turkey were substantially larger during the first few years after its debt crisis than were the corresponding transfers to the other countries". Moreover, it is asserted that "Turkey was treated more favorably by the international financial community than were the post-1982 cases of near-default"[253].

Besides its size, the timing of the external assistance had been instrumental in neoliberal policy implementation. It is noted that during the first stage of the liberalization episode in 1980-1983 period, the cumulative net resource transfer (excluding the minor items connected with foreign direct investment) was nearly $2 billion[254].

Moreover, success of the Turkish experiment was quite important for the World Bank as well as the rest of the international community. "Having already channeled a significant amount of resources to Turkey, they clearly wished to demonstrate it as a "model" for the rest of the developing world."[255] Later, as the IMF and World Bank had stressed trade and financial liberalization in their program for less developed countries (LDC) with debt servicing difficulties in the aftermath of debt-service moratorium of Mexico in August 1982, Turkey's experience at that time was given as an example of successful application of their liberalization focused approach to the management of the LDC debt crisis[256].

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[252] See also Öniş (1998a:246)

[253] Ceasun and Rodrik (1989:752)

[254] Celasun and Rodrik (1989:664)

[255] Öniş (1998a:247)

[256] Celasun and Rodrik (1989:663)

A special feature of the relationship with the international institutions in the early 1980s is that the World Bank took the leading role in Turkey, while the IMF operated in the background. Since the politicians were aware of the damage that would be led by being associated too closely with the IMF in the public mind, the World Bank became the dominant partner in relations with the Turkish authorities. The World Bank also achieved to maintain a low public profile[257]. The qualitative nature of the World Bank's conditionality allowed an element of flexibility as well as greater cooperation and commitment on the part of the government. During 1980-84 period, the World Bank provided five successive structural adjustment loans (SALs) amounting to $1.6 billion, the largest number of such loans ever made to a single country, for supporting liberalization reforms and rationalization programs in the energy, agricultural and financial sectors as well as regular project lending[258].

From the side of these institutions, there was close collaboration between the IMF and World Bank in the implementation of policies. They maintained close institutional contact through regular consultations and joint membership of missions[259]. The IMF's concern was the management of aggregate demand and the payments regime. Implementation was monitored through standard performance criteria, which emphasizes "interest rate reform, ceilings on net domestic assets of the central bank, sub-ceilings on central bank credits to the State Economic Enterprises (SEEs), limits on contracting new external debt and currency depreciation in a unified framework". These were complemented by the World Bank with a focus on the issues such as exchange rate policy, "trade liberalization, resource mobilization, financial development, public sector investment planning, SEE

[257] Öniş and Kirkpatrick (1998:131)

[258] Celasun and Rodrik (1989:672,757); Öniş (1998a:246)

[259] Öniş and Kirkpatrick (1998:144)

reorganization, and sector-specific issues"[260]. The World Bank was quite effective through its conditionalities for import liberalization. SALs were envisaged in five successive phases from 1980 to 1984 to ensure gradual import liberalization.

Table 3.5: History of IMF lending arrangements with Turkey, (1979-2002)

Facility	Date of arrangement	Date of expiration or cancellation	Amount agreed (millions of SDRs)	Amount drawn
Stand-by arrangements	Feb 04, 2002	Feb 03, 2005	12 821	11914
Stand-by arrangements	Dec 22, 1999	Feb 04, 2002	15 038	11739
of which:				
SRF	Dec 21, 2000	Dec 20, 2001	5 784	5 784 9
Stand-by arrangements	July 08, 1994	Mar 07, 1996	611	461
Stand-by arrangements	Apr 04, 1984	Apr 03, 1985	225	169
Stand-by arrangements	June 1983	Cancelled at request of new government after elections of Nov. 1983	225	
Stand-by arrangements	June 1980	June 1983	1250	1250
Stand-by arrangements	July 1979	June 1980	250	230
Stand-by arrangements	April 1978	April 1980	300	Not fully drawn

Source:IMF
http://www.imf.org/external/np/tre/tad/exfin2.cfm?memberKey1=980&date1Key=2006-02-28

[260] Celasun and Rodrik (1989:672)

Table 3.6: World Bank Structural Adjustment Loans (SALs) for Turkey, 1980-84

Loan	Date of Approval	Amount (million $)
SAL 1	Mar. 3, 1980	200.00
Supplement	Nov. 18, 1980	75.00
SAL 2	May 12, 1981	300.00
SAL 3	May 27, 1982	304.50
SAL 4	May 23, 1983	300.80
SAL 5	June 14, 1984	376.00

Source: Yağcı et al. (1985) as given in Celasun and Rodrik (1989:671)

3.4.4.2. Military Regime

The second factor which created a favorable environment in terms of policy implementation was the presence of military regime. First of all, as an impact of the military regime during 1980-83 period, the economic program of 1980 was implemented under lack of broad political participation and contestation, which were "clearly instrumental in providing the technocrats with the requisite autonomy to introduce a wide range of radical reforms and the ability to withstand the distributional consequences"[261]. It is argued that, however, "the program did not sufficiently benefit from critical evaluations and possibly constructive proposals of the various groups of participants in the political and economic life of the country"[262].

Furthermore, existence of military regime from September 1980 to November 1983, provided not only political support but also ensured continuity in the policy process and facilitated legislative and administrative arrangements pertaining to the structural components of

[261] Celasun and Rodrik (1989:678-79)

[262] Celasun and Rodrik (1989:678)

the program[263]. Moreover, resistance from different parts of the society, such as labor, was also restrained through eliminating the right to strike in the presence of the military government. Thereby, labor was automatically excluded from the decision-making process[264].

3.4.4.3. Role of the Leader: Özal

Third factor that instituted continuity in the policy making process in the early 1980s was presence of technocratic elite within state and the continuity of Özal's leadership. While Özal was the principal technocrat behind the program when it was announced by the Demirel government in 1980, the military regime retained him as deputy prime minister during 1980-82. On the one hand, continuity of leadership contributed to a quick recovery from the deep economic crisis in the late 1970s. Furthermore, this had also played a major role in enhancing the credibility of the stabilization-cum-structural adjustment program supported by IFIs such as the IMF, the World Bank and the OECD. It is even argued that the bold initiatives of Özal helped to accelerate the momentum of the liberalization process in the Turkish economy, notably in the areas of trade and capital account liberalization[265].

This was also clearly evident during the one-year period from November 1982 to November 1983 during which Özal was absent from the government, while military government was still in power. Özal resigned on July 14th, 1982 after the Bankers' crisis in June 1982. In November 1982, a new constitution was adopted by referendum. The military government continued its rule until general elections in November 1983. During that one-year period when Özal was absent,

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[263] Celasun and Rodrik (1989:664)

[264] Öniş (1998a:246)

[265] Öniş (2004:2)

policy deteriorated as budget deficits got larger and the exchange rate was increasingly overvalued. Therefore, this period reflected the fact that the primary force behind the reform program was not solely the military government.

On the other hand, it is asserted that Özal's major negative impact on the Turkish economy has been his tendency to ignore the need to develop a strong institutional infrastructure as well as to underestimate the importance of the rule of law for a well-functioning market economy[266], as happened during the 1980-82 period, which ended up with financial crisis of 1982.

3.5. The Second Phase of the Reform Period: post-1983 period

Soon after the elections in 1983, a second wave of economic reforms mainly focusing on capital account liberalization and import regime was initiated.

3.5.1. Domestic Financial Liberalization

After the financial crisis, in early the 1983, the government authorized the nine largest banks to set interest rates and allowed the smaller banks to pay a premium. However, due to reluctance of the large banks to raise interest rates to positive real levels, in December 1983, the Central Bank was authorized to determine deposit rates and to review the rates, at least every three months, on the basis of fluctuations in the inflation rate and in other economic developments[267]. Starting from 1984, deposits rates were raised sharply and generally had been kept above the rate of inflation. This policy lasted until 1988. Following the convertibility decision in 1989, banks

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[266] Öniș (2004:2-3)

[267] Central Bank (1985:24)

were allowed to set their own interest rates in consultation with the Central Bank[268].

3.5.2. Reforms in the Financial Markets

Capital Markets

The Istanbul Stock Exchange was opened in 1985 and became operational in 1986. As a number of new instruments were introduced along with the development of securities markets, liberalization of capital movements in 1989 had contributed further to the growth of the securities markets by allowing nonresidents to invest in domestic securities quoted on the capital market.

Government Securities Auctions

Before the 1980s, fiscal deficits tended to be financed by direct monetization (short-term advance facility) of the Central Bank, instead of issuing securities, as mentioned previously. In May 1985, the government began to issue Treasury bills and bonds to finance budget deficits. The government securities auctions provided the preconditions for the initiation of open market operations at the Central Bank and the formation of a secondary bills and bonds market at the Istanbul Stock Exchange[269].

Following the financial crisis in 1994, the short-term advance facility of the Central Bank was first limited and then gradually

[268] Sak (1995:66) and Akyüz (1990:99)

[269] CBRT (2002:13)

lowered[270] until 2001 when it was totally abolished with the new Central Bank Law.

Money Market Reforms

An interbank money market for short-term borrowing facilities, which is the most important institutional change, became operational in 1986. The purpose was to satisfy the short-term liquidity requirements of the banks by mobilizing the excess liquidity elsewhere available within the banking system. The CBRT developed its ability to control the liquidity and interest rate in the market through interventions. The Interbank Money Market at CBRT has provided efficient functioning of the banking sector and developed cash management understanding[271].

The banks were required to keep collateral at the Central Bank to be able to do transactions in the Interbank Money Market, while this creates transaction costs to the participants and limit the exposure of banks. These limitations led to the emergence of an alternative Interbank Market in İstanbul in the 1990s where the transactions are not collateralized and the rates of interest are higher due to uncovered counterparty risks.

The CBRT began open market operations as the main tool in implementing monetary policy in 1987. The open market operations mainly aimed to control money supply. In 1988, Foreign Exchange and Banknotes Markets were established at the Central Bank and started the daily fixing sessions of exchange rates. This market is accepted as another monetary policy tool for managing foreign exchange reserves more effectively. The Central Bank announced in January, 2002 that it would gradually end its intermediary function in Interbank Money

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[270] It was limited by 12% of the expenses of the current year's total general budget appropriations over the previous fiscal year's total budget appropriations and reduced to 10% in 1996, to 6% in 1997 and 3% for subsequent years (CBRT, 2002:14).

[271] CBRT (2002:15); Sak (1995:74)

Market and Foreign Exchange and Banknotes Markets by December 2nd, 2002[272].

3.5.3. Exchange Rate Regime

In 1983, the multiple exchange rate practices introduced previously were eliminated. On July 7th, 1984, the exchange rate regime was broadly liberalized with Decree 30[273]. In 1985, banks were allowed to determine their exchange rates for their commercial, non-commercial and interbank transactions freely[274]. The government's policy was a real depreciation, which amounted to a PPP-plus rule until 1988, as the Central Bank slowed down the rate of depreciation after 1988[275].

In September 1988, an official foreign exchange market, the participants of which are banks and the authorized foreign exchange bureaus, was opened under the auspices of the CBRT. Thereby, the exchange rate for the Turkish lira would be determined according to supply and demand conditions. Furthermore, it provided a tool for the more efficient management of foreign exchange and the currency reserves of the banking sector. [276]

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[272] CBRT (2002:15)

[273] For details, see CBRT (2002:12)

[274] CBRT (2002:12) and Sak (1995:67)

[275] CBRT (2002:6)

[276] Bayazıtoğlu et al. (1991:6)

3.5.4. Trade Liberalization

Export Promotion Policies

Preferential export credits were terminated with the intention of less reliance on direct cash incentives in 1985. However, in 1986, preferential export credits were reintroduced and the scope of export premia was extended, as preferential export credits began to be extended through Eximbank after 1987[277].

Liberalization of the Import Regime

The 1984 reform of the import regime had a particular importance for the liberalization of import system and represented a major break with the past. Basically, under the new regime, imports were classified under three lists and those not prohibited explicitly could be imported. The reductions in quantitative restrictions were accompanied by cuts in the rates of customs duties. However, these measures did not provide elimination of licensing and tariff protection for all sectors[278]. In 1985, an important step was taken towards eliminating quantitative restrictions with the abolition of the Prohibited List except three items (weapons, ammunition and narcotics).

In 1989, import liberalization gained further momentum with the reduction of tariffs and levies on imports and the number of goods subject to licenses. The government also introduced an "anti-dumping law" to protect domestic production from unfair competition in July 1989. In 1990, import guarantee deposits and licensing were phased out entirely as a new list called "The List of Investment Goods" was

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[277] For detailed information regarding each export incentive, see Togan (1996:22-29), Baysan and Blitzer (1990:14).

[278] For details related to measures of the 1984 Import Program, see Günaydın (1990) and Togan (1996:12).

created. Furthermore, customs duties and Mass Housing Fund (MHF) levies were consolidated in a single list. In January 1993, a new set of measures was introduced with elimination of all tariffs and tariff-equivalent charges other than customs duty and MHF charges, in line with the commitments given to the EU[279].

According to the Customs Union Agreement with the EU that came into force on January 1, 1996, Turkey eliminated all the duties and MHF charges imposed on EU and EFTA products as well as all the quantitative restrictions, and began to impose common customs duties for the third countries. However, import duties on some specific goods (car, truck, leather, shoes, ceramics etc.) were decreased gradually to the common customs duties level imposed by the EU until 2001 (CBRT, 2002:10).

3.5.5. Capital Account Liberalization

In the post-1980 period, in line with the reform process of 1980 Program, capital account liberalization started with the Decrees No. 28 and 30 that had been effective in December 1983 and July 1984 respectively. They brought partial freedom by allowing only authorized banks, corporations holding investment incentive certificates and foreign trade companies to contract for foreign loans. Furthermore, they allowed major freedom to non-residents to acquire financial or real assets within the country and repatriate the proceeds or capital. More specifically,

i) Commercial banks were given more authority in aligning their foreign exchange positions.

[279] CBRT (2002:9)

ii) Exporters were permitted to hold a portion of their earnings as foreign exchange sight deposits with commercial banks.[280]

iii) Banks were allowed to accept foreign exchange deposits including those of resident Turkish citizens.

iv) Banks were allowed to engage in foreign exchange operations within certain limits in proportion to their foreign exchange liabilities;

v) Authorized banks were allowed to hold foreign exchange positions abroad and engage in forward trading in international markets.

vi) The surrender requirement, the proportion of foreign exchange acquisitions that banks are obliged to sell to the Central bank was reduced in the case of export earnings and was eliminated for invisibles,

vii) Restrictions on foreign travel and investment from abroad were eased and simplified.[281]

Thereafter, Turkey quickly liberalized its capital flows, achieving almost full capital account liberalization in 1989 with Decree No. 32. With this decree, major steps were also taken for convertibility. Turkey announced to the IMF in April 1990 that she accepted obligations of Article VIII, sections 2, 3 and 4 of the IMF's Articles of Agreement, meaning full convertibility of TL[282]. Decree No. 32 included

- ✓ The residents can buy foreign exchange without any limitation from the banks and special finance institutions and they are not subject to any restrictions for keeping foreign exchange.
- ✓ Foreign exchange corresponding to any services rendered by residents for non-residents could be brought into country.

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[280] Bayazıtoğlu et al. (1991:6)

[281] Bayazıtoğlu et al. (1991:6)

[282] CBRT (2002:15); Sak (1995:67)

- ✓ It is for non-residents to buy and sell all the securities listed at the Stock Exchange and the securities issued upon the permission of the Capital Markets Board.
- ✓ It is free for residents to purchase and sell through banks and special finance institutions, the securities quoted at the foreign exchange as well as treasury and government bonds which are denominated in the currencies bought and sold by the Central Bank and to transfer their purchase value.
- ✓ Turkish residents are free to issue, to introduce and to sell securities abroad. Residents are free to bring securities to Turkey and to take them out with them.
- ✓ The proceeds of sales and liquidation of foreign capital may be transferred freely out of the country by the banks and special finance institutions.
- ✓ Obtaining foreign credits is liberalized.
- ✓ Non-residents are allowed to open Turkish lira accounts and to transfer principal and interests accruing to these accounts in Turkish lira or foreign exchange.
- ✓ Blockage on real estate sales is removed and transfer of sales income is liberalized.
- ✓ Non-residents are allowed to buy and transfer foreign exchange and sell Turkish lira abroad without any limitation.
- ✓ The banks and private financial institutions are obliged to give information about the transfers exceeding 500,000 US dollars or its equivalent of foreign exchange, except import, export and invisible transfers.
- ✓ Turkish residents are free to establish liaison offices, representatives etc. abroad.
- ✓ Residents were permitted to make direct investment abroad of up to US$25 million or its equivalent subject to prior approval; nonresidents were allowed to buy and sell any type of Turkish securities

on the stock exchange and transfer abroad the income of these securities.

Furthermore, in February 1990, residents were allowed to invest abroad in cash up to US$5 million (prior approval required for larger investments) and to secure foreign credits abroad, provided that they used banks or special financial institutions as intermediaries; nonresidents were allowed to purchase specified securities listed on the domestic stock exchange. In July 1991, nonresidents were allowed to purchase foreign exchange and transfer it abroad without limitation, and to transfer Turkish liras abroad; residents were permitted to sell freely abroad securities issued by companies in Turkey; and residents were allowed to issue securities and guarantees in foreign currency.

3.5.6. Relations with the BWI in the post-1983 era

The World Bank and the IMF divided the areas of responsibility from 1980. While the IMF's conditionality focused on monetary and fiscal policy, the exchange rate and public sector financial management, the Bank's concern was on SEE reform, trade liberalization, export promotion and rationalization of public investment. Both institutions projected a medium term financial support to Turkey.[283] Hence, the Stand-by agreement of 1980 was followed by another Stand-by arrangement of one year in 1983, which was later cancelled and replaced by a final one-year arrangement of the Özal government in April 1984[284].

In 1983, the World Bank proceeded with the Fourth and Fifth SALs, immediately after the first three SALs aimed at "ensuring that the

[283] Öniş and Kirkpartick (1998:130)

[284] Celasun and Rodrik (1989:671)

technocratic elites and especially Özal, who had resigned[285] and had been out of office after the "Bankers' Crises", would continue to implement the program once civilian rule was reestablished"[286]. After 1984, the relationship with the World Bank continued in the form of successive four sector adjustment loans in 1984-88, while the IMF continued to implement surveillance over macroeconomic policy[287].

On the other hand, it is argued that the coordination between the policies of these two institutions was not properly managed. They are criticized to have failed to develop an analytical macro framework to assess the repercussions of specific policy reforms. This, consequently, contributed to disturbance in the economic trends that eventually threatened the sustainability of the structural adjustment program[288].

The macro problems were not recognized early in the SAL process and appropriate measures were not initiated accordingly. The slippage in meeting the conditions of the SAL program was tolerated by the World Bank so that a continuous period of financing would be provided through five SALs during the reorientation period. Since the conditionality was expressed in qualitative terms, this left a scope for different interpretations by the Bank and the borrower[289]. On the other hand, this tolerance extended by the World Bank created moral hazard problems and perverse incentives for the government in

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[285] Özal resigned on July 14, 1982. Hürriyet Gazetesi (July 15, 1982)

[286] Öniş (1998a:247)

[287] Öniş (1998a:249)

[288] Öniş and Kirkpatrick (1998:130)

[289] Öniş and Kirkpatrick (1998:144)

implementation of the program[290]. Monetary and fiscal discipline imposed by the IMF was relaxed in the post-1983 period as well.

The role of these institutions in Turkish economic policy making process declined in the late 1980s, especially after Turkey registered current account surpluses in 1988-89 and got access to international capital markets[291].

3.5.7. Macroeconomic Performance

The initial implications of the program during 1980-1987 can be evaluated as moderately successful in terms of reducing inflation, current account deficit and public sector borrowing requirement (PSBR) and reaching moderate rates of growth (Table 3.7). Especially the dramatic increase in exports was perceived to be the most striking feature of Turkey's economic performance during the period. As an ironic situation, Turkey was perceived as one of the few examples of successful transition from inward to outward-oriented policies[292].

On the other hand, the government followed an expansionary strategy and relaxed fiscal discipline in the post-1983 phase, in the face of political constraints[293] together with relative absence of pressures of international lending agencies. Series of elections in the post-1983 period also exerted growing pressure on fiscal balances. Hence, general election of November 1987 and local election of Mach 1989 had a major impact in deterioration of macroeconomic performance. Public sector

[290] Öniş and Kirkpatrick (1998:138)

[291] Öniş and Webb (1998:346)

[292] Arıcanlı and Rodrik (1990:1)

[293] Öniş (1998a:249) argues that the tension between "liberal wing" and "conservative wing" in the Motherland Party became increasingly more pronounced in the second half of the 1980s. While the "liberal wing" was in favor of proceeding with the program of economic liberalization as well as monetary and fiscal discipline, the "conservative wing" wished to use the discretionary powers of state as an instrument for broadening the electoral base of the party itself.

balance deteriorated as PSBR/GNP ratio rose to 6.1 percent in 1987. This was in conflict with the underlying program.

Since there was not an adequate tax base, this expansionist strategy was financed by government through resorting to "inflation tax". Inflation rate placed to a higher platform and became one of the most serious problems of the Turkish economy. These problems led to imbalances in the financial market, distorting financial market prices, namely interest rates. Hence, the rising fiscal deficits and inflation became the main factors behind macroeconomic instability. Moreover, the resulting macroeconomic environment with high fiscal deficits, high interest rates and high and volatile rates of inflation was also in conflict with the underlying objectives of liberalization and transition to a market economy[294].

High and variable rates of inflation generated real devaluations. Keeping real interest rate at positive levels required frequent changes in the nominal exchange rates and nominal interest rates. These frequent changes in nominal variables created major uncertainty in the business community. Private business community had been complaining about high interest rates associated with large fiscal deficits[295]. This macroeconomic environment at the same time represented a corresponding separation from the economic program.

The government's high growth strategy through intensive public investment in infrastructure activities, dominance of the public sector in the financial system were also in direct conflict with the original

[294] Öniş (1998a:250)

[295] TÜSİAD (1988)

objective involving the withdrawal of the state from economic affairs[296].

Liberalization of the foreign exchange regime in 1984 resulted in enormous currency substitution, as Turkish residents were allowed to hold foreign exchange deposit accounts. The implementation of positive interest rates and depreciation of the TL resulted in a demand for foreign exchange accounts and declining share of other financial instruments in portfolios of the private sector. In the face high inflation and real devaluation, economic agents protected themselves through holding foreign exchange deposits, which reached nearly a quarter (23%) of total bank deposits by 1987. One of the key implications of the capital account liberalization emerged as currency substitution. As the currency substitution was a major problem by the second half of the 1987, the full capital account liberalization decision was taken in 1989, which further stimulated this phenomenon of currency substitution.

3.6. Assessment of the Turkish Liberalization Experience in terms of Sequencing

On the basis of these arguments, first of all, the "stabilization first" condition was not met before starting liberalization process in Turkey in the 1980 and later years as well. By constraining our analysis to the case of financial liberalization, the price stability, fiscal discipline and more importantly institution of strong banking system through prudential regulation and supervision were not satisfied at any stages of financial liberalization. Hence, we evaluate the Turkish experience as the one that does not fit to the sequencing we have advocated.

[296] Öniş (1998a:249)

Table 3.7: Selected Macroeconomic Indicators of Turkey, 1980-1989

	Average Exchange Rate (TL/US $)	Export (fob) (mio US $)	Import (cif) (mio US $)	Foreign Trade Balance (mio US $)	Export/GNP	Import/GNP	Foreign Trade/GNP	Current Account Balance (mio US $)	GNP Growth Rate (%)	Consolidated Budget Balance (bio TL)	Consolidated Budget Bal./GNP	PSBR/GNP	WPI (%)
1980	76.0	2910	-7909	-4603	4.3	11.6	-7.3	-3408	-2.8	-166.2	-3.1	8.8	107.2
1981	110.2	4703	-8933	-3864	8.3	15.8	-7.5	-1936	4.8	-123.6	-1.5	4.0	36.8
1982	160.9	5746	-8843	-2628	8.9	13.8	-4.8	-952	3.1	-157.3	-1.5	3.5	25.2
1983	224.0	5728	-9235	-2990	9.5	15.3	-5.8	-1923	4.2	-312.6	-2.2	4.9	30.6
1984	364.9	7134	-10757	-2942	12.1	18.2	-6.1	-1439	7.1	-978.7	-4.4	5.4	52.0
1985	518.3	7959	-11344	-2975	11.9	17.0	-5.1	-1013	4.3	-798.3	-2.3	3.6	40.0
1986	669.4	7457	-11105	-3081	9.9	14.8	-4.9	-1465	6.8	-1411.5	-2.8	3.7	26.7
1987	855.7	10190	-14158	-3229	11.9	16.5	-4.6	-806	9.8	-2607.4	-3.5	6.1	39.0
1988	1,420.8	11662	-14335	-1777	12.9	15.8	-3.0	1596	1.5	-3990.2	-3.1	4.8	70.5
1989	2,120.8	11625	-15792	-4219	10.8	14.7	-3.9	961	1.6	-7672.5	-3.3	5.3	64.0

Source: State Planning Organization, Ekonomik ve Sosyal Göstergeler http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Some reversals occurred in domestic financial liberalization in the aftermath of the 1982 financial crisis, as the Central Bank took control of interest rates. However, this was relaxed following the capital account liberalization decision in August 1989 without any consideration as regards to the macroeconomic environment and situation of the banking system.

Although it seems like capital account liberalization is a logical extension of the general liberalization philosophy, it should be evaluated in terms of matching between institutional set up and the sequencing of capital account liberalization. Prudential regulation and supervision was inadequate and exchange rate policy was not consistent with other macroeconomic policies. Despite some efforts to strengthen macroeconomic policies and the financial sector, serious weaknesses remained in both areas when capital account liberalization was implemented.

Furthermore, before the introduction of the full capital account liberalization in 1989, the domestic capital markets had to be functioning properly. Therefore, timing of the capital account liberalization decision in 1989 was not so consistent with the institutional setting either.

Another important issue is that capital account liberalization is taken as "all or nothing" issue, which was later seen as a mistake also by the IMF (2002:14), rather than liberalizing individual components of capital flows. Although FDI was liberalized slightly earlier than portfolio flows in 1984, stage by stage liberalization of capital account flows was not discussed in 1989. In other words, sequencing of the capital account liberalization itself should have been discussed before proceeding to full liberalization.

Consequently, our analysis clearly shows that when the whole liberalization process in Turkey is evaluated in terms of sequencing,

Turkey fails, contrary to the general view in the literature. The whole process of Turkish liberalization experience rests upon wrong sequencing phenomenon, as all liberalization process was undertaken in the presence of macroeconomic instability. Furthermore, in terms of financial liberalization, besides unstable macroeconomic environment, inability to institute strong banking system through prudential regulation and supervision was a major weakness. Hence, although timing of the capital account liberalization seems to be in the right order as it stands at the final stage of the whole liberalization process, we evaluate it as mistakenly sequenced[297]. On the basis of these evaluations, it is not surprising that the interest rate liberalization in the early 1980s and capital account liberalization in 1989 were followed by the financial crises of 1982, 1994, 2000 and 2001.

3.7. Pace of Liberalization

Özal defined the nature of the overall strategy as a gradualist one in an interview in 1982 as follows: "Change has to be gradual; we try to have what I call dynamic programming, but in certain areas, change has to be step by step. For example, on January 24 1980, we did not free interest rates. Six months later we freed them. But real freedom came at the beginning of last year (1981), when banks started to fight each other. The same applied with foreign exchange. This year (1982) we hope to change the protection scheme, which couldn't change immediately because people were so used to it."[298]

On the other hand, in terms of the whole liberalization process, it is asserted that Özal's desire was the speedy implementation of

[297] Öniş (2004:4) also evaluates the capital account liberalization decision as a premature one, arguing that it was taken in the presence of pervasive macroeconomic instability and a severely under-regulated financial system.

[298] Euromoney (1982) as given in Celasun and Rodrik (1989:667)

market-oriented reforms[299]. It is argued that the trade liberalization process could have been a much more gradual process in Özal's absence due to resistance of the important segments of the Turkish business community. Özal's intention was to take decisions of economic reforms quickly and by-pass key institutions and norms, if such institutions and norms appeared to block the path of reforms in the short-run. On the other hand, this had resulted in serious corruption in Turkey, while the primary motive was the rapid and uninterrupted implementation of reforms[300].

In the literature, the general approach is to evaluate reforms as gradualist as well. For instance, Uygur (1993:9) and Öniş (2002:11) say gradualist approach would be a more appropriate characterization of the Turkish experience. While Gökçe (1993:59) also evaluates the pace of complete stabilization and liberalization process of Turkey as gradualist, he finds financial sector reform as not strictly gradualist. He evaluates the issue as "financial liberalization is a lengthy process, which requires acceleration and deceleration based on external factors."[301] Williamson and Mahar (1998:12), on the other hand, evaluate the pace of financial liberalization in Turkey as rapid when compared with other thirty-three country experiences.

The pace of full capital account liberalization depends both on how far a country has proceeded in implementing the policies that are preconditions for such convertibility and on its willingness to take further policy measures[302]. In the Turkish experience, at the time when domestic financial market and full capital account liberalization had been realized, some major conditions were not met to the extent that

[299] Öniş (2004:13)

[301] Gökçe (1993:71)

[302] Mathieson and Rojas-Suarez (1994:344)

was required, while willingness for further policy actions was there, which we believe was instrumental in the decision in 1980 and 1989.

In terms of the reform process that took place in the 1980s, a gradualist characteristic came to the forefront, i.e., a stage-by-stage liberalization and integration into the world approach. On the other hand, our view in terms of the pace of liberalization reforms in Turkey is that each liberalization reform episode should be evaluated by itself. Although the whole liberalization process was spread to almost a decade, for instance, trade liberalization was gradually undertaken, domestic financial market and capital account liberalization was implemented in a rather short period of time. Domestic financial liberalization decision taken in 1980 was an abrupt one. Furthermore, pace of capital account liberalization was also rapid, despite the process had started in late 1983. Although there was an option to gradually liberalize capital inflows and outflows, 1989 decision was also abrupt.

3.8. Conclusion

Shift to neo-liberal model of development in Turkey did not take place through voluntary choice but as an inevitable outcome of a major balance of payments crisis in the late 1970s. Although the IMF and World Bank were the key players in the development of the policy packages in the early 1980s and influenced the evolution of economic philosophy in Turkey, it seems that they did not dictate most of its content. Furthermore, the government also presented the January 1980 policy reforms as an internally formulated program, being independent from external pressure of the IMF.

Özal, backed by the military regime was the driving force behind these measures and policy formulation. However, views of the Turkish government under Özal's leadership were highly similar to the type of program advocated by the World Bank and the IMF. This program

received strong support from the OECD governments and international agencies. A striking change as compared to previous period was that the World Bank rather than the IMF took the role of dominant partner in relations with the Turkish authorities and the international organizations. Nevertheless, as the coordination between the policies of these two institutions was not properly managed, they failed to develop an analytical macro framework to assess the repercussions of specific policy reforms. This eventually contributed to disturbance in the economic trends and threatened the sustainability of the program.

The liberalization process in Turkey was initiated with the orthodox stabilization program in 1980. While the priority of the stabilization program was not liberalization at the beginning of 1980s, in the post-1983 period, liberalization took the leading role in the program. While the initial implications of the program during 1980-1987 can be evaluated as moderately successful, post-1987 period corresponds to deteriorating macroeconomic fundamentals in the Turkish economy.

The transitional military regime from September 1980 to November 1983 had a major role in terms of ensuring the continuity of policy implementation in the initial years through establishing political stability and eliminating the right to opposition. Military regime, to some extent, ensured the neoliberal policies to be deeply rooted in the economy. Then, after these crucial years had passed without any opposition, liberalization reforms gained momentum in later years. Furthermore, continuity of Özal's leadership for almost a decade was also a major factor in implementation of reforms without a break.

Three main factors can be considered as mainly responsible for the failures of the macroeconomic policy in the late 1980s. First of all, macroeconomic stability had not become the priority of key economic institutions. Secondly, the top bureaucrats were not autonomous from the politicians, which restricted their ability to counteract the

pressures to expand the fiscal deficit. Thirdly, Özal's concern was directed to purely political issues from economic issues in the aftermath of elections in 1987, leading to fragmentation and lack of coordination in economic decision making. Hence, in the second half of the 1980s, the top-down decision-making in the Motherland Party became increasingly a disadvantage. "Once the leader departs, coordination becomes a problem in the absence of an autonomous and internally coherent bureaucracy"[303].

In Turkey, institutional development of the regulatory and supervisory system was not parallel to the deregulation of the financial sector. Although there have been attempts towards upgrading the prudential framework for the financial sector and implementing a number of measures to bring prudential regulations close to international best practices, the financial sector always functioned with fundamental deficiencies in the regulatory framework. Hence, strong banking system through prudential regulation and supervision was not instituted and "stabilization first" step was also skipped before the initial and subsequent stages of financial liberalization.

It can be argued that successive crises that occurred over a short period of time (1994, 2000, 2001) had their origins in key decisions taken during the early Özal era as well as the decision of capital account liberalization in 1989[304].The problem was that although capital account was fully liberalized almost a decade after the program's initiation, this decision was taken in an environment of high degree of macroeconomic instability and the absence of an adequate institutional framework to regulate the financial sector. The result was a dramatic increase in short-term capital inflows, as the Turkish economy became highly dependent on these highly speculative capital flows.

[303] This was further highlighted by "the appointment of two separate ministers –Güneş Taner and Işın Çelebi- in 1989, both of whom assumed responsibility for running the economy" Öniş and Webb (1998:367)

[304] As also claimed by Öniş (2004:4)

Furthermore, short-term capital flows magnified the degree of instability as these funds were used to finance rising budget deficits. While Turkey was able to evade a crisis at the end of the 1980s, debt-led growth pattern of the Turkish economy resulted in a highly fragile environment, which brought about successive financial crisis in the post-1990 era.

In the aftermath of this decision, in the 1990s, highly fragmented party system, successive coalition governments lacked the capacity and the incentives necessary for undertaking fiscal stabilization and regulation of the banking sector, which carries primary importance for the success of financial liberalization. Therefore, the period ahead of 1989 proved that the reasons behind taking full capital account liberalization decision were based on serious miscalculations.

Despite all these negative developments which had taken place mostly under the monitoring of the IMF, IMF did not seem to lose prestige, but if anything it reinforced its grip over domestic economic policies. The fact that the IMF has had domestic supporters, some of whom reluctant, has also contributed to this outcome.

CHAPTER 4

ASSESSING TIMING OF THE CAPITAL ACCOUNT LIBERALIZATION DECISION IN TURKEY ON THE BASIS OF INTERVIEWS

4.1. Introduction

The timing of economic liberalization is quite critical in terms of generating expected subsequent economic performance. While introduction of particular reforms might be quite essential in terms of a country's economic prospects, appropriateness of these policies to the current economic environment of the country should be evaluated cautiously.

There exist two main arguments as regards to the timing of the liberalization decision. The first view is that the liberalization decision is the result of external pressures. It is asserted that pressures from international financial institutions have left no choice for many developing countries, but to liberalize[305]. Furthermore, it is claimed that the main purpose of the IMF agreements lies somewhere else, such as pushing for financial liberalization. This assertion is based on the observations that as some of the IMF agreements are not associated with balance of payments problems in the participating countries, financial liberalization is mostly associated with the IMF in developing countries. Financial liberalization, in general, has been part of the stabilization/structural adjustment programs of the IMF. Hence, it is argued that developing countries that sought financial assistance from the IMF and engaged in a stabilization program have faced growing

[305] Drabek (1999:3)

pressures to liberalize their domestic financial market and capital account restrictions since 1980s[306]. This arises from the fact that the IMF monitors the compliance with the conditionality agreement and gives credit only when the requirements are satisfied. Therefore, if the program with the IMF includes domestic financial market or capital account liberalization as a component, then the participant is expected to liberalize to receive IMF credit tranch.

The alternative view as regards the timing of liberalization decision is that it is the policy-makers in the developing countries themselves who decide whether and when to liberalize. First of all, providers of financial services, such as banks, hedge funds, pension funds and insurance companies, who are criticized to be concerned primarily of their own profits, are held responsible for pushing for liberalization of financial markets. Moreover, it is argued that it is indeed not the IMF who pushes for the capital account liberalization but the politicians who hide themselves behind the IMF. If financial liberalization brings about gains in economic growth for example, then politicians may be eager to maintain the Washington Consensus policies and liberalize their capital accounts in order to maintain their office[307]. In other words, financial liberalization pushed by the IMF may generate political benefits for the reform-oriented politicians in the developing countries and give a reason to impose their preferred policies when they face domestic opposition to economic reforms. Thereby, politicians who prefer, for instance, capital account liberalization can use the IMF conditionality to resist domestic opposition and evade the blame for the negative consequences of capital account liberalization.

[306] Li (2003:4)

[307] Li (2003:10)

In such a situation, the IMF becomes responsible for undesirable consequences of these programs[308].

The other case in which governments liberalize capital accounts is to please its key supporters who are the beneficiaries of capital account openness, mainly the financial institutions and multinational corporations. It is argued that when they become internationally competitive, they will lobby and press on their governments toward liberalizing capital controls, independent of the IMF programs[309].

In this chapter, we will discuss the role of these factors in the Turkish case focusing on the capital account liberalization in 1989. The decision of full-scale opening up of the capital account in Turkey was critical in that it created a radically different environment in the context of the 1990s. Therefore, the rationale behind it should be assessed cautiously with the aim of revealing the respective impact of political and economic factors as well as the roles played by the external and domestic actors.

The degree of openness of the Turkish economy to outside world was a major decision. In terms of its sequencing, capital account liberalization was left to the last stage. However, as mentioned before, there were some other major conditions that had to be satisfied before proceeding with the further liberalization of the capital account balances, such as ensuring macroeconomic stability and strengthening the banking system. In this perspective, we suggest that even though the capital account liberalization in Turkey in 1989 has helped Turkey's integration to the world economy, its timing should be questioned.

[308] Li (2003: 8)

[309] Li (2003:9)

We intend to reveal the rationale behind the introduction of full capital account liberalization in 1989 into the Turkish economy through interviews[310] conducted with the people who held critical positions in the decision making process at that time in Turkey. Our specific questions directed to those people have been:

- Was capital account liberalization planned in any economic program of the government, for example at the beginning of 1989 or before?
- Which policy objectives and political factors had pushed the government towards taking these decisions? Which factors was the overriding factor for the decision of the government, economic or political? Why was the government so determined in implementing the capital account liberalization in 1989?
- Was it discussed within the government bureaucracy? If yes, who were involved? If yes, what was the approach of the bureaucrats? Was the capital account liberalization decision based on a consensus or one-man decision?
- Was there any serious concern expressed in the Turkish bureaucracy as regards capital account liberalization being undertaken in an environment of macroeconomic instability and fragility of the banking sector? If yes, by whom? If yes, did issues about banking regulation and supervision come on to the agenda when the 1989 decision was made? If no, why do you think that the macroeconomic instability -high inflation and budget deficit- and weaknesses in the banking sector in that period were not seen as major impediments to capital account liberalization?

[310] Interviews have been conducted with Mahfi Eğilmez and Selçuk Demiralp on November 24, 2005; with Ercan Kumcu on November 25, 2005 in İstanbul; with Faik Öztrak on November 21, 2005 in Ankara; and with Işın Çelebi on January 16, 2006 in Ankara. In 1989, Işın Çelebi was Minister of Economy; Selçuk Demiralp was General Directorate of Banking and Exchange Department at the Treasury; Mahfi Eğilmez was Deputy Undersecretary of the Treasury; Ercan Kumcu was Deputy Governor of the Central Bank, Faik Öztrak was General Directorate at the State Planning Organization. See Appendix A for the full set of interview questions.

▪ Was there any dialogue on the subject with the World Bank and the IMF? If yes, was this at the initiative of the government or the BWI? If yes, what was the approach of the World Bank and the IMF? Did they advise against it? Did they question its timing? Did they encourage or urge to implement the decision gradually?

▪ What was the reaction of the Turkish public opinion to the 1989 decision? Was there any serious opposition from politicians or business environment or any other major segments of society?

Understanding the policy environment in the post-1983 era is quite critical to have a better assessment of the capital account liberalization decision in 1989. Hence, in this chapter, the following section will discuss the post-1983 period, which can be divided into two phases in terms of the policy dynamics: the first covering the November 1983-November 1987 period, which was characterized by "the restricted form of parliamentary democracy"[311] and the second one being the post-1987 period. In section 3, reasons behind timing of capital account liberalization decision will be discussed mainly on the basis of interviews. The final section gives the conclusion.

4.2. Changing Role of the State and Politics in the 1980s[312]

The changing nature of the Turkish state during the 1980s is critical to the process of liberalization. Hence, the exact framework of the new organization of the Turkish state has to be understood before discussing the factors leading to liberalization decisions. The Turkish experience failed to materialize "retreat of state" which was expected to occur as a result of liberalization, despite significant steps taken in direction of market economy and economic liberalization. For instance, a striking shift can be observed in the nature of state intervention in

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[311] Öniş (1998b:500)

[312] Unless otherwise stated, this section heavily draws on Öniş (1998a) and Öniş and Webb (1998)

the economy along with a considerable reduction of the government involvement in the price determination process. However, "a large public sector, a legacy of the pre-1980 era, has remained largely intact". Hence, what occurred has been a reorganization as well as further centralization of the state[313]. Furthermore, as this was not accompanied by an "expansion of the society"[314], the prime ministerial powers were strengthened and extended, the basis of which could be traced back to the Constitution of 1982.

4.2. 1. 1983-1987 Period

A number of factors were instrumental in the centralization of the state. First of all, the decision making process has shifted from the traditional bureaucratic elites to political elites surrounded by a small selected group of US-educated technocrats recruited from outside the ranks of traditional bureaucracy. This is also named by Öniş (1998a:253) as "managerial bureaucracy". In other words, new layers of bureaucracy were created. "Managerial bureaucracy", which is largely independent from both society and intra-bureaucratic pressures, was conceived as a necessary condition for the consistent implementation of the economic program[315].

These operations were aimed at three main objectives: "to deal with the problem of coordination"; "to reward political friends and punish enemies"; "to take power away from the parts of the bureaucracy opposed to Özal's economic program". With the dominance of the third objective, i.e., taking power from the old

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[313] For details of this reorganization process, see Öniş (1998a:252)

[314] This has been defined by Öniş (1998a:256) "as the development of autonomous organizations in the civil society, as measured by their ability to bargain with the state elites and the degree of their institutionalized participation in the policy formulation and the implementation process".

[315] Establishment of the "Board of the Mass Housing and Public Participation Fund" in 1984 under the direct control of the Prime Minister was an example of this process.

bureaucrats-, Özal created the Undersecretariat of Treasury and Foreign Trade, immediately after he took office as prime minister in 1983. The general elections of November 1983, which brought Motherland Party to power with a decisive majority represented a return to parliamentary democracy[316]. Özal preferred to create a new agency and transferred key powers to it, rather than reforming the old bureaucracy. This was also part of the operation towards a decline in powers of the legislature vis-à-vis the executive.

Furthermore, through creation of additional ministers of state with specific responsibilities, power of the Cabinet was weakened relative to the office of the Prime Minister. Özal headed the economic team, which consisted of four or five politicians and three technocrats. The role of old agencies shifted to less crucial functions such as revenue collection (Ministry of Finance) and forecasting (State Planning Organization). Therefore, decision-making body consisted of a limited number of ministers of state, special advisors, and high-level bureaucrats[317].

On the one hand, Özal's leadership to a selected group of technocrats was instrumental in securing the degree of consistency and bureaucratic cohesion needed to initiate structural adjustment. Hence, in the post-1983 period, liberalization policies gained further momentum and strength, as liberalization objective came to the forefront. On the other hand, within the reorganization of the state bureaucracy, politicization of the bureaucracy created a major weakness. Frequent changes of its personnel through political

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[316] However, interest group activities and union activities were restricted in the framework of controlled transition to democracy. Öniş (1998b:502)

[317] These consisted of the Undersecretary for Treasury and Foreign Trade, Governor of the Central Bank and in a weaker role the Head of the State Planning Organization (Öniş and Webb, 1998:341)

appointments created a bureaucracy, which lost a sense of common vision[318].

4.2.2. Post-1987 Period

The general elections in 1987 signify the beginning of a new era in the post-1983 period. While the government received major support in the general elections of November 29, 1987, full-scale political competition effectively restarted, as leading politicians of the pre-1980 period –Demirel and Ecevit- were permitted to participate in the general elections of November 1987.

Eighteen months after the elections in 1987, municipal elections took place on March 26, 1989, from which Özal's Motherland Party emerged only as the third party. The fragmented party system re-emerged effectively with the municipal elections of March 1989 and continued thereafter. Furthermore, the lack of correspondence in the timing of local and general elections put pressures on the party in power, as competition among parties intensified, and tended to shorten the time horizons of politicians.

After the general elections in November 1987, Özal's concern was directed to purely political issues from economic issues. Hence, as Özal was less directly involved in economic management in this period, there was a trend towards fragmentation and lack of coordination in economic decision-making. Hence, while the top-down decision-making, that is, the hierarchical decision structure of Motherland Party, under a strong and dominant leader, helped the party in the early and mid-1980s, this structure became increasingly a disadvantage in the second half of the 1980s. "Once the charismatic leader figure disappeared", Turkey "experienced major difficulties in institutionalizing the reform process and sustaining broad based support for reform, in the presence

[318] Öniş (1998b:502)

of high income inequality and severe distributional conflicts"[319]. In fact, the problem could be traced to highly centralized and insulated policy-making framework created by Özal. This insulated structure and "lack of institutionalized links with interest groups increasingly became a disadvantage for coordinating policy and managing distributional conflicts under conditions of fully competitive politics". Then, Özal was elected as President in November of 1989 and resigned from the Motherland Party.

4.3. Reasons Behind the Capital Account Liberalization Decision in 1989

The August 1989[320] measures came in the form of completing the last stage of capital account liberalization and establishment of full convertibility of the Turkish lira. The reasons behind full capital account liberalization decision in 1989 will be discussed in this section mainly on the basis of interviews conducted with the people who held critical positions in the bureaucracy at that time. For this purpose, the analysis in this section involves questions[321] directed to the interviewees, which are then followed by an analysis of the answers given in the interviews and press reports on the subject gathered from scanning the daily newspapers of the time.

Interview Question 1: *What are your views on how capital account liberalization came up to the policy agenda?*

[319] Öniş (2002:14)

[320] Announced by President Özal on August 8 in a meeting organized by Istanbul Chamber of Commerce (Milliyet, August 9, 1989) and enacted on August 11, 1989.

[321] From the whole set of 21 interview questions as given in Appendix A, questions 1 to 11 are covered in this chapter.

Interview Question 2: *Do you know whether it was planned in any economic program of the government, for example at the beginning of 1989 or any time before?*

First of all, in response to the question of whether capital account liberalization was planned by the government at the beginning of 1989 or before, all interviewees declared that there was no explicit declaration of the government at the beginning of 1989 towards implementing capital account liberalization. On the other hand, it seems that although specific timing of the capital account liberalization was not explicitly declared, it was on the agenda of the government as a final destination in the liberalization process. This view is also supported by the fact that there was a department in the Treasury, solely responsible for making preparations for capital account liberalization in Turkey, which became active following Özal's election as prime minister in 1983.

How the capital account liberalization issue came up on the policy agenda in August 1989 was explained by one of the interviewees as follows: According to him, it emerged from an inspiration of a high level bureaucrat working in the Treasury from discussions in the OECD meetings about the necessity of capital account liberalization for developing countries. Then, the story develops, as this bureaucrat, being inspired from the OECD meetings, prepared and sent a draft Decree No.32, first to Güneş Taner (Minister of Economy in charge of the Treasury) and then to Turgut Özal. Hence, the event seems to have been initiated by a government official as regards to the benefits of capital account liberalization for the Turkish economy. Then, according to this story, Özal was quick to take ownership of this proposal, as the Decree No.32 became effective as of August 11, 1989, i.e. soon after the proposal had been presented to him. Most of the other

interviewees, on the other hand, stated that they had heard this explanation, but did not attach much credence to it.

Interview Question 3: *What do you think were the main policy objectives and political factors pushing the government towards taking this decision? Which factors in your view was the overriding factor for the decision of the government, economic or political?*

Interview Question 4: *Why do you think that the government was so determined in implementing the capital account liberalization in 1989?*

When all responses are evaluated as regards to the question of which factors had motivated the government to take this decision, it seems that the decision was motivated by a mixture of economic and political considerations. Hence, the reasons behind it were two-fold. However, the general perception among the interviewees is that political factors were dominant. Our comment is that worsening economic conditions in Turkey were the underlying reasons behind this decision, as their political reflections together with some other populist policy considerations motivated Özal finally to take this decision. Hence, an interaction of the economic and political factors had been instrumental in shaping the decision of the government.

First of all, turning our attention specifically to the economic factors, the momentum of reform process entered into decline towards the end of 1980s. Furthermore, November 1987 represented the return of unrestricted party competition and distributional pressures associated with this process. Increased distributional pressures and the inability of the government to contain them manifested itself in the form of larger fiscal deficits and high inflation rates[322].

[322] Kazgan (1995:201) and Öniş (2003:6)

Hence, at the time when the government expressed its intention for capital account liberalization in the summer of 1989, Turkey was experiencing severe economic problems. Public sector deficits were high with a public sector borrowing requirement (PSBR) to GNP ratio reaching 4.8 percent of GNP in 1988 and 5.3 percent in 1989. Inflation rate was high with 70.5 percent WPI in 1988 and 64 percent WPI in 1989. Furthermore, growth rate was low in two consecutive years, with 1.5 percent in 1988 and 1.6 percent in 1989[323], in the face of an underdeveloped financial system.

As the economic conditions worsened and the reform process was delayed, the government, first of all, envisaged the large capital inflows following capital account liberalization as a way out to restore growth. In these years, growth stimulus had shifted from an "export-based" one into an "import-based" one through capital imports[324]. Therefore, one of the primary economic objectives of the government was restoring growth. It is asserted that Özal had hoped to attract large amounts of external capital through an open capital account regime[325], which, in turn, was expected to be instrumental in accelerating the pace of economic growth.

Secondly, the financing needs of the government due to high fiscal deficits and local elections in March 1989, were instrumental in the decision of full capital account convertibility in 1989. The fiscal deficit began to increase in 1986. While the year 1989 was characterized by chronic inflation and high public sector deficits, in that year, monetization of the fiscal deficit was restrained to 15% of total budgetary appropriations by a protocol signed between the Central Bank and the Treasury. As can be seen from Table 4.1, while

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[323] DPT, www.dpt.gov.tr

[324] Kazgan (1995:201)

[325] Kazgan (1995:206) and Öniş (2004:18)

the share of external borrowing was rather small, the main source of financing was domestic borrowing. Hence, it is generally claimed that easing up of the financial constraint on surging public expenditures was one of the primary factors underlying the capital account liberalization decision.

Table 4.1: Financing of Consolidated Budget Cash Deficit (Percentage Share)

(Net)	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
External Borrowing	11.7	67.9	-7.1	-49.3	32.5	-24.8	-0.4	-10.4	4.5	-5
Domestic Borrowing	17.9	93.8	50.8	39.7	41	79.6	71.2	70.5	71.6	85.7
Central Bank Advances	68.5	103.5	19.5	39.9	18.5	29.1	16	13.8	17.1	5.6
Other	1.9	-164.9	36.8	69.7	8	16.1	13.2	26	6.8	13.6
Total	100	100	100	100	100	100	100	100	100	100

Source: State Planning Organization (1990:55)

Furthermore, it is argued that excess supply of foreign exchange in the economy and current account surplus provided an opportunity for the government to take this decision, while making at the same time the consequence of this decision too risky in case of a shortage of foreign exchange[326].

Consequently, rather than the aim of satisfying final goal of the stabilization program, which was capital account liberalization, some other economic concerns have been instrumental in the decision of capital account liberalization decision.

From the political perspective, the local elections of March 1989 represented a drastic decline in the support of the ruling Motherland Party. Hence, Özal, as the Prime Minister, had lost some of his public support and experienced a major setback in the municipal elections of March 1989. When compared to the first years of the government in the

[326] Cem Boyner's comment in *Millliyet* on August 10, 1989.

early 1980s during which radical and major economic decisions were taken rather easily, Özal seemed to have lost his reformist character. Therefore, especially "Güneş Taner[327] was encouraging Özal to take major reformist decisions to regain public support"[328], especially in the form of capital account liberalization, considering the economic benefits that this was expected to bring about.

Hence, the quick move towards capital account liberalization might have been a reaction to regain popularity and electoral support on the part of Özal. More explicitly, regaining electoral support had necessitated an accelerated process of economic growth, improvement in employment prospects and a drastic decline in inflation. Öniş and Webb (1998) assert that the increase in inflation in the late 1980s was a key factor underlying Özal's loss of popularity. Thus, since large inflows of capital were expected to generate a domestic consumption and investment boom, capital account liberalization was regarded as at least a short run remedy to achieve these objectives by attracting external capital.

Akgüç (1989:11) in his column in *Milliyet* on August 26, 1989 evaluated the capital account liberalization decision as a maneuver to regain the public support and extend the government's tenure in office. He has asserted that it was a way of deceiving the public that economic prospects were bright.

Furthermore, it is probable that Özal had thought that this public support would also help him during presidential elections in November 1989. As interviewees have stated, without Özal's plans to be elected as President at the end of 1989, the scenario could be quite different. Hence, Özal's plan concerning the presidency represented a major

[327] Güneş Taner was Minister of Economy in charge of the Treasury.

[328] *Hürriyet* (August 9, 1989)

turning point. There were also comments in the press related to his announcement of Decree No 32 on August 8, 1989 that "Özal gave the message that he almost finalized his mission. It was time to take the next step, i.e. the move to Presidency"[329]. In other words, it seems that the timing of the capital account liberalization was quite linked to the timing of presidential elections, as Özal seems to have seen the next step in his career as being the president.

Interview Question 5: *Do you know whether the capital account liberalization maneuver was discussed within the government bureaucracy?*

a. If yes, who were involved?
b. If yes, what was the approach of the bureaucrats?

Interview Question 6: *Were you personally consulted?*

Interview Question 7: *What was your own view on the subject?*

Interview Question 8: *What is your position on the debate that liberalization reforms in 1989 were based on a broad consensus or one-man decision?*

Discussions concerning the Decree No.32 within bureaucracy had occurred in a rather short time period, about 20 to 30 days. Tigrel, Undersecretary of SPO, explained the situation in an interview in *Hürriyet* on August 30, 1989 by stating that the reason why a detailed discussion was not made between the SPO and the government before the Decree No. 32 had been put into force, was due to its timing. It came into force in the summer season during which most of the bureaucrats and cabinet ministers were on holiday. He added that since the government had wanted to implement this decision quickly, there

[329] *Hürriyet* (August 10, 1989)

had been no opportunity for a detailed discussion. On the other hand, interviews revealed the fact that Central Bank officials had been called back from holiday to discuss Decree No.32 in detail before it was publicly announced.

According to press reports of the time, Decree No.32 had been taken against the will of the Central Bank and the SPO[330]. Hence, while the leading economic institutions such as the Central Bank (CBRT) and State Planning Organization (SPO) were against capital account liberalization, the Treasury took the side of the government, as Decree No.32 was prepared together with Treasury officials. The opposition of the CBRT and SPO was based on the belief that the macroeconomic conditions of the Turkish economy at that time was not appropriate to handle the risks that capital account liberalization may bring about. The issue at stake was not to discuss whether the Turkish economy should liberalize the capital account or not. The Central Bank accepted the necessity of capital account liberalization for the Turkish economy; its opposition was based on its timing. Hence, there was a conflict between the government on one side and the CBRT and the SPO on the other. Both the CBRT and the SPO evaluated the timing of this decision as a mistake. In view of the dynamics of the economy at that time, the Central Bank evaluated the full convertibility decision as wrong and declared that it would place severe burdens on the economy[331].

Therefore, both the SPO and the CBRT were suggesting that capital account liberalization should be postponed until a sizeable and sustainable reduction in the public sector deficits was achieved. Ersel (1996:48) has claimed that the Central Bank was also concerned that the short-term positive effects of capital account liberalization might

[330] Also, see *Hürriyet* (August 11, 1989)

[331] Also, see *Hürriyet* (August 11, 1989)

lessen the pressures on the government to undertake the structural reforms necessary to reduce the public sector deficits.

While views of the Central Bank were reflecting the economic concerns, the government's approach reflected to a great extent political concerns as Özal mentioned to one of the interviewees that "This is a political decision and I will take it." The general perception of all the interviewees, except one, is that the decision was taken primarily at Özal's own initiative[332] and constituted one of his final acts as the Prime Minister. Hence, the decision was pushed contrary to the advice of the Central Bank. It is asserted further by Öniş (2004:29) that the process of capital account liberalization could have been delayed, if Özal had not pushed so decisively for the move to full convertibility in August 1989. Hence, it seems that capital account liberalization largely reflected a one-man decision.

Interview Question 9: *Was there any serious concern expressed in the bureaucracy as regards to capital account liberalization being undertaken in an environment of macroeconomic instability and fragility of the banking sector?*

a. If yes, by whom?

b. If yes, did issues about banking regulation and supervision come on to the agenda when the 1989 decision was made?

c. If no, why do you think that the macroeconomic instability -high inflation and budget deficit- and weaknesses in the banking sector in that period were not seen as major impediments to capital account liberalization?

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[332] Öniş (2004:4) also holds this view.

Capital account liberalization undertaken in an environment of both macroeconomic problems and weaknesses in the banking sector points to a paradox in terms of the additional risks it entailed. Our interviews have revealed the fact that concerns in relation to these factors were expressed by bureaucrats from both the CBRT and the SPO. Especially, CBRT's point of opposition was based mainly on the concerns of weaknesses in the banking sector and macroeconomic instability issues such as high rates of inflation and fiscal deficit.

Interviews have revealed that although there were some discussions in 1988 to establish an independent supervisory and regulatory authority, the government rejected this idea basically under the influence of officials in the Treasury. The World Bank later proposed a plan to give this authority to the Central Bank. Nevertheless, this turned into a struggle of power between the Treasury and the Central Bank. While some officials in the CBRT looked favorably to this idea, some others found this attempt as a source of conflict between monetary policy and soundness of banks. The government decided to continue with the existing situation, i.e., Treasury has continued to be the institution responsible for banking supervision. Hence, Özal had the objective of achieving capital account liberalization before taking on the presidency. Banking sector supervision, as well as macroeconomic problems were not at the center of discussion and not viewed as major impediments to opening capital accounts.

Consequently, while banking sector supervision and macroeconomic problems represent economic concerns, political reasoning behind the capital account liberalization decision helps to resolve the paradox of how this decision were undertaken despite these economic impediments.

Interview Question 10: *Do you know whether there was any dialogue on the subject with the World Bank and the IMF?*

a. If yes, was this at the government's initiative or the BWI's?

***b.** If it was the BWI's, what was the latter's approach? Did they advise against it? Did they question its timing? Did they encourage or urge to take it gradually?*

In terms of assessing the impact of external actors such as the IMF and the World Bank on capital account liberalization, first the relationship between the government and these institutions in the post-1983 period should be considered. There was a one-year standby agreement with the IMF in 1983, which was later cancelled and replaced by a final one-year arrangement in April 1984[333]. After 1984, the relationship with the World Bank continued in the form of four successive sector adjustment loans during 1984-88, while the IMF continued to implement surveillance over macroeconomic policy[334]. The slippage in meeting the conditions of the Structural Adjustment Loan program was tolerated by the World Bank so that a continuous period of financing would be provided through five SALs during the reorientation period. Since the conditionality was expressed in qualitative terms, this left a scope for different interpretations by the Bank and the borrower[335].

Hence, in 1989, Turkey was not engaged in an agreement or program with either the IMF or the World Bank. Interviewees generally consider capital account liberalization as a domestic decision, except the fact that Özal's experience in the World Bank in the late 1970s may

[333] Celasun and Rodrik (1989:671)

[334] Öniş (1998a:249)

[335] Öniş and Kirkpatrick (1998:144)

have been instrumental in pushing forward capital account liberalization as a final step in the liberalization process. Hence, Özal's sympathy for liberalization policies might have overshadowed the risks that capital account liberalization carried, especially considering the inappropriate economic conditions at the time in terms of opening the country fully to external capital flows.

The IMF did not appear in the forefront during the days when the capital account liberalization decision was taken. However, on the basis of interviews, we can argue that the IMF was involved after the draft of Decree No.32 was ready. In other words, the government resorted to IMF's advice. The IMF's role at this stage was largely a supportive one. The striking fact about this supportive role is that the IMF showed no attempt to urge Turkey in terms of the risks involved and the inappropriate sequencing of reforms that had been followed[336]. Besides not warning Turkey about the associated risks, the IMF suggested some minor adjustments so that Turkey would be accepted as being committed to Article VIII of the IMF[337]. It is declared by the IMF that the Turkish lira, thereby, would be convertible. Convertibility of the Turkish lira had been in Article VIII terms, not in the sense of economic meaning.

On the other hand, the formal discussion of Decree No.32 in the IMF occurred only in the aftermath of capital account liberalization decision, in September 1989, during the IMF Executive Board Meeting regarding Turkey's Article IV consultation. In the discussions during the

[336] This issue was discussed in Chapter 3.

[337] Article VIII of the IMF consist of the following sections: Section 1. Introduction; Section 2. Avoidance of restrictions on current payments; Section 3. Avoidance of discriminatory currency practices; Section 4. Convertibility of foreign-held balances; Section 5. Furnishing of information; Section 6. Consultation between members regarding existing international agreements; Section 7. Obligation to collaborate regarding policies on reserve assets; See http://www.imf.org/external/pubs/ft/aa/aa08.htm, for details.

meeting, the full convertibility decision was strongly supported by the IMF. The directors of the USA, England, and Germany suggested that the Turkish experience could be presented to other countries as a successful example[338]. The Executive Director of Turkey, Jacques de Groote, evaluated this decision as the one which is quite convenient to IMF's suggestions[339]. Hence, the IMF ignored the rules of sequencing they suggested in the literature. Their approach was somehow reflecting the belief that liberalization is always better than otherwise, even when the conditions are not supportive.

Interview Question 11: *How do you assess the reaction of the Turkish public opinion to the 1989 decision? In your view, was there any serious opposition from politicians or business environment or any major segments of society?*

Özal announced the full capital account liberalization decision together with further reduction of tariffs and levies on imports, i.e. further import liberalization, on August 8th of 1989. Hence, in the few days following the announcement, a shock effect was felt rather than a major opposition. For instance, Cem Boyner, President of TÜSİAD, on August 10, 1989 declared that

> Recent changes concerning capital account regime represent a step towards convertibility. We evaluate every step on the way of liberalization as positive. On the other hand, since convertibility is an important decision for the Turkish economy, it should not be decided on the basis of current account surplus. Turkey's long-term prospects should be considered and timing should be arranged in a way that reversals in policies would not be needed.[340]

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[338] *Hürriyet* (September 18, 1989)

[339] *Hürriyet* (September 18, 1989)

[340] *Milliyet* (August 10, 1989)

Nevertheless, this mood was quite short-lived. Then, critics became more outspoken, as comments were directed more on measures pertaining to import liberalization. Boyner's declaration to the press[341] on August 14 was very tough with lots of accusations regarding policy path of the government in the post-1987 period, including that of the capital account liberalization decision. Then, in the following days, Boyner was supported by members of leading business organizations[342], especially on the basis of criticisms related to corruption and fraud in government.

These decisions were generally evaluated as "shock" decisions by the business community. TOBB also expressed criticism especially regarding the timing of capital account liberalization in its meetings, such as the one in İzmir on August 25, 1989[343]. In response to these criticisms, Pakdemirli, the Finance Minister, declared:

> All preconditions are satisfied before convertibility. If there exists a timing mistake, but there is not, it could only end up with a deterioration of exchange rate equilibrium. Then, this problem will be solved by setting new exchange rate equilibrium. Discussions related to timing reflect politic concerns and these criticisms are over-dosed…[344]

It is mentioned in Hürriyet on August 14 (1989:4) that "economic bureaucracy found convertibility decision as both unconvincing and political". As Hürriyet (1989:4) wrote: "important factor is whether the economy is ready and economic structure is strong enough for

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[341] Boyner's words as "the government is the executioner of the Turkish industry" led to major controversy in the following days. His accusations were also directed towards corruption in the government. See *Hürriyet*, August 14, 1989.

[342] Şinasi Ertan from TOBB (The Union of Chambers and Commodity Exchanges of Turkey), Yalım Erez from İTO (İstanbul Trade Chamber). *Hürriyet* (August 15, 1989:4)

[343] *Hürriyet* (August 26, 1989)

[344] *Hürriyet* (August 26, 1989)

convertibility….official declaration of convertibility is not enough to make the Turkish lira convertible …"

4.4. Conclusion

The timing of capital account liberalization in Turkey has been quite critical in terms of shaping subsequent economic performance, as can easily be recognized from the vast amount of literature that exists on the subject, holding capital account liberalization in 1989 responsible for crises since the 1990s. As a result, the questions on government's agenda and which factors were behind this decision become important.

The main purpose of this chapter was to analyze and reveal the underlying phenomenon of the capital account liberalization decision through interviews conducted with the people who held critical positions at the time as well as the relevant literature and press reports. On the basis of this analysis, it can be concluded that capital account liberalization was the final destination, which was projected since the first days of the Özal government. Preparations towards finally achieving this objective had started in an office in the Treasury. It seems that ideas in this direction had been in Özal's mind during his career in the World Bank in the 1970s.

The timing of capital account liberalization corresponded to a period in which Özal lost much of his public support and was preparing himself to be President. In other words, it was the last days of Özal as Prime Minister. He probably wanted to achieve this objective before he became President.

The alleged benefits of capital account liberalization also seem to have played a major role in speeding up this process. Loss of public support for Özal could in part be attributed to the low rate of growth

and high inflation experienced during 1988 and 1989. Furthermore, the large public sector borrowing requirements also necessitated new sources of funding. All of these factors seem to have played a part in triggering the liberalization decision. The expected recovery in economic indicators following liberalization was seen as a remedy to regain public support.

The role of external actors, in this case the IMF, has been limited. The IMF only played a supportive role through confirming that the decision was in line with its policies and suggestions. On the other hand, although the timing of the decision was not correct in terms of sequencing proposed by the IMF, there was no warning by the IMF about the strengthening of the banking sector and improving macroeconomic fundamentals in spheres like inflation and fiscal deficit.

It seems that domestic decision makers have shaped and taken the decision of capital account liberalization, while the interaction of economic and political factors has played a major role in its timing.

CHAPTER 5

QUALITATIVE ANALYSIS OF CROSS COUNRTY EVIDENCES AS REGARDS TO PRUDENTIAL REGULATION AND SUPERVISION

5.1. Introduction

Prudential regulation and supervision is a major condition for successful financial liberalization and the proper sequencing of financial liberalization. However, its importance began to be mentioned prominently only after serious financial crises such as the Asian crisis. Its inclusion to stabilization programs and to Washington Consensus approach also follows the severe crises.

Nevertheless, contrary to the suggestions of the international institutions and economists towards ensuring strong prudential regulation and supervision prior to financial liberalization, the evidence indicates that in many countries, prudential regulation seems to have seriously lagged the process of financial liberalization in practice. What is striking for our purposes is that although many countries seem to have established the legal framework, banking regulation and supervision remains weak due to implementation failures, which end up in severe financial crises. This characteristic also appears as the distinguishing factor between developing and developed countries.

In this chapter, our aim, first of all, is to examine a group of countries so as to understand whether they put into place the legal framework of banking sector supervision and regulation before financial liberalization. Whether prudential regulation and supervision are put into effect is critical in terms of eventual success of the financial libelization reforms as well as preventing vulnerability to crisis.

Nevertheless, having legal framework in existence does not guarantee effective implementation. Hence, secondly, we examine country experiences as regards to the timing of effective implementation of banking regulation and supervision with respect to both financial liberalization reforms and financial crises. The purpose is, here, also to see whether there exist implementation failures, although legal framework is ready. These analyses would also enable us to make a comparison against the Turkish experience.

The organization of the chapter is as follows: In the second section, previous studies are reviewed. In the third section, seven country experiences are examined. The final section concludes.

5.2. Review of Previous Studies

Walter (2002:10) concluded for East Asian countries that the main problem about financial regulatory reform in these countries is basically related to the issue of implementation failures rather than passage of a particular reform. Although extensive reform program was adopted in the wake of regional financial crisis of 1997/98, these reforms are said to be insufficient in that enforcing new prudential rules became impossible with the existing bureaucratic resources, institutional capacity and corruption[345].

Lindgren et al. (1996) analyzed soundness of financial systems of thirty-four countries. They provide a qualitative description of the status of prudential regulation and supervision in these countries in the years leading up to banking crises. Their analysis indicates that of these countries, only five (Bolivia, France, Indonesia, Japan and United States) had an adequate legal and supervisory framework, while enforcement and supervision were weak even in these countries.

[345] Walter (2002:10)

Regulatory systems of the remaining countries are described as weak and inadequate and supervisory system as even weaker.

According to the analysis performed by Kaminsky and Schmukler (2003:22) on 28 country experiences, institutional reforms do not predate liberalization, while government reforms in most of the cases are implemented within a few years after the partial opening of financial markets. In other words, countries generally do not tend to improve their financial systems before liberalization as opposed to policy prescriptions. According to the analysis of Williamson and Mahar (1998:29), only two industrialized countries, Germany and Japan[346] improved supervision prior to reforms and among the developing countries, Israel, Morocco and Peru strengthened their prudential supervision system during their financial liberalization period, while only Peru raised the level substantially. Among the other countries (Australia, Egypt, France, Mexico, New Zealand and Taiwan) that strengthened their systems of prudential supervision during their financial liberalization period, only France and New Zealand reached a level that can be comparable with other industrial countries. Williamson and Mahar (1998:29) counted sixteen countries within their sample of thirty-four countries that waited at least two years after liberalization had begun before starting to improve prudential regulation and supervision.

As Turkey quickly liberalized its capital flows in 1989, there were serious weaknesses, despite some efforts to strengthen the financial sector. In particular, inadequate prudential regulation and supervision

[346] Japan, however, still has a low level of prudential regulation by industrial-country standards. (Williamson and Mahar, 1998:29).

and the important role of large state-owned banks led to excessive risk taking, setting the stage for serious crises in 1994 and in 2000-01[347].

5.3. Country Experiences

The countries examined in this chapter, i.e., Argentina, Chile, Mexico, Paraguay, Indonesia, the Phillippines and Korea, have generally ignored the recommendations on sequencing. In other words, they mostly deregulated financial sectors and opened capital accounts well before instituting a strong prudential regulation and supervision of the banking sector. Hence, despite the general consensus on describing financial liberalization and weak prudential regulation and supervision as a dangerous combination, which would most probably end up with financial crisis, implementations in general have been just the reverse. We conclude that major improvements to prudential supervisory frameworks only took place after the crisis, rather than before it in the countries examined in this chapter.

5.3.1. Argentina

In Argentina, although comprehensive prudential regulations were introduced in 1977, parallel to the financial liberalization that took place in 1976-1977, their implementation and ensuing banking supervision were inadequate. Moreover, banking supervision had weakened in the aftermath of financial reforms until the financial crisis in 1981, despite continuation of regulatory and supervisory measures throughout 1981.

The financial crisis began with a failure of a major bank[348] in March 1981. Among many factors that had been instrumental in

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[347] IMF (2002:17)

[348] By March 1981, the government had liquidated a total of 62 financial institutions, holding approximately 20 percent of the country's total deposits.

generating the financial crisis of 1981, weak banking supervision and prudential regulations played a major role. Only four years after the financial liberalization, i.e. in the aftermath of the crisis in 1981, supervisory system was strengthened and supervision was reorganized through the introduction of new accounting, auditing, and reporting standards as well as reorganization of the responsible department of the central bank[349].

After this aborted attempt of liberalization, Argentina began financial liberalization in the early 1990s again. Financial sector had an impressive recovery until 1994, as deposits and loans grew rapidly. However, domestic banks were not careful in their lending strategies which resulted in deterioration in their portfolio quality. The Tequila crisis in 1995 hit the banking system in Argentina very hard[350]. In the first quarter of 1995, the accumulated losses corresponded to 12 percent of the banking sector's net worth.

In the aftermath of the Mexican crisis of 1995, vulnerability of the banking system to shocks became clear. With the aim of overcoming these difficulties, a number measures were introduced to restructure the banking sector by injecting more capital, promoting mergers and acquisitions and creating incentives for foreign banks. Deposit insurance scheme financed by private funds were introduced to increase depositor confidence and safety net of the banking sector[351].

These policies initially yielded positive results. In the second half of the 1990s, private bank provisions in relation to total credit increased substantially; the capital adequacy ratio reached the levels far beyond 8 percent of the Basle I; the share of foreign banks more

[349] Bisat et al. (1999:100)

[350] See for details Stallings and Studart (2002:15)

[351] Stallings and Studart (2002:17)

than doubled between 1994 and 1999. Therefore, the banking sector was more solid especially in terms of dealing with the emerging market crises of the late 1990s, as compared to its ability to deal with Mexican crisis in 1995. However, these positive developments were eventually undermined after the devaluation in 2002, as banking sector went into crisis[352]. Hence, Argentinian experience points to implementation failures from the begining of the process.

5.3.2. Chile

The Chilean financial liberalization points to the fact that financial reform can be risky even with fiscal adjustments and a restrictive monetary policy under weak prudential regulation and inadequate supervision. Although several measures were introduced in terms of banking supervision and regulation[353] within the stabilization program implemented between 1974 and 1981, important weaknesses in the supervisory and regulatory framework remained.

Prudential regulations were "poorly designed and inadequately implemented, particularly with respect to the concentration of bank ownership, restrictions on bank loans to interrelated entities and loan classification and provisioning requirements"[354]. This situation especially "permitted a rapid credit expansion to nonviable projects and subsequent distress borrowing on account of the persistence of high real lending rates" [355]. The ownership structure had also contributed to excessive lending to interrelated entities. Moreover, there was a

[352] Stallings and Studart (2002:17)

[353] In 1974, minimum capital requirements were raised and penalties imposed for noncompliance, restrictions were placed on the concentration of bank ownership and bank disclosure, and reporting requirements were strengthened.

[354] Bisat et al. (1999:113)

[355] Bisat et al. (1999:112)

widespread perception that the government would rescue depositors in the event of a bank crash, "although explicit peso-deposit guarantees did not exist in Chile until 1983". Due to this implicit deposit guarantees, market discipline on the banks was weak. Furthermore, firms' expectation of a government bailout also led them to borrow excessively[356].

Consequently, Chile faced a serious banking and financial crisis in 1981. The crisis resulted in temporary reversal of regulations and a strengthening of regulation and supervision. Therefore, the crisis forced the authorities to take immediate action through restructuring the banking sector with intervention to 21 private financial institutions, including the two largest banks in the country. Banking supervision was further strengthened through further measures taken in 1982 and through a new banking law[357] in 1986.

Following these restrictions, capital account liberalization was implemented gradually: firms were allowed to issue bonds and shares in external markets; institutional investors (banks, pension funds and insurance companies) were permitted to hold external assets; capital controls were gradually removed. Basel Committee's advice of 8 percent capital requirements was adopted in 1997.

Besides its strong macroeconomic fundamentals (low levels of external debt, strong trade balance, high growth and fiscal balance) at that time, Chilean banking system had already gone through major changes in supervision, regulation and structure. Hence, Chile being

[356] Bisat et al. (1999:111)

[357] Bisat et al. (1999:112), Stallings and Studart (2002:13).

different from the other countries in the Latin American region was less vulnerable to the Mexican crisis[358].

5.3.3. Mexico

After a long period following banking crisis in 1982, financial liberalization[359] accelerated in 1988. Then, share of bank credit to the private sector and lending in foreign currency increased significantly[360]. As capital inflows increased rapidly, new banking regulations were introduced in response to the growing concerns about risks[361]. Despite these new prudential regulations, banks continued to expand private sector lending[362] rapidly, as share of bank credit to private sector almost doubled during the period between 1989 and 1994. Nevertheless, rapid credit expansion eroded the quality of banks' loan portfolios and increased their vulnerability to adverse shocks. Consequently, non-performing loans increased from around 2 percent of total loans in 1990 to 9 percent in 1994, as a result of lending to risky borrowers by banks. Furthermore, in the face of these weaknesses, it is argued that banks most probably underestimated non-performing loans and overestimated the level of CAR[363].

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[358] See Stallings and Studart (2002:16) for details.

[359] Interest rates were freed, liquidity requirements were eliminated, credit allocation directives were abolished, and previously nationalized banks were privatized (Stallings and Studart, 2002:13).

[360] Stallings and Studart (2002:13)

[361] In March 1991, loan classification and provisioning rules were strengthened and the minimum capital adequacy ratio (CAR) was gradually raised from 6 percent in 1991 to 8 percent in 1993. Furthermore, regulations requiring a minimum amount of foreign exchange liquidity and limiting foreign currency exposures were introduced (IMF, 2002:75).

[362] Real private sector bank credit grew at an average annual rate of 28 percent between 1989 and 1994, bringing the stock of private sector bank credit from 15 percent of GDP to 35 percent of GDP.

[363] IMF (2002:76)

Furthermore, there was a general perception that government would assist to banks in difficulty. This had originated mainly from extension of full deposit insurance to the newly privatized banks by the government. Moral hazard led by this implicit deposit insurance and especially the consideration of "too big to fail" for some banks distorted the markets' perception of risks. Furthermore, the newly privatized banks engaged in high-risk activities in order to generate high returns on equity[364]. Stallings and Studart (2002:13) argue that reckless and sometimes fraudulent lending as a result of poor supervision and underdeveloped regulations characterized the first years of privatization.

Hence, the inability to assess risks properly as well as improved access to international capital markets coupled with the lack of proper supervision and inadequate regulatory and accounting standards led to the excessive risk taking in the Mexican financial system. Consequently, the fact that banks and foreign investors took excessive risk led to large imbalances in the financial sector in the period preceding the 1995 crisis.

In Mexico, crisis occurred in the presence of significant macroeconomic imbalances, large short-term debt[365] and high capital mobility. Therefore, significant depreciation of the peso in end-1994, coupled with the sharp rise in interest rates and economic downturn had a severe impact on financial conditions of the banking sector, intensifying further the currency crisis. In the aftermath of the crisis in 1994/95, banking sector was involved in a costly restructuring process that took many years. The government set up several programs to help

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[364]IMF (2002:76)

[365] By end-1994, according to the Bank for International Settlement, the ratio of short-term debt to international reserves on a remaining maturity basis increased to over 500 percent.

capitalize and strengthen the banking system. Moreover, a number of banks were intervened and later re-sold, leading to a dramatic increase of foreign participation in the banking sector[366].

A new financial legislation was approved in 1998 and then implemented. The main changes were new deposit insurance scheme, which ended the full deposit guarantee that had been implemented previously; stricter accounting standards; a series of measures to improve lending practices; and stricter rules on capital quality.

5.3.4. Paraguay

Paraguay embarked on significant trade and domestic financial liberalization and further liberalization of the already open capital account in 1989 and the early 1990s. However, at the time when the financial liberalization had started in 1990, the financial sector was already fragile and the prudential framework and supervisory capacity were weak. Although the authorities were aware that one third of the banking system was insolvent as early as 1989, financial deregulation was not accompanied by the strengthening of prudential regulations and supervision. The problems were existent such as lax licensing requirements and low required capitalization, which permitted the rapid increase in the number of new financial institutions, despite many with weak and corrupt management. While a system of loan risk classification and provisioning was introduced at the end of 1992, banks did not apply it and resisted its enforcement even though long grace periods (five years) were obtained for compliance. Non-performing loans began to increase in 1992, signaling problems in the banking system as a whole. Quite contrary to what was actually needed, which include enforcement of capital and other regulatory requirements or closing down of insolvent banks, the authorities provided liquidity to

[366] Stallings and Studart (2002:18)

weak banks, either through the central bank or through placement of deposits from public institutions. In March 1995, immediately before the outbreak of the crisis, 10 of the 34 banks in the system had capital deficiencies[367].

Furthermore, lack of both adequate powers and resources to exercise effective supervision over the expanding number of financial institutions and political interference from taking prompt corrective actions constrained the supervisory authorities.

The rapid credit expansion fueled by large capital inflows in an environment of weak prudential framework and supervision and poorly managed financial institutions significantly worsened the quality of loan portfolios. This ultimately resulted in financial sector crisis in May 1995. Initially the third and the fourth largest banks in the system were intervened after failure in the payments system. This was followed by intervention to eight more banks and other financial institutions. However, since a number of banks remained in serious difficulties, three banks, which include the largest locally owned bank were closed or merged in 1997 and three more banks were eventually closed in 1998. Since the weaknesses in the prudential framework and problem institutions were not addressed immediately, the crisis continued for four years[368].

5.3.5. Indonesia

In the pre-reform period before 1982, as banks were supervised by the central bank, prudential regulations and banking supervision were weak. While the total number of financial institutions remained largely unchanged during the first phase of the financial reforms implemented in the period of 1983-1986, in the second phase of

[367] IMF (2002:85-89)

[368] IMF (2002:86-88)

reforms, which began in October 1988, the number of financial institutions increased significantly[369].

In the second phase, "prudential regulations were strengthened by limiting the concentration of bank lending, extending central bank supervision to the rural banks and non-banks, and developing a comprehensive supervisory monitoring system"[370].

As a result of rapid increase of banks and branches following the second phase of financial liberalization in 1988, banks began to take excessive risk in lending. As private banks intentionally and extensively lent to related companies without sound credit analysis, these practices resulted in high levels of non-performing loans[371]. Furthermore, asset quality of many banks deteriorated. Then, the 1988 reforms were immediately followed by bank runs and liquidity problems that were resolved through support from Bank Indonesia. This reflected the weaknesses in bank supervision and regulation and in banking solvency.

Therefore, although Indonesian financial liberalization began in the early 1980s, measures related to prudential regulation were taken only in the early 1990s. Furthermore, although prudential regulations were frequently updated, shortcomings in the legal and regulatory framework remained, especially in the areas of loan classification and provisioning in the pre-crisis period. While banking supervisors were aware of the drawbacks of these practices, they were not focused on loan restructuring as an additional indicator of banking sector soundness. Furthermore, there were no effective bank closure and exit regulation for failed banks. Instead, Bank Indonesia had taken over

[369] Bisat et al. (1999:116-121)

[370] Bisat et al. (1999:118)

[371] Abdullah and Santoso (2000:81)

failed private banks. Although a bankruptcy law was passed in 1996, it was deficient[372].

The more serious problem was enforcement of regulations, often due to political interference[373]. Although supervisory framework was improved, serious implementation failures remained. For instance, since "violations of prudential rules were not appropriately sanctioned", "noncompliance was widespread"[374]. On-site supervision was ineffective. Furthermore, insolvent banks remained in the system, given the problems with bank closure. This situation created moral hazard problems[375].

5.3.6. The Philippines

Financial reform measures included a gradual liberalization of interest rates during the period 1980-84. The Philippines faced a major financial sector crisis during 1981-86. "Fraud in the commercial paper market resulted in large-scale defaults by borrowers in this market and in bankruptcies among a number of non-bank financial intermediaries and their holding companies"[376]. Hence, a consequent loss of confidence had initiated the crisis in 1981. This crisis spread to banks, as investors withdrew their funds and caused a number of the institutions to fail. "These failures were followed in 1982 and 1983 by intensified government assistance to financial and non-financial institutions, including emergency lending and equity contributions to public financial institutions and the takeover of troubled private financial and non-financial institutions by government financial

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[372] IMF (1999:55)

[373] IMF (1999:55)

[374] IMF (1999:58)

[375] IMF (1999:58)

[376] Bisat et al. (1999:135)

institutions"[377]. The crisis deepened in 1984, as a balance of payments crisis followed unstable political environment in the first half of 1983. Then, the government announced moratorium on external debt payments to foreign commercial banks. This led to financial panic which resulted in runs on financial institutions, including commercial banks. Hence, large-scale capital outflows and a contraction in financial intermediation occurred[378].

> The extensiveness of the crisis can be traced partly to a failure to enforce supervisory rules on credit meeting requirements; inadequacies in the rules on provisioning for overdue loans; various banking irregularities exacerbated by the political environment; and excessive risk taking by bank holding companies through newly created and inexperienced subsidiaries[379].

Furthermore, it is asserted that the central bank did not establish firm provisioning rules and practices regarding the accrual of interest on overdue loans[380].

Supervision of various categories of financial institutions was diversified: banks were supervised by the central bank, while many non-bank subsidiaries were monitored by the Securities and Exchange Commission. Excessive interrelated and risky lending occurred mainly due to ineffective application of lending rules to customers associated with banks. Furthermore, rules for the provisioning for bad debt, were not transparent. "Troubled banks exploited this weakness by accruing interest on non-performing loans and distributing book profits"[381].

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[377] Bisat et al. (1999:136)

[378] Bisat et al. (1999:136)

[379] Bisat et al. (1999:137)

[380] Bisat et al. (1999:137)

[381] Bisat et al. (1999:137)

Consequently, weak supervisory framework associated with liberalization increased the vulnerability of the financial system to a shock of confidence.

5.3.7. Korea

Liberalization process of the financial sector began in the early 1980s and moved gradually. However, liberalization of domestic financial markets was not accompanied by appropriate supervision and regulation of financial institutions. Therefore, the regulation and the supervision of the financial system were weak before the crisis of 1997 and not adapted to the environment of liberalized capital account[382].

Weak prudential standards and supervisory forbearance were major deficiencies of the Korean banking system. There were structural problems such as weaknesses in the financial sector and poor governance in the corporate sector dominated by chaebols. Financial position of the corporate and financial sector deteriorated as a result of deficiencies in credit allocation. In the period preceding the 1997 crisis, banks financed investment on the basis of availability of collateral rather than risk assessment. Furthermore, credit was not allocated to the sectors with best economic performance but to viable projects encouraged by policy-based bank lending. This, therefore, played a major role in deterioration of the financial position of the corporate sector. IMF argues that a long history of government involvement in bank lending decisions deterred the development of adequate credit analysis and risk management skills. As chaebols' high leverage and low profitability made them vulnerable to adverse shocks, this affected

[382] Kang (1998:4)

adversely the health of the banking system that had high exposure to chaebols[383].

Furthermore, supervisory authorities used the power to waive prudential requirements, as this facilitated forbearance and nontransparent enforcement as well as providing Korean financial institutions little incentive to take corrective measures. In 1995, provisioning requirements were relaxed, as the provisioning requirement for doubtful loans was reduced from 100 percent to 75 percent and for securities losses from 100 percent to 30 percent. Although there were regulations on bank loan exposure to large corporate groups, these regulations were rarely enforced. Since standards for loan classification and provisioning, accounting standards and standards for concentration of risk and large exposures were inadequate, banks also financed corporations without adequate capital and provisioning for possible loan losses. Therefore, building supervisory capacity was not a priority during the boom years preceding the 1997 crisis[384].

The system of supervision was fragmented[385] besides its poor quality. This provided a suitable environment for high-risk practices. Moreover,

> trust accounts set up by the commercial banks, the merchant banks, and other financial institutions were subject to much more relaxed regulations on provisioning and exposures. The lack

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[383] IMF (2002: 68-69)

[384] IMF (2002:69)

[385] Supervision of the specialized banks and the non-bank financial institutions was carried out by the Bank of Korea and Ministry of Finance and Economy, as commercial banks were supervised by the Bank of Korea. IMF (2002:69) Dekle and Kletzer (2001:25)

of coordinated supervision encouraged the migration of business toward these less regulated and riskier institutions[386].

Furthermore, there was a widespread perception that banks and corporations would be bailed out if they encountered difficulties.

The contribution of the non-bank financial institutions to imbalances and the crisis turned out to be crucial as a result of considerable increase in risky lending operations by non-bank financial institutions. Non-bank financial institutions obtained considerable advantage as a result of a combination of factors such as weaker prudential framework for these institutions than for banks and interest rate liberalization that favored money market instruments over direct lending. Particularly, chaebols owned most of the merchant banks, which financed investment projects through the commercial paper market during the period 1993-96. As these investments started to sour in early 1997, large chaebols went into bankruptcy, eroding international confidence in the Korean financial system[387].

The main problem was that failures in the soundness of banks were not immediately remedied once detected by bank supervisors. Furthermore, changes to prudential regulations were made in a way to allow banks to report profits and capital positions that were misleading.

5.4. Conclusion

Our analysis over the experiences of seven countries points to implementation failures from the begining of the process. Although legal framework of the regulatory and supervisory framework was introduced after or together with the liberalization reforms, both weaknesses in the legal context and implementation seem to have been instrumental in falling into trouble of crises many times in these

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[386] IMF (2002:69)

[387] IMF (2002:70)

countries. A closer look reveals that the major problem is generally the weak implementation of existing rules and regulations, rather than absence of them.

Hence, there exists a strong resistence against implementing reforms up to the point where a major economic crisis makes a drastic change inevitable. In other words, "unless the financial system reached a point of complete collapse"[388], which is a crisis, resistance force remains intact. Then, remarkable improvements to prudential regulatory and supervisory frameworks typically follow rather than precede crisis. Nevertheless, even the crisis sometimes remains incapable of efficient enforcement of rules, as happened after the crisis in many East Asian countries[389].

For the Asian countries that we examined in this chapter, namely in Korea, Indonesia and Philippines, although financial liberalization began in the early 1980s, measures related to prudential regulation were taken only in the early 1990s. The main problem in those countries was that although policymakers perceived the need to improve prudential regulation during implementation of financial liberalization and introduced some new regulations before the crisis, these new prudential rules failed to be enforced. Walter (2002:10) asserts that this chronic behavior is quite pervasive in the East Asian countries. This is partly explained by the difficulty of pushing through new legislation in often fragmented democratic political systems, more importantly by the powerful political forces that favor regulatory forbearance[390]. It is even argued that, since the crisis in 1997, although most prudential systems in East Asia seem converging to international regulatory standards, regulatory forbearance remains prevalent.

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[388] Alper and Öniş (2002:3)

[389] Walter (2002:7)

[390] Walter (2002:23)

Furthermore, insolvent banks were kept in the system in these Asian countries and there was a widespread perception that banks would be bailed out if those banks encountered difficulties, leading the moral hazard problem to get chronic. Therefore, the situation in these countries can be described as formal convergence but continued implementation failure. Walter (2002:23) asserts that if countries keep substantial financial sector and capital controls such as those in China, then regulatory failures would not necessarily be so disastrous.

In the Latin America region, prudential regulations were poorly designed and inadequately implemented. Hence, having not only adequate regulations but also inadequate implementation emerges as important problems. In Argentina and Chile in the first phase of reforms, although financial reform was in fact accompanied by a strengthening in prudential regulations, implementation was ineffective and some critical regulations did not even exist. Some of the regulations were rescinded because of the inability to implement them. While such capacity is in part technical, it mainly requires the absence of political interferences.

For the first phase of reforms in the late 1970s, the problem in both Argentina and Chile mainly emerges from introduction of financial liberalization as an abrupt one-time change that did not allow the ongoing development of an implementing capacity. Furthermore, abruptness of financial liberalization did not give the private financial institutions themselves the time to develop internal monitoring, credit appraisal, and risk management processes, nor did banking supervision ensure that bank management had the appropriate capacity for such monitoring and appraisal. In the second attempt at liberalization, Chile, being an exception, had a well-developed system of prudential regulation and supervision before liberalization of the capital account,

while Argentina did not improve regulation and supervision until the Mexican crisis hit its banking system.

In Mexico, prudential regulations were introduced a few years after financial liberalization. However, reckless and fraudulent lending due to poor supervision and inefficient regulations in an environment of improved access to international capital markets resulted in excessive risk taking in the Mexican financial system in the period preceding the 1995 crisis. Attempts towards strengthening the banking system intensified only after the crisis.

In almost all countries examined in this chapter, moral hazard problem led either by explicit or implicit deposit guarantee or by the consideration of "too-big-to fail" for some banks distorted the markets' perception of risks. This situation encouraged excessive risk taking by financial institutions. Furthermore, when this factor was combined with a kind of guarantee that penalties to unsound banking practices were neither made explicit nor enforced, which occurred in the countries such as Argentina, Chile, Philippines, and Indonesia[391], banks have found a great incentive to provide risky loans at high interest rates. These factors seem to have stimulated implementation failures to a major extent in the countries examined in this chapter.

[391] Villanueva and Mirakhor (1990:520)

CHAPTER 6

REGULATORY AND SUPERVISORY FRAMEWORK OF THE TURKISH BANKING SECTOR IN THE POST-1980 PERIOD: REASONS OF IMPLEMENTATION FAILURES

6.1. Introduction

The early "sequencing literature" puts less emphasis on the role of prudential regulation and supervision of the banking system. While the combination of macroeconomic stabilization, trade and financial liberalization was strongly emphasized in the Washington Consensus policies in the early 1990s, less attention was given to the institutional/governance issues within appropriate sequencing[392].

Only after serious financial crises such as the Asian crisis, prudential regulation and supervision began to be stressed as an important precondition of successful financial liberalization[393]. Öniş (2002:17) asserts that the Argentine and Turkish crises demonstrated the threats of premature capital account liberalization in an environment of weakly regulated financial systems. McKinnon (1998:57) also criticizes the "Washington Consensus" approach for underemphasizing the need to invest in institutional infrastructure before introducing liberalization reforms, while favoring financial liberalization.

Hence, in the face of the crises in emerging market economies in the 1990s, the Washington Consensus approach started to compose a

[392] Naim (1999)

[393] Walter (2002:3)

new agenda through encompassing the importance of prudential regulatory framework in its policy line, while financial liberalization continued to be promoted as welfare enhancing[394]. In other words, the original Washington Consensus has not changed, but was augmented with institutional elements, one of which is prudential regulation and supervision of the banking sector. The general policy line of the IMF, therefore, continues to be the argument that financial liberalization is worth having despite the risks, as solution entails building a regulatory framework which can support it.

This renewed approach, named "Augmented Washington Consensus"[395] policies was then reflected in the conditionalities of the IMF programs for many countries, particularly as observed in the IMF stabilization program of 1999 for Turkey. Hence, the recent literature on sequencing suggests the appropriate sequencing as macroeconomic stabilization and prudential regulation and supervision first, and only after the satisfaction of these conditions capital account liberalization is suggested[396].

Nevertheless, the evidence for emerging markets regarding the timing of financial liberalization and institutional reforms displays that reforms to institutions occur mostly after liberalization is completed[397], as discussed in chapter 5 on the basis of country experiences. Furthermore, even the crisis sometimes becomes incapable of initiating the implementation of rules and regulations, as happened in the

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[394] Kapur (2001), also see our chapter 2, above.

[395] This specific naming belongs to Rodrik (2001)

[396] See Chapter 2 for detailed discussion.

[397] Kaminsky and Schmukler, (2003:22)

aftermath of the Asian crisis[398]. In other words, the problem is that although formal convergence towards "best practices" has occurred, divergence still continues in practice, given the regulatory forbearance in some of the crisis-hit countries. Alper and Öniş (2002:13), for instance, characterizes the distinguishing factor between emerging economies like Turkey and established economies as weak implementation of rules and regulations in practice rather than absence of such rules and regulations.

While this is, in part, due to little attention given to governance/prudential regulatory and supervisory conditions within sequencing framework by the international financial community, basically, the political economy factors also play a major role in these implementation failures. Enforcing new prudential rules may be impossible with existing bureaucratic resources. Sometimes enforcing a new rule may be impossible due to institutional capacity or corruption[399]. Furthermore, there may be some issues of particular relevance to countries that international best practices do not cover explicitly or do not stress sufficiently.

From the side of BWI, this means that the BWI recommend deep and bureaucratic reforms without adequately understanding the difficulties of achieving successful reforms of this kind[400]. Hence,

> a major criticism that can be leveled against the IMF is that ….. the IMF appears to severely underestimate the political and institutional problems associated with the construction of strong

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[398] The Asian experience has shown that the crisis has been ineffective in initiating the implementation of the regulatory and supervisory rules and regulations in some countries.

[399] Walter (2002:7)

[400] Walter (2002:6)

> regulatory institutions needed to cope with the pressures of financial globalization[401].

In the literature, the reason why in practice so many countries diverged from optimal sequencing is a rarely mentioned issue. We believe that the reasons behind lack of proper implementation of banking sector regulations in many emerging market economies need to be questioned. In this chapter, turning our particular attention to the case of the Turkish banking sector, our aim is to discuss the reasons behind lack of proper implementation of regulatory and supervisory reforms. We will discuss the role of political and institutional forces behind implementation failures of banking sector reforms with particular attention to the Turkish experience. To this end, we will examine the relevant characteristics of political and institutional forces at work in the 1980s and 1990s in Turkey. The main purpose of discussing these political and institutional factors is to explain why financial liberalization, contrary to what is suggested, precedes prudential regulation. We also ask whether domestic actors remain indifferent to the importance of this issue. Our analysis highlights the complexities involved in establishing effective regulation. Furthermore, the role of external anchors such as the IMF in pushing for regulatory reforms in Turkey is analyzed. In that context, we try to find out whether the domestic political and institutional factors outweigh the role of external actors.

This chapter is organized as follows: The underlying factors behind implementation failures are examined in section 2. Section 3 gives an overview of banking sector developments in Turkey in the post-1980 era, particularly, in terms of establishing effective prudential regulation and supervision in the banking sector and the underlying reasons behind implementation failures of Banks Act of 1985. Then, this is followed by conclusion in the section 4.

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[401] Öniş (2002:18)

6.2. Reasons of the Implementation Failures

It is pertinent to ask in the first place why politicians delay enhancing prudential supervisory frameworks so much, being aware of the large costs of financial crises. It seems that various political and economic reasons lie behind these pervasive implementation failures in many developing countries[402].

Before discussing the reasons behind implementation failures, it should be recognized that at least in the short to medium run, prudential regulatory and supervisory frameworks place an enormous burden upon the governance capabilities of the government. "Augmented Washington Consensus" approach also seems to underestimate the difficulties of governance reform. It is beyond simply adopting "international best practices" in legal frameworks and operating principles of prudential supervision and enhancing the capacity of officials to understand and implement these new rules. Hence, IFIs and economists who focus only on recommending deep political and bureaucratic reform, while ignoring the difficulties of achieving successful reforms of this kind are criticized[403]. It is also argued that even if rules change, persistence of chronic governance failures might possibly result in even more devastating financial crises[404].

First of all, role of two inherent characteristics of the developing countries should be mentioned as impediments on the way to the strong regulation and supervision of the banking sector. The first one is technical knowledge imperfection concerning both optimal sequencing

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[402] See Walter (2002) and Alper and Öniş (2002) on this point.

[403] Walter (2002:6)

[404] Walter (2002)

and the importance of enhanced prudential supervision[405]. The second factor[406] is that regulators and managers may not have enough resources and knowledge to do their job properly. Insufficient training and expertise of bank supervisors in emerging markets is a serious problem of many countries[407]. They also may not have the managerial capital to deal with the rapid growth of lending that typically follows financial liberalization. Then, excessive risk taking may accompany rapid credit growth. Therefore, insufficient expertise and resources to monitor banks' new lending activities allows excessive risk taking by banks, leading to a deterioration in balance sheets[408]. Existence and persistence of large weaknesses in banks' balance sheets may further delay the strengthening of banking supervision through preventing effective and uniform enforcement of prudential norms[409].

From the perspective of politic economy dimension, one of the reasons of the implementation failures is that implementation of financial liberalization is much easier than that of new prudential regulations. Implementation of financial liberalization requires minimal institutional capacity as it involves removal of existing controls. Therefore, especially in countries with weak governments, since deregulation is the easier option, financial liberalization is undertaken in the first place with the hope that stronger prudential rules and enforcement may be achievable in the long run. It is argued that this

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[405] This has been the case in Indonesia, Korea and Thailand. Walter (2002:7)

[406] See Mishkin (1999:16) for the other reasons.

[407] Noy (2004: 342)

[408] Mishkin (1999:15)

[409] Sundararajan (1999:188)

strategy has really been followed by many technocrats in various countries[410].

Secondly, political institutions may allow vested interests to block reform[411]. This can be explained[412] by focusing on distributional factors and sectoral interests: The benefits of financial liberalization are concentrated among borrowers and some financial sector firms, while the costs are diffused and often delayed. On the contrary, the benefits of prudential supervision, which are preventing crises, are dispersed, as the costs are concentrated mainly on the financial sector. This means that while the lobbies of the financial sector would have strong incentives to push for financial liberalization, they would have little incentives to push for enhanced prudential supervision. Another source of opposition to stricter prudential regulation may arise from large borrowers, if regulation raises the cost of finance[413].

Walter (2002:20) focuses on two main institutional factors to explain why serious implementation failures occurred in East Asian countries, despite adoption of reforms: ownership structures dominated by families and the state on the one hand and politically subordinate supervisory institutions on the other. Hence, if financial system remains relations-based and lacked prudential regulation, banks could take risky loans and thereby increase the fragility of the financial system. He asserts that the legal regime has often exhibited a strong degree of inertia in East Asian countries fundamentally due to political rather than legal reasons.

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[410] Walter (2002:8) reached this conclusion on the basis of the interviews he conducted.

[411] Walter (2002:7)

[412] Hamilton-Hart (2000:110)

[413] Walter (2002:21)

For instance, in Indonesia, Thailand and Korea, since interconnected lending is very pervasive, imposition and enforcement of new rules which limits connected lending were faced with great opposition of powerful lobbies. It is argued that this factor, for instance, helps explain why prudential regulation was limited or weakly enforced in the Asian countries before the crisis and why prudential regulation follows financial liberalization rather than precedes it[414].

Another related explanation is that electoral laws may affect the incentives for elected politicians to undertake prudential reform[415]. Politicians may resist raising prudential standards, even after crises, since this may undermine the position of banks, who are often substantial contributors to political financing. In other words, the political cost of raising prudential standards might be declining amount of political donations, which is collected from banks or debtors of politicians. Hence, banks generally affect electoral politics. In societies with weak political parties, politicians may appeal to organized interests rather than the median voter[416].

On the other hand, improvements to prudential regulation generally follow crises, since the median voter bears much of the cost of wrong sequencing, i.e., prudential regulation coming after financial liberalization. Hence, when the crisis hits the country, governments may come under general electorate pressure to raise prudential standards[417].

While the above arguments are helpful in explaining why improvements to prudential regulatory and supervisory frameworks

[414] Walter (2002:21)

[415] See Rosenbluth and Schaap (2002) and Walter (2002:8-9) for more detail.

[416] Walter (2002:9)

[417] Walter (2002:21)

tend to follow crises, they don't explain why in some countries vested interests are less successful in blocking the implementation of prudential standards than in others. It is argued that one factor leading to this difference between countries could be external pressure such as the IMF programs, which insists on regulatory reforms[418]. However, despite these external pressures, implementation failures still exist in the countries that stick to the IMF programs.

Alper and Öniş (2002) explain this situation on the basis of their analysis on Turkish experience. They (2002:19-21) argue that while the primary impetus for regulatory reform originates from the external actors such as the IMF and the World Bank, their role has been in general a discontinuous process. They have little power to push the implementation of these reforms once the legal structure of reform is introduced. Only when the autonomous sphere of action of domestic actors has been substantially undermined following the emergence of a significant crisis, then they succeed in getting heavily involved in the process. The fact that the IMF began to assign a fundamental role to banking sector regulations in stabilization programs only after being exposed to severe criticism in the aftermath of the Asian crises is a case in point.

Another important factor, which lies behind these implementation differences between countries, is corruption. It is argued that in the face of severe fiscal constraint, even uncorrupt politicians and officials may have an incentive to offer the private sector the regulatory forbearance they demand. When the banking sector carries the burden of high non-performing loans (NPLs), then raising prudential standards like capital adequacy ratios (CARs) may increase the short-term fiscal and hence electoral costs of crisis resolution, if the situation develops into a condition in which the

[418] Walter (2002:21)

government has to recapitalize banks. Hence, "after severe financial crisis, the costs of raising prudential standards may be high for the financial sector itself, for heavily indented firms and sectors as well as for the median voter"[419]. Since distribution of resolution costs may lead to political struggle, the government may delay the realization of such costs, even if this raises the ultimate cost of resolving the financial sector problems. "Delay can be achieved by regulatory forbearance, increased debt issuance rather than current taxation"[420].

Walter (2002:2) argues that this is what exactly happened in East Asian countries in the aftermath of the Asian crisis. It is argued that it then became difficult for large debtors and banks to oppose such reforms as compared to the pre-1997 period. On the other side, although politicians came under severe pressure from voters and IFIs to raise prudential standards in the aftermath of 1997, they found the way out through formally raising the standards, but encouraging the financial supervisory authorities to forbear in terms of their implementation. The reason behind this attitude was the high NPL burden of the banking sector. Raising the prudential standards may require the government to recapitalize banks, which increases the fiscal costs of crisis resolution. Therefore, it seems that the less the fiscal constraint, the greater the ability of the government to move towards implementation[421].

The implication of the foregoing discussion is that domestic political and institutional factors seem to outweigh the external factors in explaining the degree of implementation. This is quite evident from the experiences of East Asian countries in the post-crisis period. The IMF pressure on these countries to adopt best practice regulatory

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[419] Walter (2002:21)

[420] Walter (2002:21)

[421] Walter (2002:21)

frameworks as part of conditionality of IMF packages during 1997/98, has not been successful. Malaysia's substantially better performance in this respect, may, on the other hand, be due to its refusal to engage in the IMF programs.

6.3. Regulation and Supervision of the Turkish Banking Sector

6.3.1. The Banking Law of 1985 (Banks Act No:3182)

In the early 1980s, more specifically before the 1982 financial crisis, the reformers' main belief was that enhancing competition is enough for ensuring a sound and strong development in the banking sector. Owing to 1982 crisis, authorities realized the need to focus on banking sector regulation[422]. Hence, during 1983, some steps were taken in terms of regulation of the financial sector in general and banking sector in particular. For instance, Savings Deposit Insurance Fund (SDIF) was established at the Central Bank through an amendment to the Banks Act in 1983 and banks were required to participate in the SDIF[423]. The purpose was to provide insurance for savings deposits. While this original regulation involved an upper limit for each saving account, it was subsequently amended so as to leave the determination of the upper limit for deposit insurance to the discretion and authority of the Council of Ministers.

Major banking reform legislation[424] was enacted on May 2, 1985. Substantial changes were made in the Banks Act[425] with the aim of strengthening the banking system. This law was a landmark in the

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[422] Ersel (2000:3), Denizer et al. (2000:11)

[423] "Savings Deposit Insurance Fund" had been founded with the Decree of Law On Banks Nr. 70 dated July 22, 1983, which annulled the Act Nr. 7129.

[424] Banks Act No:3182 published in the Official Gazette on May 2, 1985.

[425] The first Banks Act of Turkey was approved by the Parliament in 1936. This act was replaced by Act No. 7129 in 1958.

context of regulation and represented the first major attempt to regulate the banking sector[426]. The Banks Act of 1985 included issues related to the structural problems of the banking system with the aim of providing a legal basis for prudential regulation and supervision of the banking system. It also contained provisions regarding the establishment and capital structure of banks, branch banking, foreign banking, deposits, credits and other investments, deposit insurance as well as the transfer, merger and liquidation of banks[427]. Additionally, the Banking Law set the requirement for a unified accounting plan to be used in the banking sector.

More specifically, the Banks Act of 1985 authorized "the Sworn Bank Auditors associated with the Treasury to examine banks' legal compliance and their financial standing"; "authorized the government to change the management of banks in trouble"; and "introduced provisions for a minimum capital base for banks and a capital adequacy ratio in line with the BIS guidelines"[428]. Furthermore, "credit extended to a single customer as well as to related parties was tightly limited. Banks were forced to report non-performing loans separately and they were required to cover defaulted loans through provisions"[429].

6.3.2. Problems in the Regulatory and Supervisory Framework in the 1980s and 1990s

Although it seems that the legal framework was in place after the Banking Act of 1985, the crises of the post-1990 period revealed the weaknesses of the banking system. In this section, political and institutional factors which were instrumental in leading to

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[426] Alper and Öniş (2002:13)

[427] The CBRT (2002:17) and Bayazıtoğlu (1991:11)

[428] Ersel (2000:4)

[429] Ersel (2000:4)

implementation failures of the legal framework will be discussed. We group these factors under two headings: first of all, bank regulation was not the primary objective of the regulatory authority; secondly, political authority was directly involved in the regulatory process leading to politicization.

Conflict of Objectives of the Supervisory and Regulatory Authority

Treasury was the principal institution responsible for bank supervision and regulation until the Banks Act No. 4389 in 1999. Besides on-site examination, establishment of an effective off-site supervision system became an important objective of the authorities. The Sworn Bank Auditors associated with the Treasury were authorized to monitor legal performance and financial structure of the banks.

External auditing became mandatory for banks, which were required to be audited by independent external auditors every year in accordance with the globally accepted principals of accounting. Furthermore, the Central Bank was unofficially incorporated into the supervision process. A division at the CBRT was founded in 1986, which mainly undertook off-site supervision, and if it was deemed necessary, it carried out on-site supervision of banks as well. Later, by January 1987, banks were required to present their financial reports audited by independent external auditors to the Central Bank[430].

Nevertheless, the Treasury had performed its supervisory role to a limited extent in practice, since, first of all, there was a fundamental conflict of objectives in the operations of the Treasury[431]. Although the

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[430] The CBRT (2002:17)

[431] Demirbank's case is given as an example to the obvious conflict of interest between the two primary objectives of the Treasury. It is argued that Demirbank implicitly helped the Treasury with its large portfolio of government securities. Therefore, it is asserted that for that reason, the authorities decided to pursue a

Treasury was the key institution responsible for banking sector regulation, this responsibility was put into a secondary place in terms of its objectives. The primary focus of the Treasury was directed to financing of the budget and meeting day-to-day cash flow constraints of the government. Therefore, the conflict was between having cheap financing of the public sector borrowing requirement on the one hand and bank regulation on the other. The Treasury faced very little incentive to regulate the banks whose holdings of government securities reached excessive amounts, while providing cheap financing for public sector deficit as well as maturing debt. On the other side, possible restructuring of banks would have involved measures such as injection of liquidity using public funds, which would have come into conflict with budget financing.

Politically Subordinate Supervisory Authority

Politicization of the regulation process also impeded the effectiveness of the regulatory process, leading to a bias towards keeping failing banks in the system. There were inherent shortcomings of the Banks Act of 1985 itself. Political authority, in particular the Minister in charge of Economic Affairs, was directly involved in the regulatory process, which restricted the autonomy of the regulatory authority to make difficult decisions. If a bank was identified as operating in an unsatisfactory manner, then it would have been reported to the Minister himself. Then, in principle, according to Article 64, the Minister could set in motion a regulatory process and place the bank under the surveillance of the Treasury. Nevertheless, this did not automatically result in a consequent punishment or enforcement to exit from the system under the Banks Act of 1985, if the banks in question do not restructure themselves. Article 64 of the Banks Act assigned excessive discretionary power to the Minister in charge, while the

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policy of regulatory inaction. (November 2000 crisis was triggered by Demirbank's severe liquidity problems. See for more detail, TCMB (2003)).

Minister was authorized "to take all measures" to improve the condition of the bank including tax breaks. In this phase, the Treasury is empowered to take an active part in the management of the bank to restructure and facilitate an improvement in its performance. However, the banks under article 64 did not have any incentive to improve their condition[432]. This means that there was no exit strategy for poorly performing banks.

Consequently, number of banks under Article 64 was about 15 or more for eight to ten years in the 1990s. Denizer et al. (2000:12) assert that removal from this list seems to have been a negotiated process rather than a regulatory decision. This is quite apparent from the evidence that no single bank was closed whose financial condition was poor and deteriorating until 1999, except during crises period such as 1982 and 1994. Finally, the IMF required the closing of five banks for the Stand-by agreement of 1999. Those banks were all operating under Article 64 for a long period of time.

Hence, the regulatory framework was characterized by the lack of autonomy of the regulatory authority to undertake difficult decisions. Furthermore, as Alper and Öniş (2002:14) argue:

> Bureaucrats involved lacked the power and the incentives needed to confront both the politicians and the banking lobbies resisting regulatory action. Their preference in this environment was to adopt a course of "regulatory forbearance" or a stance of inaction considering the costs of intervention involved[433]. From a bureaucratic point of view, an active and interventionist regulatory stance would invite direct confrontation with individual banks that could often exercise significant political influence. In a political environment characterized by a weak and fragmented party system, and unstable coalition governments, the Minister involved also lacked the power and

[432] Denizer et al. (2000:12); Alper and Öniş (2002:13)

[433] For instance, it is argued that the explosive potential of Demirank's high-risk high-profit strategy was already well known to participants as well as the regulatory authorities well before the crisis in 2000 had occurred (Alper and Öniş, 2002:17).

> incentives needed to initiate regulatory action. In such an environment, the optimal strategy for politicians was to delay actions leading to significant current costs in terms of generation of output and employment losses.

Hence, although the problems of the banks were well known, as reported and documented extensively by the Treasury, no steps were taken. This has contributed to risk taking behavior of the banks, arising largely from the unification of the banking regulation and budgetary financing tasks in a single institution. The Treasury had weak incentives to regulate undercapitalized banks with excessive holdings of government securities, as these holdings eased deficit financing. Furthermore, this distortion seems to have been instrumental in the heavy politicization of banking supervision and regulation[434].

6.3.3. The Banking Law of 1999 (The Banks Act No: 4389) and Establishment of the Banking Regulation and Supervision Agency (BRSA)

The Banks Act[435] was substantially reformed in June 1999 with the aim of strengthening the supervisory authority and to provide a proper framework to deal with the problem of banks. This law introduced two main radical changes to the regulation of the banking system. One of them was the establishment of Banking Regulation and Supervision Agency (BRSA) as an independent body with administrative and financial autonomy. Until 1999, the Treasury, the CBRT and the CMB had been the three main regulatory bodies of the financial sector in Turkey. The Treasury was responsible for regulating and supervising both on-site and off-site, while the CBRT was responsible from supervising the banks basically off-site based on a very comprehensive reporting system.

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[434] Denizer et al. (2000:13); Alper and Öniş (2002:15)

[435] For information about Regulation on the Establishment and Operations of BRSA see http://www.bddk.org.tr/turkce/mevzuat/Teskilat_Yonetmeligi_bddk2005.doc

The new Banks Act No. 4389 authorized the establishment of BRSA as the regulatory and supervisory body for the Turkish banking sector. It was intended to unite the regulatory and supervisory power on banks that was divided between the CBRT and the Treasury, as well as eliminating the political interference on supervisory and regulatory matters. Furthermore, the management of Security Deposit Insurance Fund (SDIF) was transferred to the BRSA from the CBRT.

BRSA was established as an independent supervisory body with full authority to adopt and enforce prudential regulations. However, there occurred some delays in the appointment of BRSA's Board[436] and personnel due to the political intervention[437]. This task was only accomplished on August 31, 2000. This time lag clearly showed the reluctance for or even resistance to reform in the political sphere. As the appointment of the Board was a "structural performance criterion" of the IMF program, which had to be met to receive IMF financial assistance (named "tranche"), the appointments were finally announced, just one day before the IMF deadline.

Credibility and full autonomy of the BRSA is open to discussion. Although political pressures could still be effective in the new environment, this time, it would be in a rather indirect manner. It can also be said with confidence that political pressures are more limited compared to the previous situation. Previously, the Minister could exercise direct influence over the actions of the Treasury on the

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[436] The Board, the decision making body of the Agency, consisting of seven members, has been recognized as "the sole authority to license as well as to withdraw the license of banks, and to decide on the takeover of failing banks by the SDIF". The board members are appointed by the Council of Ministers upon the proposal of the State Minister in charge of the economy. "The Council of Ministers designates one of the appointed candidates as the chairman and another as the vice-chairman".(Banks Association of Turkey, 2000:9)

[437] According to the Banking Law No: 4389, dated June 1999, the Board of BRSA should have been appointed by the end of September 1999 and the BRSA should have commenced its operations by the end of 1999. However, the BRSA could not commence its operations until September 2000, creating a period of regulatory forbearance.

banking sector. Therefore, establishment of BRSA reduced to a large extent the ability of politicians to distort the process of bank regulation. However, since the chairman and the members of the Governing Board of BRSA are appointed by the political authority, it can be asserted that, in principle, the Council of Ministers can have an indirect influence on the decisions of BRSA through their impact on the selection of the Board members[438]. The establishment of the BRSA has also been instrumental in reducing the scope for banking lobbies to resist regulation by recourse to the political process.

Therefore, the new Banks Act was a major step in the direction of overcoming the weaknesses that were known to exist in the system for a long time. However, since the accumulated and neglected problems of the system were so deep and unavoidable, as discussed in detail in Chapter 9, even this major step failed to prevent the eruption of the 2000-2001 crises.

6.3.4. Role of External Actors in the Banking Sector Regulation

External actors, primarily the IMF has played a major role in establishing banking regulatory reform in Turkey. Later, the possibility of Turkey's EU membership also contributed to the reform process. Therefore, Turkey recently faced a double external anchor pushing for regulatory reform[439].

However, in Turkey, the big impetus came only when the autonomous sphere of action of domestic political actors was substantially undermined in the aftermath of a significant economic crisis. Therefore, the role of external actors in the two major regulatory attempts (Banks Act No. 3821 in 1985 and Banks Act No. 4389

[438] Alper and Öniş (2002:22)

[439] Latin American countries did not have such an opportunity (Alper and Öniş, 2002:20).

in 1999), both following financial crises with bank failures, has been substantial as they have been the primary actors in the process of instituting regulatory reform.

On the other hand, a striking point of particular relevance in this context here is that once the legal infrastructure of reform has been set, then the role of external actors in pushing the implementation of these reforms becomes limited. On the basis of the interviews we carried out, it can be argued that despite the IMF, the World Bank and the leading officials of the Central Bank intended to form an independent regulatory agency such as BRSA in the late 1980s, they did not have the power or the autonomy to overcome domestic political pressures in the absence of an explicit crisis. People interviewed have argued that controlling banks, i.e, being the sole regulatory and supervisory authority, gave enormous advantage and power to the hands of the government. The importance of this power was such that even the ministers within the cabinet competed for it amongst each other. Hence, the government did not want to lose this power. The 1994 crisis does not represent a landmark in bank regulation. Despite explicit bank failures during this crisis, bank regulation did not appear as a key part of the ensuing stabilization program[440].

In contrast, the Banks Act of 1999 formed a landmark in terms of bank regulation in Turkey in which the IMF was directly involved, especially in the establishment of BRSA. The IMF responded to the pervasive criticisms against its policies in the aftermath of the Asian crisis with a certain time lag and started to give banking sector regulation a priority in its stabilization programs.

It is also asserted that an equally important factor that increased the power of the IMF in the Turkish context was the growing realization

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[440] Alper and Öniş (2002:20)

on the part of politicians and public at large of an impending fiscal and financial crisis[441]. Therefore, although important steps were taken to build strong regulatory institutions for effective implementation of the banking sector reform, they occurred in a protracted manner with the main initiative coming from external rather than domestic actors with the possibility of a crisis, also playing a part.

6.4. Conclusion

The question why politicians delay enhancing prudential supervisory frameworks, while being well aware of the large costs of financial crises, is an important one. Various political economy reasons lie behind these pervasive implementation failures, as well as others such as technical knowledge imperfection, inadequate resources and knowledge, and insufficient training and expertise of bank supervisors. Easier application of financial liberalization as compared to banking regulation and supervision, governance capabilities of the government, ability of certain interest groups to block reforms, politically subordinate supervisory institutions, and direct involvement of the political authority in the regulatory process can also be cited among the political reasons.

Almost the same factors were in action in the Turkish banking experience. Among these, the direct involvement of the political authority in the regulatory process and the low priority attached to bank regulation on the part of the regulatory authority in the presence of multiple and conflicting objectives were particularly prominent.

In the Turkish experience, while weakness of bank regulation was quite apparent from various bank failures in 1982 and 1994 crises, the authorities did not take adequate regulatory action. Therefore, it can be concluded that unless a crisis undermines the dominance of domestic

[441] Alper and Öniş (2002:21)

actors, domestic political factors and institutional weaknesses outweigh the external factors in explaining the degree of implementation.

On the other hand, the impact of external pressures such as those emanating from the IMF programs on implementation of reforms deserves to be questioned. The general conclusion reached on the basis of country experiences, which is also supported by the Turkish experience, is that they have little power to bring about effective implementation of the reforms once the legal framework is introduced.

CHAPTER 7

PRUDENTIAL REGULATION & SUPERVISION AND FINANCIAL CRISES: A CROSS COUNTRY EMPIRICAL INVESTIGATION

7.1. Introduction

Weakness of the regulation and supervision of the financial system is viewed as a major factor, contributing to the emergence of bank failures[442] and financial crisis. It is argued that if financial liberalization is accompanied with weak prudential supervision of the banking sector, then it will result in excessive risk taking by financial intermediaries and a subsequent crisis[443].

Analogous to these arguments, weak regulation and supervision has been held at least partly responsible for leading to crises in countries ranging from the United States and Japan, to Korea and Mexico, Chile, Thailand on the one hand, to India, Russia, Ghana and Hungary, on the other[444]. The most striking and strong arguments in this context have been raised for the Asian crisis. It is asserted that it would have been possible to avoid the Asian crisis, if banks had been supervised well[445]. Mishkin (2001:8) provides support for this thesis by arguing that the non-crisis countries in East Asia, which are Singapore, Hong Kong and Taiwan, had very strong prudential supervision. Corbett, Irwin and Vines (1999:193) claim that vulnerability to crisis in Asia was created by "liberalization of both trade and financial markets in the

[442] Fischer and Reisen (1992:103), Noy (2004:341), Mishkin (2001:8)

[443] Demirgüç-Kunt and Detradiache (1998), Edwards(2000), Rossi(1999), Mehrez and Kaufmann(2000)

[444] Barth et al. (1999a:1)

[445] Williamson (1999:10), Intal et al. (2001:43)

presence of an unreformed financial system"[446]. Then, more recently, economic crises experienced by Turkey in 2000 and 2001 have drawn attention to the strong correspondence between weak regulation and supervision of the banking system and the outbreak of crises. In the case of Turkey, it is argued that weaknesses in the regulation of both public and private banks contributed significantly to the emergence of crises[447].

Furthermore, a cross country comparison[448] conducted by Williamson and Mahar (1998) concludes that prudential regulation and supervision was stronger in countries experiencing less severe financial crisis as compared to those experiencing a more severe crisis. Besides, average level of prudential regulation and supervision in the five-year period preceding a crisis is found not to be independent from the occurrence of a banking crisis.

While soundness of the banking sector, of course, is not the only element that generates vulnerability to economic crisis, banking regulation and supervision emerges as a major component of vulnerability to crisis. It is argued that as capital account liberalization intensifies capital mobility, this imposes a greater burden on a country to assure that its financial system is well supervised and regulated[449]. It is asserted that strong banking systems can better handle reversals in capital flows, while weak and inefficient banking systems are less able

[446] "The key mistake, which led to the vulnerability of the financial system in Asia, is believed to be that the old-style financial system continued into the new era of liberalization" (Corbett, Irwin and Vines, 1999:194).

[447] Alper and Öniş (2002:2) argue that private commercial banks were instrumental in the outbreak of November 2000 crisis, while it was public banks that were the chief culprits in the subsequent crisis of February 2001.

[448] They constructed an index of the level of prudential regulation and supervision in thirty-three countries. Average level of prudential regulation and supervision in all the countries that experiences financial crises is examined regardless of whether the crisis occurred before or after liberalization.

[449] Dornbusch (1998:20)

to cope with volatile capital flows, therefore, are more vulnerable to contagion[450]. This means that they are more likely to propagate and magnify the effects of financial crises on other economies. Furthermore, it is claimed that concerns about banking solvency or inadequate regulatory frameworks may encourage capital flight.

While an extensive literature is devoted to explain reasons and consequences of financial, mostly banking, crises, reforms proposed to help preventing crises mostly include changes in existing financial regulations and supervisory standards. There exists a long list of "best practices" for the regulation and supervision of banks, which is proposed by the Bank for International Settlements (BIS) and further extended by the IMF and the World Bank. The underlying phenomenon is the belief that if only policymakers in countries around the world would implement particular regulatory and supervisory practices, then banks would be sound and strong, which would prevent banking crises to great extent.

Hence, almost all international financial institutions, but especially the World Bank and the IMF have begun to urge countries to adopt and implement appropriate regulations and supervisory practices for their financial systems. For instance, Barth et al. (1999b:1) emphasize that the World Bank stresses the importance of prudential regulation and supervision more than ever in its all financial sector reviews and projects. It is believed that improvements in the existing financial systems will reduce the likelihood of financial instability and crisis.

The validity of these assertions and beliefs should be questioned, as there is relatively very little empirical evidence that supports the advice for regulatory and supervisory reforms. For instance, there exist

[450] Johnston (1998:5) and Johnston et al. (1997:7)

only a few studies that question whether the so-called "best practices" currently being advocated by international agencies are the best ones for promoting well-functioning banks and whether successful practices in the United States succeed in countries with different institutional and political environments[451].

The reason for the absence of adequate empirical evidence in the literature is the lack of detailed cross-country comparisons of financial and regulatory systems for developing countries and the difficulty of obtaining adequate measures to describe the regulatory and supervisory structure. It was only very recently, in 1999, that data on the practices of various financial regulatory and supervisory authorities for a wide range of countries began to be assembled and analyzed. Hence, the push to reforming financial regulation and supervision by international institutions has begun without even the knowledge as to whether or under what circumstances these efforts will be successful[452]. Furthermore, advice for banking reforms to prevent banking crises began without sufficient information about the extent to which these regulatory and supervisory reforms increase or decrease the likelihood of a banking crisis. Besides, there is very little knowledge about the appropriate way to reform financial sector regulation and supervision in many countries. In view of the fact that capital requirements and regulatory standards recommended by the Basel Committee are designed for industrial countries, their appropriateness for emerging market countries have been rightly questioned in recent years especially in the face of severe banking crises[453].

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[451] Barth, Caprio and Levine (2002:1)

[452] Barth et al.(1999a:3)

[453] This argument is mainly raised and discussed by Rojas Suarez (2001).

The first extensive effort to collect worldwide information related to bank regulations and supervisory activities has been designed and implemented by Barth et al. in 1999, who designed a questionnaire for more than 107 countries[454]. Then, they used this data to assess the relationship between specific regulatory and supervisory practices and banking sector development and fragility in a series of studies[455].

Our purpose in this chapter, first of all, is to see whether there really exists a clear association between weaknesses in the regulation and supervision of the banking sector and financial crises through an empirical analysis. We specifically ask the following questions: Is the weak banking sector supervision and regulation a major contributor to financial crisis? What is the relative role of macroeconomic deterioration in the generation of the crisis, especially when examined together with variables related to the supervisory and regulatory framework. Our analysis differs from that of Barth[456] et al. (2002) in that we incorporate various macroeconomic indicators into the analysis.

We also tackle the following questions: How does financial liberalization lead to the banking sector problems and financial crises and under which conditions? Why is there a need for a strong regulatory and supervisory framework for the banking system? In that context, what is the role of regulation and supervision of the banking sector in preventing the problems in the banking sector generated by financial

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[454] This survey was funded by the World Bank. The data were based upon surveys sent to national bank regulatory and supervisory authorities: The contact individuals at national regulatory and supervisory agencies were provided by the Basel Committee on Banking Supervision. Furthermore, participants to World Bank seminars for bank supervision from emerging market countries were also asked to complete the survey. Furthermore, World Bank personnel traveling to countries that had not yet responded to the survey delivered the survey to the appropriate officials. The data is available at the following website:
http://www.worldbank.org/research/projects/bank_regulation.htm.

[455] Barth et al. (1999a), (1999b), (2002)

[456] Inflation was the only macroeconomic indicator they have used in their banking crises regressions.

liberalization? What is the framework of the prudential regulation and supervision of the banking sector currently proposed by international agencies?

This chapter is organized as follows: The issue of how financial liberalization affects the banking system and the reasons for the consequent need for supervision and regulation of the banking sector is explored in section 2. This is followed in section 3 by a discussion of the general framework of regulation and supervision proposed by international agencies. Section 4 discusses previous studies. Section 5 is devoted to our empirical analysis. Section 6 concludes.

7.2. Financial Liberalization and Excessive Risk Taking by Banks

Financial liberalization may intensify or lead to problems in the banking sector through introducing new and highly complex elements of risk[457] to the financial system. The main problem emerges when banks expand their risky activities at rates that far exceed their capacity to manage them prudently. Banks generally have an incentive to engage in excessive risk-taking and speculative activities as long as they guarantee that their failure will not threaten their shareholders and managers. This guarantee is provided by deposit insurance, implicit or explicit guarantees for bail-out by the government and through easy access to the lender-of-last resort facility[458].

7.2.1. Deposit Insurance

Deposit insurance, which is a scheme particularly observed in developing countries, is designed to protect depositors and attract

[457] These risks, which affect both banks and non-banks, are credit risk, market risk and liquidity risk. For more detail of each type of risk, see Appendix C.

[458] Akyüz (1993:16)

funds to the banks, as this. Nevertheless, this scheme provides a kind of guarantee that financial institutions would not be allowed to go broke and/or government bail-outs would protect them. Under these circumstances, banks, in particular, would expect that the government would bail them out, since banks are more likely than other financial institutions to be bailed out. This gives an assurance to depositors and foreign lenders that they do not need to monitor these institutions[459]. Then, banks having this guarantee, being obliged to pay very little for the insurance coverage, may have all the incentives to channel funds into high-return, high-risk and speculative projects and be illiquid[460].

These incentives provided by deposit insurance system stimulate excessive risk-taking by banks in the presence of weak prudential regulation and poor supervision, either in design or enforcement or both, such that the levels of bank capital and provisions for loan losses become inadequate. McKinnon (1998:56) calls this situation as the "overborrowing syndrome", which refers to excessive bank lending.

The presence of full implicit or explicit deposit insurance leads to moral hazard[461]. Hence, as financial liberalization creates new opportunities to take on risk, the result is excessive risk-taking in the presence of weak regulatory/supervisory system, which cannot limit the moral hazard created by the government safety net.

It is argued that the main reason behind the collapse of the domestic financial system in Latin America in the early 1980s was the belief among depositors and financial intermediaries that the

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[459] Mishkin (2001:8)

[460] Akyüz (1993:16)

[461] Moral hazard occurs after the transaction takes place. A lender is subject to hazard that the borrower has incentives to engage in activities that are undesirable from the lender's point of view, i.e. the activities that make it less likely that loan will be paid back. Again, many lenders will lend less than they would otherwise so that lending and investment will be at suboptimal levels. (Mishkin, 2001:2).

government would step in crisis times to protect depositors' savings and prevent closure of financial firms. Even if there is no explicitly stated guarantee by the government, the fact that there is no credible threat of bankruptcy and a belief of full guarantee among domestic depositors and foreign lenders resulted in moral hazard problems. These problems were further aggravated by inadequate supervisory and prudential regulation system.

According to Corbett et al. (1999:209), Asian crisis was the "consequence of insufficient institutional development in the region during the miracle boom period". It is argued that implicit guarantees in the financial system were one of the major flaws during the period of liberalization. Therefore, one of the factors that created vulnerability in Asia was the presence of a bank-based financial regime in which "there was implicit promises of a government bailout of the financial system in the event of bad out-turns"[462].

Consequently, strengthening prudential regulation and supervision is necessary to deal effectively with the banking sector risks, particularly in the context of capital account liberalization. Moreover, strong regulatory and supervisory policies are important to minimize moral hazard (including corruption, fraud and excessive risk taking) in the banking system. It is important that policymakers develop institutional mechanism, so as to enhance the roles and functions of regulators and tackle moral hazard.

[462] Corbett et al. (1999: 191)

7.3. The Need for Prudential Regulation and Supervision

On the basis of the discussions above, strengthening prudential supervision seems necessary first of all, to deal effectively with interest rate and exchange rate risks and other banking sector risks, particularly in the context of capital account liberalization.

Secondly, strong regulatory and supervisory policies are important to minimize moral hazard (including corruption, fraud and excessive risk taking) in the banking system. Furthermore, it is important that policymakers develop institutional mechanisms, so as to enhance the roles and functions of regulators and tackle moral hazard on the way to strengthening domestic financial sectors.

Thirdly, the existence of systemic risk provides strong arguments for regulation[463]. Since each bank is an integral part of the payment system, failure of a bank can generate a domino effect on the other solvent and profitable banks. Therefore, risk of a system failure forms the basis of the argument of insuring banks against liquidity shocks. Systemic risk also explains the existence of both lender of last resort and deposit insurance, which leads to the problem of moral hazard. Asian crisis of 1997 is an example for the problem of systemic risk.

Another reason for bank regulation is the existence of asymmetric information problem and the inability of small depositors to monitor banks. Concerning the inability of small depositors to monitor banks, it is argued that there is a need for the regulatory authority agent to act as a public representative of depositors[464].

Alper and Öniş (2002:5) assert that effective regulation is particularly important for what they call "transitional financial

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[463] See Alper and Öniş (2002) and Santos (2000:5-6) for a detailed discussion.

[464] Alper and Öniş (2002:5-6)

systems" to describe a system where market liberalization proceeds rapidly in the absence of an effective legal and institutional infrastructure. These intermediate regimes is said to be observed in emerging market economies such as Turkey, Mexico and Argentina. It is argued that such transitional financial systems are characterized by a fundamental asymmetry. While the banking sector may have little impact on the development of the real economy under normal conditions, a major financial crisis can have a devastating effect on real economic performance. Due to this fundamental asymmetry, it is argued that there is a clear need to develop a strong regulatory framework for the banking sector in terms of both preventing crises and achieving long-term economic growth.

Furthermore, it is strongly recommended that problems such as non-performing loans; connected lending among related banks and firms as well as the concentration of loans to specific sectors and firms should be solved through prudential regulation before full domestic financial liberalization. The potential official credit risks arising from institutional failures such as mispricing of risk or widespread fraud provide a strong case for improving the domestic system of prudential supervision[465].

It is also argued that prudential regulations should ensure first of all, the solvency of lending institutions. Prudential regulations should ensure adequate levels of liquidity for financial intermediaries so that they can handle the mismatches between average maturities of assets and liabilities, which generate risks associated with the volatility in deposits and interest rates. In order to prevent currency mismatches, i.e. to reduce imbalances in the maturities of assets and liabilities of financial intermediaries, strict regulations are needed. It is especially

[465] Mathieson and Rojas-Suarez (1994:344)

claimed that prudential regulation should be particularly strict with respect to the intermediation of short-term external credits[466].

Hence, supervision and prudential standards should be improved so as to ensure that banks meet capital requirements, make adequate provision for bad loans, limit connected lending, and publish informative financial information, and that insolvent institutions are dealt with rapidly[467].

7.4. Framework of Prudential Regulation and Supervision

Ultimate objective of prudential regulation and supervision of the banking sector is, therefore, stabilizing the financial system and obtaining public confidence in its stability, as well as being able to manage systemic risk and protect clients. Strong regulatory and supervisory policies are also important to ensure viability and health of the banking system[468].

7.4.1. Capital Requirements (Capital Adequacy Ratio)

It is suggested that the framework for financial regulation should be such that one set of rules would operate during normal times and would be designed to minimize the likelihood of a financial crisis, while another set of rules would operate when a crisis emerges[469]. However the design of an appropriate regulatory framework is not simple due to existence of information asymmetries and problems of incomplete and imperfect information. Therefore, it is quite difficult to regulate banks, as information problems affect all participants whether they are creditors, shareholders, senior bank managers or even regulators.

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[466] Ocampo (2000:32)

[467] Fischer (1998:4) and Mathieson and Rojas-Suarez (1994:343)

[468] Fischer and Reisen (1992:128)

[469] Barth, Caprio and Levine (2002)

Although the general direction that the banking reforms need to move is clear, the appropriate mix of different components of regulation and supervision is open to discussion. It is argued that prudential regulations should include the whole spectrum of risks in the banking system. While they usually tend to cover credit risk, they are suggested to embrace other risks such as default, liquidity and interest rate risks[470]. Although financial authorities in industrial countries have a number of tools at their disposal to assess the quality of banks' balance sheets and off-balance sheet commitments, the summary statistic for bank risk, which includes a composite assessment of credit and market risks, is the capital-to-risk-weighted-asset ratio (capital adequacy ratio). The reason why the capital adequacy ratio can take the function of a summary statistic for risk[471] is explained by arguing that at least in theory, enforcement of each of the other supervisory ratios implies an adjustment in the value of assets and liabilities that ultimately affects the size of the bank's capital account.

Another reason for capital requirements emerges from the moral hazard problem that derives from deposit insurance[472]. Since banks operate within a public safety net, i.e. they have access to central bank funds in an emergency and they are often covered by publicly provided deposit insurance, these facilities allow banks to take excessive risks. As safety nets create incentives for banks to take on more risk, there emerges a need for banks to be supervised and regulated. Therefore, it is argued that forcing banks to have sufficient capital at risk is a way to achieve this objective[473].

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[470] Fischer and Reisen (1992:128)

[471] See Rojas-Suarez (2001:2) for more detail.

[472] Rojas-Suarez (2001:3)

[473] Rojas-Suarez (2001:3)

On the other hand, it is asserted that even in the absence of deposit insurance, capital requirements are needed to minimize the outbreak of a systemic banking crisis[474]. It is argued that requirement of sufficient capital not only helps to minimize the occurrence of crisis, but minimizes the total social cost of crisis resolution if a crisis occurs. Therefore, capital requirements are not just linked to individual bank's assets but also to the risk of systemic failures.

It is argued that the implementation of capital requirements has been quite helpful for regulators and supervisors in industrial countries in terms of constraining bank risk. Capital requirements are expected to provide a buffer against unexpected losses for ensuring safety and soundness of the banking system. That is to say, accumulation of capital in banks' balance sheets is expected to act as buffer against adverse shocks they face in order to minimize the likelihood of severe financial disturbances. As capital absorbs possible losses, it is the ultimate determinant of a banks' lending capacity.

The Basle I Accord published in 1988 by the Basel Committee on Banking Supervision has been the central guide for regulating bank capital requirements. However, the Basle I Accord is criticized[475] on the basis that it has severe limitation in the appropriate assessment of bank risk, as it includes only the credit risk. For that reason, the Basel Committee has issued a new proposal named "Basel II Accord" to modify the previous one. However, despite the problems leading to the proposal of Basel II, there is a consensus among industrial countries on capital requirements providing an efficient mechanism to ensure bank

[474] Rojas-Suarez (2001:3)

[475] See Rojas-Suarez (2001) for a discussion of these criticisms.

soundness. That is to say, appropriateness of capital as a supervisory tool is not even discussed among industrial countries.[476]

Since capital requirements have been perceived as a successful supervisory tool in industrial countries, emerging market countries are also advised to adopt similar rules for capital adequacy. Therefore, many emerging market countries though at very different paces have begun to implement recommendations on capital adequacy requirements of the Basel Committee on Banking Supervision as a part of financial sector reform process since late 1980s[477]. On the other hand, while implementation of capital requirements is quite appropriate for the regulators and supervisors in industrial countries, its appropriateness for developing countries is open to discussion.

7.4.2. How Appropriate Is the Proposed Regulations for Developing Countries?

Since capital requirements recommended by the Basel Committee on Banking Supervision, i.e. regulatory standards, are designed for industrial countries, their appropriateness for emerging market countries are questioned in recent years in the face of severe banking crises. Rojas-Suarez (2001), for instance, questions whether the capital adequacy requirements have worked as an effective early-warning mechanism signaling problems in individual banking institutions[478]. She (2001) concludes that capital ratios have been meaningless in signaling banking sector problems and the capital to

[476] Rather "the discussion centers on issues such as who should determine the right amount of bank capital: the authorities or the markets? and what instruments should count as core capital: only equity or subordinated debt?" Rojas-Suarez (2001:4)

[477] See Rojas-Suarez (2001) for detail.

[478] Rojas-Suarez (2001) examines a group of countries on the basis of a representative set of key indicators used by supervisors to assess the strength of individual banks. It is concluded that while performance of these key indicators in predicting bank difficulties was not good, the capitalization ratio was the worst performer.

asset ratio has not been a useful early-warning indicator of the banking sector problems.

The main problem is that capital requirements derived from Basel I or Basel II does not reflect the risks taken by banks in emerging markets[479]. Hence, a uniform framework for capital standards may not be appropriate for all countries. It is argued that a direct application of Basel capital standards to emerging markets is not the appropriate way to strengthen banking systems. It is claimed that the problem is not related to the Accord itself, since the Basel Accord is "designed as a set of recommendations for the adequate holdings of capital by large banks operating internationally" [480]. It is claimed that "the problem lies in its application to countries that do not meet the requirements for the Basel standards to work effectively"[481]. Therefore, Walter (2002:14) also suggests that bank capital ratios generally should not be compared either across time or across countries[482].

Since "capital ratios cannot perform their supervisory role of containing excessive risk taking activities of banks" [483], a large number of problems has emerged in the banking sector of many emerging market countries. Hence, it might be concluded that capital

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[479] Rojas-Suarez (2001)

[480] Rojas-Suarez (2001:28)

[481] Rojas-Suarez (2001:28)

[482] Walter (2002:11-12) explains very clearly the reason why bank capital ratios are not comparable. Briefly, loan accounting rules, provisioning rules, deferred taxes, sources of capital and unrealized capital gains and losses are calculated very differently by each country. In other words, there is no general standard accepted by each country in the calculation of capital adequacy ratios, therefore, calculations show a wide variety across countries. See Walter (2002:11-12) for further detail.

[483] Rojas-Suarez (2001:4)

requirements have usually not operated as an efficient supervisory tool in these countries as well, quite contrary to expectations[484].

Two sets of recommendations are suggested for emerging market economies while designing a standard that compensates this weakness of Basel I and II[485]. It is argued that a simple capital to risk-weighted assets ratio is appropriate for emerging markets. However, it is discussed that there should be two fundamental differences relative to the current Basel Accord. One is related to the minimum capital requirements.

As the Basel Committee recommendations on banks' capital adequacy set the overall minimum capital-to-risk-weighted-asset ratio at a fixed 8 percent, Rojas-Suarez (2001:3) claims that why it is set at this level needs to be questioned. It is argued that since the risk of a systemic banking crisis varies significantly across countries, especially between emerging and industrial countries, then this level should be adjusted accordingly. Since economic and financial volatility is higher in emerging market economies compared to industrial countries, "the buffer stock required by banks to withstand unexpected shocks without becoming insolvent is larger in the former group of countries than the latter" [486].

Walter (2002:14) asserts that the quality of assets in much of East Asia may be lower than those of banks in other countries, due to the common practice of connected lending in these countries. Therefore, it is argued that required capital adequacy ratios (CARs) for these banks should be higher than that for banks in advanced countries, i.e., those proposed by the Basle Committee on Banking Supervision of

[484] Rojas-Suarez (2001:4)

[485] Rojas-Suarez (2001:28-30)

[486] Rojas-Suarez (2001:35)

the Bank for International Settlements to constrain the risk-taking by government-insured banks[487].

In practice also, required CARs are considerably higher than the 8% Basle minimum in some East Asian countries including Hong Kong and Singapore. On the other hand, it is argued that Basle committee does not give any guidance as to how much these required CARs should be higher in emerging market countries, partly due to the political sensitivity of the issue[488].

7.5. Previous Studies

The question that we aim to answer in this chapter, i.e. the issue whether the weak banking sector regulation and supervision is closely associated with financial crisis, has been explored empirically in a few studies.

Demirgüç-Kunt and Detragiache (2000) found that presence of an explicit deposit insurance scheme tends to increase the probability of systemic banking problems. For the period 1981-97 that they examined, they have concluded that moral hazard played a significant role in leading to systemic banking problems, especially since countries with deposit insurance schemes did not control successfully the negative effects of moral hazard through appropriate prudential regulation and supervision.

One of the studies that examines the links between capital account liberalization, prudential regulation and supervision and financial crises is an IMF Working Paper by Rossi (1999). The difficulty of comparing regulatory practices for a range of counties is overcome in this study through developing an index that accounts for differences of

[487] Ocampo (2000:32); McKinnon (1998:57)

[488] Walter (2002:14)

the regulatory and supervisory practices of different countries in terms of internationally accepted guidelines. One of the results of the study is that lax prudential practices and higher depositors' safety seem to exacerbate financial fragility. Rossi (1999:15) concludes that banking crises are more likely in the presence of controls on outflows, of laxer prudential regulation and high depositors' safety. The striking conclusion of his paper is that capital account liberalization is found not to have contributed to the banking crises, as one would expect from a study carried out by an IMF staff member. Furthermore, a less repressed financial system is found to allow countries to achieve financial stability and higher economic activity over the business cycle.

Noy (2004) searches for empirical evidence to the hypothesis that if liberalization is accompanied by insufficient prudential supervision of the banking sector, then it will result in financial crisis. He concludes that insufficiency of the prudential regulation and supervision presents only a medium term threat to the banking sector. However, he complains about the weaknesses of supervision variables he used in regressions. Furthermore, he (2004:356) adds that "the onset of banking crisis is a process that embodies a lot of institutional and political details that have been, until now, beyond the reach of econometric research". On the other side, he found almost all macroeconomic and financial variables he included –inflation, M2/reserves ratio, GDP growth rate, real exchange rate and foreign interest rates- as significant contributors to the likelihood of a banking crisis.

Barth, Caprio and Levine (1999b) questioned whether countries with more restrictive regulatory systems have a lower probability of suffering a banking crisis. They (1999b:12) found that restricting bank activities tends to increase the likelihood of suffering a major crisis. Particularly, in countries in which securities activities are restricted,

the likelihood of a banking crisis is greater. This finding is quite opposite to those which claim that stricter restrictions on the allowable activities of banks constraints excessive risk taking behavior. Furthermore, Barth et al.(2002:15) found no evidence for the proposition that strict capital adequacy regulations ameliorate the risk taking incentives produced by generous deposit insurance. They (2002:15) argue that while these results do not imply that capital is unimportant for bank fragility, "they suggest that there is not a strong relationship between the stringency of official capital requirements and the likelihood of a crisis after controlling for other features of the regulator and supervisory regime". Furthermore, they accept that "this finding contradicts conventional wisdom and the current focus of the policy advice being advanced by international agencies"[489].

7.6. Empirical Analysis

7.6.1. Data

The main challenge of finding regulatory and supervisory data on cross country basis has been solved by using the database that is compiled by Barth, Caprio and Levine by conducting a survey[490] on the different financial regulatory and supervisory environments that exist in 107 countries throughout the world. These survey results give information about the extent to which various regulatory and supervisory practices in different countries accommodate international best practices. The regulatory and supervisory data are measured over the 1998-2000 period[491]. Since most of the crises occurred throughout

[489] Barth et al. (2002:15)

[490] Barth, Caprio and Levine designed and implemented a survey funded by the World Bank to collect information on bank regulations and supervisory practices.

[491] Barth et al. (2002:16) mentions that of the 107 responses received, 13 responses were received in November 1998, 65 were received in 1999, and 29 in early 2000. Data is available at the following website: www.worldbank.org/research/interest/intrstweb.htm

the 1990s and a time-series database on the full range of bank regulatory and supervisory policies is not available, a careful examination of the regression results is needed. On the other hand, the assertion extended by Barth, Caprio and Levine (2001) that restrictions on bank activities have not changed much over the last two decades removes the doubt to a major extent.

Indices used in the empirical analysis were provided by Barth, Caprio and Levine on our request. Basically, these aggregate indices are obtained by incorporating the answers to many questions[492]. Table 7.1 provides information about all variables by name, definition and sources. The entire database embraces 5 qualitative and 2 quantitative variables. Quantitative variables are control variables, which are inflation and current account balance as a percentage of GDP as the macroeconomic factors likely to lead to a financial crisis.

The sample covers both developing and developed countries. The 40 countries included in the sample are as follows: Developing countries are Argentine, Brazil, Chile, China, Czech Republic, Greece, Hungary, Indonesia, India, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Thailand, Turkey and Venezuela. Developed countries are Austria, Australia, Belgium, Canada, Denmark, France, Finland, Germany, Ireland, Israel, Italy, Japan, Spain, Switzerland, Sweden, Netherlands, New Zealand, United Kingdom and United States.

[492] For more information about specific survey questions used to construct indices, see Barth et al. (2002:21)

Table 7.1. Data Base

Name	Definition	Source
Qualitative Variables		
Systemic Banking Crisis	Whether a country suffered a major banking crisis according to Caprio-Klingebiel (1999) during the 1990s or late 1980s. Dummy, where 1 indicates a crisis.	Database requested from Barth, Caprio and Levine
Capital Regulatory Index	It measures both the extent of regulatory requirements regarding the amount of capital that banks must have relative to specific guidelines and the extent to which the source of funds that count as regulatory capital that can include assets other than cash or government securities, borrowed funds, and whether the sources of capital are verified by the regulatory or supervisory authorities. It ranges in value from 0 to 9, with a higher value indicating greater stringency. (Barth, Caprio and Levine, 2002:17)	Database requested from Barth, Caprio and Levine
Restrictions on Bank Activities	It includes restrictions on securities, insurance and real estate activities plus restrictions on the ability of banks to own and control non-financial firms. (Barth, Caprio and Levine, 2002:16)	Database requested from Barth, Caprio and Levine
Moral Hazard Index	This index is taken from Barth, Caprio and Levine (2002:19) who adopted from Demirgüç-Kunt and Detragiache (2000). Demirgüç-Kunt and Detragiache (2000) used principal components to capture the presence and design features of explicit deposit insurance systems with the latter including: no coinsurance, foreign exchange deposits covered, interbank deposits covered, type of funding, source of funding, management, membership and the level of explicit coverage. The higher the value, the greater is moral hazard. (Barth, Caprio and Levine, 2002:20)	Database requested from Barth, Caprio and Levine
Bank Development	It equals claims on the private sector by deposit money banks and as a share of GDP and is the average value over the 1997-99 period to smooth any business cycle fluctuations. (Barth, Caprio and Levine, 2002:21)	Database requested from Barth, Caprio and Levine

Quantitative Variables		
Inflation	Average inflation rate during the five years prior to the crisis in countries that experienced a banking crisis. In countries that did not experience a crisis, the average inflation rate during the five years prior to the survey, 1993-97 is used. (Barth, Caprio and Levine, 2002:29)	Database requested from Barth, Caprio and Levine
Current account balance (% of GDP)	For the countries that experienced a crisis, current account balance as percent of GDP is taken prior to crisis year. In countries that did not experience a crisis, current account balance as percent of GDP in 1999 is used.	World Development Indicators (WDI) online database, World Bank
GDP per capita growth (annual %)	For the countries that experienced a crisis, GDP per capita growth is taken prior to crisis year. In countries that did not experience a crisis, GDP per capita in 1999 is used.	World Development Indicators (WDI) online database, World Bank
Real interest rate (%)	For the countries that experienced a crisis, real interest rate is taken prior to crisis year. In countries that did not experience a crisis, real interest rate in 1999 is used.	World Development Indicators (WDI) online database, World Bank
Domestic credit provided by banking sector (% of GDP)	For the countries that experienced a crisis, domestic credit provided by banking sector as a percent of GDP is taken prior to crisis year. In countries that did not experience a crisis, data in 1999 is used.	World Development Indicators (WDI) online database, World Bank
Gross private capital flows (% of GDP)	For the countries that experienced a crisis, gross private capital flows as a percent of GDP is taken prior to crisis year. In countries that did not experience a crisis, data in 1999 is used.	World Development Indicators (WDI) online database, World Bank

7.6.2. Descriptive Statistics and Regression Results

The relationship between banking crises and regulatory and supervisory environment are examined using both simple correlations and logit regressions. We first present the simple correlations between each of the measures of the regulatory environment and banking crises. Then, regression results are presented, where we control for inflation and current account balance to GDP ratio. Although all quantitative

variables are involved in these regressions, only the results related to inflation and current account balance to GDP ratio will be reported. This arises from the fact that other quantitative variables have been found insignificant. It is important to control for these variables, i.e., macroeconomic indicators in evaluating the relationship between the regulatory/supervisory environment and banking crises.

7.6.2.1. Correlations

On the basis of correlations between banking crisis and regulatory environment as well as macroeconomic indicators, we found positive correlation between banking sector crisis and generosity of the deposit insurance regime (high values of the Moral Hazard Index), inflation as well as regulatory restrictions on bank activities (see Table 7.2). In other words, increases in the rate of inflation, more generous deposit guarantee and restrictions on bank activities raise the likelihood of suffering a banking crisis. There is a negative correlation between banking sector crisis and capital regulatory index and current account balance to GDP ratio. Signs of these correlations are as expected. Signs of all correlation coefficients are as expected.

Table 7.2: Correlations Among Selected Variables

	Major Banking Crisis	Capital Regulatory Index	Moral Hazard Index	Restrictions on Bank Activities	Current account balance (% of GDP)	Inflation
Major Banking Crisis	1					
Capital Regulatory Index	-0.52	1				
Moral Hazard Index	0.41	0.18	1			
Restrictions on Bank Activities	0.53	-0.37	0.009	1		
Current account balance (% of GDP)	-0.32	0.19	0.14	-0.16	1	
Inflation	0.39	-0.42	0.28	0.37	-0.25	1

7.6.2.2. Estimation Methodology and Regression Results

In the empirical analysis, the dependent variable is a dummy variable called CRISIS, where CRISIS equals 1 if a country suffered a banking crisis and CRISIS equals 0 otherwise. A country is considered to have a crisis if the estimated losses to the government due to bank failures are greater than five percent of GDP[493].

[493] Barth, Caprioand Levine (1999b:14)

Table 7.3: Banking Crises Regressions

Equation	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Constant	-1.7109 (0.0399)	-0.8066 (0.3821)	-1.97 (0.0440)	-0.8627 (0.3724)	-1.834 (0.3022)	-0.0053 (0.9984)	-0.7679 (0.5996)	1.3614 (0.1473)
Restrictions on Bank Activities				1.1821 (0.0448)		1.371 (0.3072)	2.0310 (0.0252)	1.8399 (0.0929)
Capital Regulatory Index		-1.0898 (0.0651)			-3.9793 (0.0143)	-3.7381 (0.0362)		-3.7836 (0.0313)
Moral Hazard Index			0.5278 (0.0411)		1.5308 (0.0225)	1.5622 (0.0417)	1.0998 (0.0352)	1.5323 (0.0306)
Current Account to GDP ratio	-0.03189 (0.7543)	-0.0181 (0.8706)	-0.1721 (0.2549)	-0.0582 (0.6038)			-0.4858 (0.0762)	
Inflation	0.2835 (0.0461)	0.1956 (0.1498)	0.2689 (0.111)	0.2403 (0.1199)	0.3963 (0.1693)	0.1961 (0.5922)	0.1299 (0.5170)	

Note: Each column gives complete logit results. P-values are in parenthesis. Capital regulatory index, moral hazard index and restrictions on bank activities are principal component versions.

Table 3 presents logit regressions on the relationship between the likelihood of experiencing a banking crisis and each bank regulation and supervision indicator, while controlling for macroeconomic instability indicators such as inflation and current account balance to GDP ratio, which are generally accepted as important determinants of banking crises.

The overall empirical test results based on logit regressions state that moral hazard and the capital regulations emerge as the most important variables that affect the probability of a banking crisis. The results suggest that there is a robust relationship between capital

regulations, i.e. stringency of official capital requirements and the likelihood of a crisis after controlling for other characteristics of the regulatory and supervisory environment and macroeconomic instability indicators (equations 2, 5, 6). This finding is contrary to the one reached by Barth et al. (2002:33). On the other hand, this result is quite consistent with the current policy advices of the international institutions.

Results also support the association established in the literature between the generosity of the deposit insurance system and the likelihood of a banking crisis[494]. This positive relationship is quite robust to alterations in the control variables. Furthermore, tighter capital regulations do not seem to mitigate the negative impact of moral hazard problem generated by generous deposit insurance system, which is a striking message against propositions raised by international financial institutions towards stressing more stringent capital requirements as a remedy to generous deposit insurance system. Hence, while an increase in the moral hazard increases the probability of a banking crisis, an increase in the capital regulatory index decreases the probability of such a crisis.

A third seemingly important variable is the restrictions on bank activity. When we control for macroeconomic indicators (equation 4), countries with more restrictions on bank activities have significantly high probabilities of suffering a banking crisis. Positive link between the likelihood of a crisis and greater restrictions on bank activities are explained by Barth et al. (2002:31) by arguing that diversification of income sources through nontraditional bank activities –allowing banks to engage in an assortment of activities- tends to be positively

[494] Demirgüç-Kunt and Detragiache (2000) reached the conclusion that deposit insurance generosity predicts future banking crises. Barth et al. (2002:34) also find a strong relationship between these two variables.

associated with bank stability, especially in economies with active non-bank financial markets.

Most importantly, the regression results suggest that the macroeconomic dynamics such as inflation and the current account deficit, turn out to be insignificant when the structural variables are added to the regressor set. When these structural variables such as the moral hazard index and capital regulatory index are accounted for, the impact of these macroeconomic variables become negligible.

Table 7.4: OLS Regression Results

	Inflation	Current account balance (% of GDP)
Constant	**10.8368** **(0.0001)**	**-2.6518** **(0.0233)**
Capital Regulatory Index	**-5.6313** **(0.0241)**	**0.7091** **(0.5382)**
Moral Hazard Index	**1.9236** **(0.029)**	**0.255** **(0.5316)**
Restrictions on Bank Activities	**2.8993** **(0.1907)**	**-0.6412** **(0.5437)**

Table 7.4 presents the OLS regression results, where inflation and current account balance to GDP ratio is regressed on a set of regulatory and supervisory indicators. While inflation is significantly associated with capital regulatory index and moral hazard index, current account balance does not present any significant relationship. This result point to the fact that in countries where there exists macroeconomic instability as indicated by high rates of inflation, structural weaknesses in the banking system are also common.

7.7. Conclusion

If financial liberalization is undertaken in the presence of weak prudential regulation and supervision of the banking sector, financial liberalization motivates and enables excessive risk taking by financial institutions and creates distortions in the allocation of credit. It further increases the vulnerability of banks to shocks and subsequent crisis. On the other hand, presence of efficient supervision and regulation is viewed as a guarantee that prevents excessive risk taking, hence, it is argued that financial liberalization is unlikely to have adverse effect on the stability of the banking sector.

Inherent micro-economic imperfections facing the banking industry such as adverse selection, moral hazard, principal-agent issues and other micro-imperfections due to informational asymmetries and uncertainties lay the basis of the difficulties of designing appropriate framework for banking sector regulations and of preventing excessive risk taking activity by banking sector. Excessive risk taking, in turn, results in deterioration of financial sector balance sheets, which can, by itself, be sufficient to lead to financial or economic crises. Thus, it seems that regulatory improvements should discourage excessive risk-taking by financial institutions.

The issue of the appropriateness of proposed regulations for developing countries is not considered in the present study. Instead, we consider the role of regulatory and supervisory framework in the context of banking crises. In particular, we ask whether weak regulatory and supervisory framework is sufficient for creating a suitable environment for crisis. Empirical results point to the robust significance of deposit insurance and capital requirements in leading to crises. While moral hazard arising from deposit insurance was found as a major factor in leading to crises before by other studies, capital regulatory index was found insignificant by Barth et al.(2002). Our test

results indicate that capital regulations is a major factor in the prevention of crises, which give important support to the propositions led by international agencies towards ensuring higher capital requirements. On the other hand, tighter capital regulations do not seem to mitigate the negative impact of moral hazard problem generated by generous deposit insurance system, which is a striking message against propositions raised by international financial institutions towards stressing more stringent capital requirements as a remedy for generous deposit insurance system.

While inflation is a major macroeconomic indicator, with a significant role in the generation of crisis, its significance weakens to a major extent, when accompanied with regulatory and supervisory factors. Hence, the significance of regulatory and supervisory framework of the banking system is once more justified.

A very important policy lesson that can be derived from the empirical findings is that the nature of the banking crises is closely associated with the institutional structure of the financial system rather than macroeconomic conditions of the economy. It is concluded that once a solid institutional structure of the banking system is established, worsening macroeconomic conditions need not lead to a banking crisis. Thus, in order to prevent banking crises, the policymakers should focus more on the institutional factors, such as moral hazard problem, capital regulations and restrictions on bank activities. On the other hand, if these conditions are not met, then worsening macroeconomic conditions most probably lead to a banking crisis. In this empirical analysis, only institutional factors related to the banking sector are taken into consideration, due to difficulty of obtaining cross country data concerning political institutional factors.

While this conclusion supports the view that weakness of the banking system has played a major role in leading to 2000 and 2001

crises in Turkey, since we were not able to include political institutional factors into the analysis as well as other institutional factors, we do not claim that it would have been possible to prevent crises in Turkey through proper implementation of prudential banking regulation and supervision.

CHAPTER 8

EXPLAINING FINANCIAL CRISES WITH A SPECIAL FOCUS ON THE ROLES OF INSTITUTIONAL FACTORS

8.1. Introduction

There exists a voluminous literature about financial and currency crises that occurred in the 1990s. There are different approaches to crises. The literature was focused on balance of payments crises (currency crises) in the late 1970s and early 1980s. This literature emphasized the inconsistency between fiscal and monetary policies and the exchange rate commitment[495] as the major reason of crises. In the wake of the Mexican and Asian crises in the 1990s, the subject of financial crises has come to the forefront of academic and policy discussions and the focus of literature changed towards stressing self-fulfilling expectations[496] and herding behavior in international capital markets as the underlying reasons of these financial crises.

The East Asian financial crisis also provided the lesson that imprudent and inappropriately sequenced financial liberalization increases vulnerability to speculative attacks and financial crisis. Gradual liberalization of capital flows and strengthening of domestic financial systems emerged as important measures besides good macroeconomic fundamentals. Moreover, the reason why the Washington Consensus policies are incomplete and flawed[497] is explained by arguing that they divert attention from other important

[495] This is known as first generation model of crises. See Krugman (1979)

[496] This is known as second generation model of crises. See Obstfeld (1986)

[497] See Ahrens (2000:7-8) for further details on this subject.

sources of macroeconomic instability such as weak financial systems and an improper sequencing of financial liberalization. Stanley Fischer as the IMF First Deputy Managing Director, accepted in 1998 that "liberalization without a necessary set of preconditions in place may be extremely risky"[498]. Hence, especially in the aftermath of the Asian crisis, the supposition that capital account liberalization should follow the strengthening of domestic financial sector gained wide support in academic circles and international organizations such as the IMF.

There exist different approaches aimed to explain financial crises. In this chapter, we will give a brief review of these approaches. Our approach takes institutional weaknesses as the major reason behind financial crises. A study of 53 countries from 1980 to 1995 concludes that as financial liberalization increases the likelihood of banking crises, that probability decreases the stronger the institutional conditions for liberalization such as lack of corruption and bureaucratic interference and respect for the rule of law are in place[499].

Stanley Fischer (1997) as the IMF First Deputy Managing Director, also concedes that institutional imperfections played a significant role in bringing about the Asian crisis. Weak financial regulation and supervision[500] was the characteristic of the crises in Mexico, East Asia and Russia. It is argued, for example, that the Asian crisis reflects the deeper problem of governance, which "stems from a mix of political

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[498] IMF (1998:82). The preconditions for financial liberalization listed in IMF Survey (1998) are "a sound macroeconomic framework; a strong domestic financial system, including improved supervision and prudential regulations covering capital adequacy etc.; a strong and autonomous central bank; timely, accurate and comprehensive data disclosure.

[499] Demirgüç-Kunt and Detragiache (1998)

[500] The non-crisis countries in East Asia by contrast, Singapore, Hong Kong and Taiwan had very strong prudential supervision (Mishkin, 2001:8)

patronage, financial sector fragilities, weak corporate governance and lax bankruptcy laws"[501].

Under the scheme of close government and business relationship[502] as happened in East Asia, financial institutions extend loans to politically well connected borrowers. This leads to moral hazard problem, as both lenders and borrowers feel the guarantee that their actions will be covered by implicit government guarantees. Then, "this provokes overindulgent behavior"[503]. The problem is that

> in a context of politics of patronage, prudent regulation and supervision of the financial sector becomes difficult and bankruptcy laws become lax. Thus, overindulgent behavior by the private sector becomes institutionalized and sows the seeds of a financial crisis[504].

In a liberalized financial system, if banking supervision is weak and legal remedies against fraud are easy to circumvent,

> banking crises may be caused by widespread looting: bank managers not only may invest funds in projects that are too risky, but they may invest in that are sure failures but from which they can divert money for personal use[505].

Looting behavior is argued to have been at the root of the crises in the USA and Chile in the late 1970s[506]. Hence, it can be deduced that

[501] Chowdhury and Islam (2001:6)

[502] This is called "crony capitalism" or the politics of patronage.

[503] Chowdhury and Islam (2001:7)

[504] Chowdhury and Islam (2001:7)

[505] Demirgüç-Kunt and Detragiache (1998:8)

[506] Akerlof and Romer (1993)

"a weak financial system that allows fraud to go unpunished should increase the probability of a banking crisis"[507].

One of the main theses in this chapter is that looting behavior and fraud are the characteristics of institutionally weak societies. Hence, in this chapter, our explanation of crises takes institutional weaknesses and the failure to democratize polity successfully, i.e. poor governance as the root causes of the crises in the post-1990 period in emerging market countries. However, "domestic governance failures cannot explain why and when the crisis began, since such failures had persisted for some time before the crisis"[508].

The plan of the chapter is as follows: the next section discusses types of crises and evolution of a financial crisis. Models of crises in the literature and evaluation related to these models are examined in section 3. Section 4 gives criticisms related to Washington Consensus approach to crises. Section 5 analyzes financial crises with an emphasis on institutional aspects, i.e., providing a critique of institutionally weak societies in terms of falling into crises. Section 6 concludes.

8.2. Financial Crises

The major role of financial markets and institutions is to channel funds to those individuals and firms with productive investment opportunities. To achieve this well, market participants must have accurate information and make right judgments about the extent of creditworthiness of the investment opportunities. On the other hand, asymmetric information, in which one party to a financial contract has much less accurate information than the other party, leads to two main

[507] Demirgüç-Kunt and Detragiache (1998:8)

[508] Walter (2002:1)

problems, which are adverse selection[509] and moral hazard[510], in the financial system. Mishkin (2001:2) gives a definition of financial crisis in this perspective as

> a financial crisis is a disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities.

Financial crises are categorized as currency (i.e., balance of payments) crises, banking crises and debt crises[511]:

- A *currency crisis* is characterized by speculative attacks which results in a substantial devaluation (or sharp depreciation) of the currency or forces the authorities to defend the currency by expending large volumes of international reserves or by sharply raising interest rates[512].
- A *banking crisis* occurs when actual or potential bank runs or failures induce banks to suspend the internal convertibility of their liabilities or make the government and monetary institutions to intervene to prevent this by extending assistance on a large scale.[513]

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[509] Adverse selection occurs before the financial transaction takes place and lenders will try to tackle the problem of asymmetric information by monitoring good from bad credit risks. However, this process is inevitably imperfect and fear of adverse selection will lead lenders to reduce quantity of loans they might otherwise make Mishkin (2001:2).

[510] Moral hazard occurs after the transaction takes place. A lender is subject to hazard that the borrower has incentives to engage in activities that are undesirable from the lender's point of view, i.e. the activities that make it less likely that loan will be paid back. Again, many lenders will lend less than they would otherwise so that lending and investment will be at suboptimal levels Mishkin (2001:2).

[511] Fourçans and Franc (2003:xiii); IMF (1998:74)

[512] IMF (1998:74)

[513] IMF (1998:74); Fourçans and Franc (2003:xiii).

- A *debt crisis* takes place when a country cannot service its private or sovereign foreign debt[514].

As one type of crisis may develop into another, they might also take place together. During the 1970s, there was no apparent link between currency and banking crises, when financial markets were highly regulated. In the 1980s, banking and currency crises become more interlinked, as financial liberalization across countries became more widespread[515]. Then, as many of the countries have both currency crises and banking crises around the same time[516], the link between banking and currency crises began to take attention.

It is argued that the dynamics of financial crises in emerging markets occur through some stages[517]. In general, banking crisis occurs before the currency collapse[518]. Initially, deterioration in financial and non-financial balance sheets occurs[519] and then triggers currency crisis. Stages can be summarized as follows:

Stage 1: While banking crises precede balance of payments crises (e.g. in Turkey and Venezuela in mid-1990s), they might have common causes, one of which is a shock to financial institutions. This shock can be financial liberalization[520] and/or increased access to international capital markets.

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[514] IMF (1998:74); Fourçans and Franc (2003:xiii)

[515] Kaminsky and Reinhart (1999:474)

[516] called twin crises by Kaminsky and Reinhart (1999)

[517] Mishkin (2001) identifies three stages. Kaminsky and Reinhart (1999)

[518] Kaminsky and Reinhart (1999:474)

[519] Mishkin (2001:7) defines this as the first stage of financial crisis. The currency crisis is assumed to be the second stage.

[520] Mishkin (2001:8); Kaminsky and Reinhart (1999) argue that financial liberalization often precedes banking crises.

Association between Financial Liberalization and Crises

Financial liberalization opens up the channel for foreign capital to flow into banks and other financial intermediaries in the emerging markets[521]. Capital inflows that resulted from financial opening generate a rapid and considerable increase in lending, which eventually creates excessive risk-taking on the part of banks in the presence of weak prudential regulation and supervision. According to Mishkin (2001:8), this excessive lending occurs mainly due to the reason that banks and other financial institutions lack the expertise and risk-assessment systems to evaluate and respond to the risk appropriately. This excessive risk taking in turn resulted in huge loan losses and subsequent deterioration of banks' and other financial institutions' balance sheets[522] as well as increase in non-performing loans (NPLs)[523].

Hence, as financial liberalization creates new opportunities to take on risk and the result is excessive risk-taking. It is argued that this deterioration in financial sector balance sheets by itself can be sufficient to lead to financial or economic crisis. Another effect of financial liberalization is to increase leverage in the corporate sector, again increasing the vulnerability to a financial crisis[524].

There is a vast literature which claims that fragility induced by financial liberalization carries the risk of leading to financial crisis[525], i.e., financial liberalization precedes crises. Studies that examine the

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[521] Also, in some cases, peg-to-dollar exchange rate regime gives foreign investors a sense of lower risk, further attracting capital flows (Mishkin, 2001:9).

[522] Arteta and Eichengreen (2000:21) also found that domestic financial liberalization raises the risk of crisis, presumably by facilitating risk taking by intermediaries.

[523] Mishkin (2001:8)

[524] Mishkin (2001:9)

[525] Kaminsky and Reinhart (1999), Demirgüç-Kunt and Detragiache (1998), Williamson and Mahar (1998), Glick and Hutchison (1999), Akyüz and Cornford (1999)

correlation between financial liberalization and crises reach the following conclusions:

- Williamson and Mahar (1998:54) conclude that financial liberalization was associated with the crises for most of the countries they examined, while urging that not all of the crises following financial liberalization can be evaluated as a direct result of liberalization. They rather see financial liberalization at least as a contributory factor in the crises of Argentina (1980), Chile, Mexico (1994), the Philippines, Thailand, Turkey, the United States and Venezuela.
- Kaminsky and Reinhart (1999:476) claim that highly regulated nature of the markets during most of the 1970s may be the reason why banking crises were very rare during that period. In their analysis, they examine 20 countries during the period 1970-95 and concluded that "while the number of currency crises per year does not increase as much as during the 1980s and 1990s, the number of banking crises per year more than quadruples in the post-liberalization period"[526]. Most liberalization episodes in the 1980s and 1990s were associated with financial crises of various severities. Among the 26 banking crises that the authors have studied, in 18 crises, the financial sector had been liberalized during the preceding five years. "Only in a few cases such as the early liberalization efforts of Brazil in 1975 and Mexico in 1974", financial liberalization was not followed by financial crisis. They also found that the "probability of a banking crisis conditional on financial liberalization is higher than the unconditional probability of a banking crisis"[527]. They conclude on the basis of the evidence that "twin crises might have common origins in the financial

[526] Kaminsky and Reinhart (1999:476)

[527] Kaminsky and Reinhart (1999:480)

system deregulation and the boom-bust cycles and asset bubbles that accompany financial liberalization"[528].

- Most recent banking and currency crises occurred after financial deregulation or liberalization. Kaminsky and Reinhart (1999) report that some 70 percent of banking crises were preceded by deregulation and that financial liberalization was statistically significant in explaining banking crises, although not currency crises.
- Demirgüç-Kunt and Detragiache (1998) show that banking crises have typically occurred in the wake of financial liberalization that lead to a credit boom in which the banks significantly expand their lending activities.

These findings support the hypothesis that openness of emerging markets to international capital flows, combined with a liberalized financial structure, make these countries particularly vulnerable to crises.

Stage 2 : In the second stage, currency crisis emerges a result of a speculative attack to the domestic currency triggered by a variety of factors under the conditions of above-mentioned vulnerabilities. The central bank cannot take necessary measures like raising interest rates, in that it would do too much harm to weak financial sector by deteriorating the balance sheets of banks[529] further and increasing the cost of financing for highly leveraged corporations. Hence, collapse of the currency deepens the banking crisis, and the peak of the banking crisis most often comes after the currency crash, indicating a vicious

[528] Kaminsky and Reinhart (1999:480)

[529] The traditional banking business involves "borrowing short and lending long", i.e. assets of a bank typically have longer maturity than its liabilities. Thus, a rise in interest rates directly causes a decline in net worth, because in present value terms, an increase in interest rate lowers the value of assets with their longer duration more than it raises the value of liabilities with their shorter duration (Mishkin, 2001:5).

circle[530]. Once the investors recognize that a central bank cannot defend the currency, they prefer profits from selling the currency, making the currency to depreciate more[531].

Stage 3: In the third stage, after speculative attack occurs and causes currency depreciation, the debt dynamics in emerging market countries, i.e. the short duration of debt contracts and their denomination in foreign currencies, generates three mechanisms[532] through which the currency crises increase asymmetric information problems in credit markets and thereby lead to a financial crisis[533].

The converse has also occurred, i.e., what began as currency crises in some Asian countries followed by banking and debt crises, as happened most clearly in Indonesia. In such situations, the fragility of the banking or corporate sector is fully revealed only after the speculative attack, which exacerbates banking and debt problems[534].

While IMF (1998:75) argues that one might precede another does not necessarily imply causality[535], Schmukler et al. (2001:2) describe

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[530] Kaminsky and Reinhart (1999:475)

[531] Mishkin (2001:11)

[532] The first mechanism is the direct effect of currency depreciation on the balance sheets of firms (Mexico, Indonesia). The second mechanism works through further deterioration in the balance sheets of the financial sector, led by devaluation of the domestic currency, provoking a large-scale banking crisis. The third mechanism is that the devaluation can lead to higher inflation (Mexico, Indonesia and Turkey). This increase in expected inflation after currency crisis led to a sharp rise in nominal interest rates, raising the interest payments by firms. This deteriorates firms' cash flow position and further weakens their balance sheets, which then increase adverse selection and moral hazard problems in the credit market (Mishkin, 2001:12)

[533] Mishkin (2001:12)

[534] IMF (1998:75), Kaufman (2000)

[535] The reason they claim this is that banking sector difficulties may not always be apparent, especially in poorly supervised and inadequate regulated systems, or in circumstances where lending booms and asset price inflation may mask banking problems until a correction in asset prices exposes the fragility of the financial

the situation as either one of them causes the other or they result from common factors.

8.3. Models of the Crises

There have been several theoretical and empirical models to explain how crises occur. They come up with different explanations as regards to the reasons of the crises and the dynamics of how they occurred. Mainly three types of models are distinguished in the currency crisis literature. Below, we will give a very brief review of these approaches.

- The first one, "*first generation*" models or the so-called "*canonical*" crisis models (pioneered by Krugman (1979)) explain currency crisis as the result of a fundamental inconsistency between domestic policies –typically the persistence of money-financed budget deficits- and the attempt to maintain a fixed exchange rate[536]. In other words, they view the main reason of speculations and pressures on a currency as the deteriorated macroeconomic fundamentals in a unique-equilibrium economy[537]. On the other hand, a number of economists[538] argue that government budgets were either in balance or showed surplus in many recent crises and therefore "first generation" models of crisis are not well suited to explain these episodes. Krugman (1996:5) describes what is wrong with canonical crisis model by saying that

> it represents government policy (though not the market response) in a very mechanical way. The government is assumed to blindly keep on printing money to cover a budget deficit,

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system. The same is true for problems linked to corporate sector indebtedness (IMF, 1998:75).

[536] Krugman (1996:4)

[537] Fourçans and Franc (2003:xiv)

[538] Velasco (1987) for the case of Chile; Sachs, Tornell and Velasco (1996) for Mexico; Radelet and Sachs (1998) for Asia.

> regardless of the external situation; the central bank is assumed to doggedly sell foreign exchange to peg the exchange rate until the last dollar of reserves is gone. In reality, the range of possible policies is much wider.

- Then, *"second generation"* crisis models (pioneered by Obstfeld (1994)) are developed. While multiple equilibria exist in these models and the occurrence of multiple equilibria cause self-fulfilling attacks, speculators' self-fulfilling expectations trigger crises, even though fundamentals do not deteriorate. Therefore, the outbreak of the currency crisis in a country is not related to its macroeconomic situation. These models became popular following the Exchange Rate Mechanism (ERM) crisis in 1992/93, as there were no critical developments in fundamental macroeconomic variables. According to "second-generation" models, a currency crisis occurs as a result of coherent self-fulfilling expectations, rational herd behavior and contagion[539]. While before the 1990s, financial crises were considered to occur in individual countries, the experience of Mexican crisis of 1994-95; the East Asian crisis of 1997-98 and the Russian crisis of 1998 has brought to the scene that a crisis in one country can rapidly spillover to the rest of the world, i.e. contagion effect. However, macroeconomic links between countries do not play any role in this type of currency crisis contagion. Models of pure contagion theory rely on the framework that characterizes the transmission of speculative attacks, which cannot be explained by the evolution of macroeconomic fundamentals[540].

- "Third generation" models build upon "first" and "second-generation" models and were developed after the Asian crisis in 1997. These models attach importance to fundamentals, but do not neglect the potential effects of speculators' self-fulfilling expectations. A common feature of these models is that fundamentals do not only

[539] See for more detail Obstfeld (1994); Babic and Zigman (2001); Fourçans and Franc (2003)

[540] Fourçans and Franc (2003: 64)

include fiscal and monetary policies but also the level of unemployment and even the policy makers' reputation.[541]

8.3.1. Inability to Make Generalization as Regards to Macroeconomic Conditions

It is generally claimed[542] that one cannot make generalization as to the macroeconomic conditions under which financial and currency crises have occur. For example, in some crises such as the ones in Mexico, Thailand and Turkey, current account deficits were large and unsustainable, while it was small in the crises of Indonesia and Russia. Although there were significant overvaluation of the domestic currency in the crises of Mexico, Russia, Brazil and Turkey which used exchange rate as a nominal anchor to bring inflation down, this has not always been the case, as the appreciation of currency was moderate or negligible in most East Asian countries. In addition, while large budget deficits were associated with the crises in Russia, Brazil and Turkey, the budget was balanced or in surplus in Mexican and East Asian crises. Finally, in Brazilian and Russian crises, external debt was owed primarily by the public, while primarily it was by the private sector in East Asian crises[543].

8.3.2. Differences between the Crises of Developing and Developed Countries

It is asserted[544] that the nature and effects of financial instability and crises differs between developed and developing countries. The crises in developing countries are typically characterized as initially

[541] Fourçans and Franc (2003: 105)

[542] Akyüz and Cornford (1999:17)

[543] Akyüz and Cornford (1999:17)

[544] Akyüz and Cornford (1999:15)

emerging from domestic financial instability created by reversal of external capital and sharp depreciation of the domestic currency[545]. This, in turn, generally translates into currency turmoil, payments difficulties and even external debt crises. On the contrary, currency turmoil[546] in developed countries usually does not translate into domestic financial markets and domestic financial disruptions do not necessarily lead to currency and payments crises.

There are a number of factors that lead to these differences between developed and developing countries[547]. First of all, since the size of financial markets is small in developing countries, even entry or exit of medium-size investors from industrial countries is capable of creating serious price fluctuations, while their share in these markets account for only a small percentage of their portfolios. Secondly, developing countries are more vulnerable due to their higher net external indebtedness and higher shares of their external debt denominated in foreign currencies. In addition, when the external debt is mostly that of private sector rather than sovereign governments, then the vulnerability of the domestic financial system increases further[548].

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[545] Akyüz and Cornford (1999:15)

[546] Currency turmoil that generally involves large movements that result from buying and selling decisions by economic actors in currency markets often do not affect seriously the fundamental indicators of the country such as relative price levels, microeconomic performance and the stance of macroeconomic policies. Akyüz and Cornford (1999:16)

[547] Akyüz and Cornford (1999:16)

[548] Akyüz and Cornford (1999:16)

8.4. Critique of the Washington Consensus Approach to Crises

Washington Consensus approach mainly blamed mismanaged macroeconomic policies[549], i.e. distortionary macroeconomic policies, including high inflation, large budget deficits and misaligned exchange rates as the primary reason of bad macroeconomic performance and financial crises. For instance, overvalued exchange rate is regarded as the reason of macroeconomic problems in 2001 crisis of Argentina by many economists. Hence, macroeconomic policies are blamed for macroeconomic problems. Nevertheless, Acemoğlu et al. (2002:9-10) argue that while there exist correlations between macroeconomic policies –high inflation, budget deficit, overvalued exchange rate- and economic volatility and crises, the causality is not clear. Ahrens (2000:6) believes that stereotypical application of the Washington Consensus policies to address the sources of the crises "in East Asia was misguided from perspective of the populations and governments of the affected countries themselves as well as numerous international observers".

Furthermore, in crisis resolution as well, the IMF treated different crises the same. Similar macroeconomic policies and the structural reforms were suggested by the IMF as a remedy to different crisis such as the Mexican crisis in 1994 on the one hand and Korea in 1997 in 1997-98 on the other. Bustelo (1998:20) argues

> the IMF's prescription seems to be totally independent from the state of economic fundamentals. Economies with budget surpluses (or small public deficits), high savings rates, low inflation and outward orientation, such as those in East Asia in the late 1990s, are equated with others afflicted with fiscal profligacy, low savings, high inflationary pressures and inward-oriented growth, such as Latin America in the 1980s.

[549] Demirgüç-Kunt and Detragiache (1998) found strong evidence for the association between the emergence of banking crises and a deteriorated macroeconomic environment.

The IMF is criticized to suggest almost the same conditions in both cases, despite obvious differences in the nature of their respective crises.[550]

Stiglitz (2002:74) states that the mistake of the Washington Consensus Policies is that they were based on a simplistic model of market economy, the competitive equilibrium model, in which Adam Smith's invisible hand works perfectly. However, the invisible hand works most imperfectly whenever information is imperfect and markets are incomplete as in developing countries.[551] Stiglitz (2002:74) says

> Even if Smith's invisible hand theory were relevant for advanced industrialized countries, the required conditions are not satisfied in developing countries…. The market system requires competition and perfect information. But competition is limited and information is far from perfect - and well-functioning competitive markets cannot be established overnight…. In some cases, reforms in one area, without accompanying reforms in others, may make matters worse. This is the issue of sequencing. Ideology ignores these matters; it says simply move as quickly to a market economy as you can. But economic theory and history show how disastrous it can be to ignore sequencing.

Hence, it is argued that problems at the root of the crises were not lack of fiscal or monetary discipline but structural in nature. Washington Consensus type of approach to crises is criticized by arguing that they choose the easy way of addressing problems, while the problems in the crises countries, in fact, reflect the underlying institutional problems they face[552]. Even when the governments pursued sound macroeconomic policies, they failed to establish adequate institutional arrangements to supervise and monitor activities especially in the financial and banking sectors, which lay the basis of subsequent

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[550] Private sector related debt in Asia versus public sector related debt in Latin America. Bustelo (1998:20)

[551] Stiglitz (2002:73)

[552] Acemoğlu (2002:3)

crises. Hence, the main argument is that the crises might reflect the effect of institutional factors on economic outcomes[553].

Consequently, Washington Consensus policies are criticized on the basis of the assertion that they lack strong institutional background and did not recognize that institutional underpinnings were really important. It is claimed that "the Washington Consensus ignores social and political effects and hence the interdependence of the economy and the polity", as well as "the institutional problems related policy formulation, implementation and enforcement". In other words, this means, it ignores the fact that "economic institutions and activities are embedded in a complex fabric of social and political institutions"[554].

8.5. Institutional Reasoning of Financial Crises[555]

The issue why greater instability is expected in institutionally-weak societies and the channels through which institutions are linked to economic instability in institutionally-weak societies are briefly explained as follows: There are few constraints on rulers, i.e, there is lack of effective constraints on politicians and politically powerful groups in these societies. Since having/controlling political power provides gains, there will be increasing willingness of various groups to fight to come to power and enjoy these gains. Furthermore, in societies with institutional problems, politicians may be forced to pursue unsustainable policies to satisfy some groups and remain in power. When these policies are abandoned, volatility may arise. Furthermore, in a society with weak institutions, entrepreneurs may invest in

[553] Acemoğlu et al.(2002:10)

[554] Ahrens (2000:8)

[555] Unless otherwise stated, this section heavily draws on Acemoğlu et al. (2002).

sectors/activities from which they can withdraw their capital more quickly. This contributes to potential economic instability[556].

On the other hand, a change in the balance of political power may result in the attempt of the new political group to use that power to redistribute assets and income to themselves, creating economic turbulence. In societies where institutions prevent this type of redistribution can avoid this turbulence.

Relative role of macroeconomic variables with respect to institutions in the generation of crisis is questioned empirically as well. It is concluded that standard macroeconomic variables often blamed for economic crisis play a relatively minor role[557]. A more striking outcome is that these macroeconomic variables, with the possible exception of exchange rate misalignment, do not seem to be a major mediating channel through which institutions affect economic outcomes. Hence, macroeconomic policies which are often blamed for crises do not appear to be the major mediating channel for the impact of institutions on economic instability. On the other hand, weak institutions appear to create macroeconomic problems through a variety of both microeconomic and macroeconomic channels. Hence, it is asserted that these macroeconomic problems are symptoms of deeper institutional causes[558].

It is argued that these empirical findings do not indicate that "macroeconomic policies do not matter for macroeconomic outcomes"[559]. However, the main argument is that bad macroeconomic outcomes and volatility arise from the power struggle to control the

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[556] Acemoğlu et al. (2002:11-12)

[557] Acemoğlu et al. (2002:4)

[558] Acemoğlu et al. (2002:48)

[559] Acemoğlu et al. (2002:5)

state to take advantage of the resulting rents, which is a characteristic of institutionally weak societies.

The question of why some countries suffer from crises, while some others can escape from it is also explained by a similar standing point:

> countries pursuing poor macroeconomic policies also have weak institutions, including political institutions that do not constrain politicians and political elites, ineffective enforcement of property rights for investors, widespread corruption and a high degree of political instability[560].

That is to say, the problem of institutionally weak-societies is to constrain the people controlling political power. Hence, institutional factors lead to cross country differences in volatility and crises.

Therefore, it can be argued that even without the bad macroeconomic conditions, economic crises might occur due to weak institutions. Hence, the problem is the inability to deal with their own economic shocks, and perhaps more importantly their political shocks in institutionally weak societies, which is claimed to have first-order importance by Acemoğlu et al. (2002).

8.5.1. The Framework of Institutional Reforms

In the face of the failures of the Washington Consensus policies in the 1980s and 1990s, the main criticisms toward the Washington Consensus policies, which argue that they ignore the importance of institutional factors have gained some ground. Then, there have been a shift in the Washington Consensus policies from laissez-faire to "market-friendly" approach. Rodrik (2001:14) identifies this new

[560] Acemoğlu et al. (2002:2)

approach as "Augmented Washington Consensus"[561] or "enlightened standard development model". Although this new approach continued to advocate liberalization of trade and capital movements, "the scope of domestic economic liberalization was limited, in particular, by recognizing more fully the legitimacy of state intervention in cases of market failure."[562]

Table 8.1: Elements of "Washington Consensus" and "Augmented Washington Consensus" Approach

The Original Washington Consensus	**The Augmented Washington Consensus *The original list plus:***
Financial Liberalization	Corporate Governance
Trade Liberalization	Independent central banks/inflation targeting
Openness to FDI	Anti-corruption
Privatization	Flexible Labor Markets
Reorientation of Public Expenditures	WTO Agreements
Tax Reform	Financial Codes and Standards
Unified and Competitive Exchange Rates	"Prudent" Capital Account Opening
Fiscal Discipline	Non-intermediate Exchange Rate Regimes
Deregulation	Social Safety Nets
Secure Property Rights	Targeted Poverty Reduction

Source: Rodrik D. (2002) "After Neoliberalism, What?"

The "Augmented Washington Consensus"[563] view goes beyond liberalization and privatization to emphasize the need to create the institutional underpinnings of market economies (Table 8.1). Reforms now include financial regulation and prudential supervision, governance and anti-corruption, legal and administrative reform, labor-market

[561] They are also called in the literature as "Second Generation Reforms" or "Washington Consensus Plus"

[562] Gore (2000:793)

[563] Rodrik (2001)

'flexibility' and social safety nets. Hence, countries are required to satisfy a long list of institutional requirements in order to maximize the gains and minimize the risks of participation in the world economy. Therefore, along this "Augmented Washington Consensus" approach, reaping the gains from openness requires a full complement of institutional reforms.

The new argument asserts "simple policy changes are ineffective, …, unless they are grounded strongly in institutional reforms"[564]. These new reforms which are sometimes called "second-generation reforms" targeted to "overcome the apparent inefficacy of the earlier wave of reforms relying heavily on liberalization, stabilization, and privatization"[565].

Rodrik (2001:15) however, sees these reforms as "biased towards an Anglo-American conception of institutional soundness and as driven largely by the requirements of integration into the world economy". Moreover, this approach is criticized on the basis of the argument that it provides no sense of priorities among a long and highly demanding list of institutional prerequisites. What is even more striking is the fact that key institutional reforms envisaged by the "Augmented Washington Consensus" in areas such as corporate governance, financial supervision, trade law and social safety nets did not take place in Europe or Northern America until quite late in the economic development process[566]. Therefore, many of the items on the "Augmented Washington Consensus" agenda should be viewed as outcomes of successful economic development rather than its prerequisites. On the basis of these criticisms, Rodrik (2001) argues that the "Augmented Washington Consensus" entailing heavy-duty

[564] Rodrik (2004:2)

[565] Rodrik (2004:2)

[566] See Chang (2000) as cited in Rodrik (2001)

institutional reforms encompass an impossibly broad and unfocused development agenda[567] and hence, is "bound to disappoint, just as its predecessor did"[568].

Nevertheless, Rodrik (2001) stresses the need to avoid the kind of thinking that a specific type of institution —mode of corporate governance, social security system or labour market legislation, for example— is the only one compatible with a well-functioning market economy. Hence, there is no single mapping between a well-functioning market and the form of non-market institutions required to sustain it. In other words, "effective institutional outcomes do not map into unique institutional designs"[569]. Therefore, in order to find out the institutional arrangements that work locally, experimentation is needed, since "reforms that succeed in one setting may perform poorly or fail completely in other settings"[570]. On the other hand, overemphasis of the BWI on prudential regulation and supervision as a remedy for crisis reflects the kind of thinking that associates one form of institutional framework with a well-functioning market.

Hence, the argument is that institutional development cannot be acquired through following "augmented Washington Consensus" prescriptions, i.e. the "best practice" institutions guide. In other words, "good institutions cannot be acquired without significant

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[567] Rodrik (2001:16)

[568] Rodrik (2002:1)

[569] Rodrik (2004:9)

[570] Rodrik (2002:7) argues that this explains "why successful seven countries—China, India, South Korea, and Taiwan among others—have almost always combined unorthodox elements with orthodox policies. It could also account for why important institutional differences persist among the advanced countries of North America, Western Europe, and Japan—in such areas as the role of the public sector, the nature of the legal systems, corporate governance, financial markets, labor markets, and social insurance mechanisms".

domestic adaptations"[571]. This also means that the needs of developing countries are better served within a "thin" set of rules for global economic governance rather than a "thick" set of rules aimed at maximizing trade and investment flows.

Rodrik (2002:8) proposes an alternative view to institutional development. In his formulation, liberalization of trade and capital flows and adopting "best-practice" institutions are hardly key factors at the outset of the development process. Rather than enhancing poor countries' access to markets in the advanced industrial countries and propagate codes, standards, and "best practices", this type of development "enables poor countries to experiment with institutional arrangements and leaves room for them to devise their own, possibly divergent solutions to the developmental problems". It also evaluates

> the demands of institutional reform not from the perspective of integration ("what do countries need to do to integrate?") but from the perspective of development ("what do countries need to do achieve broad-based, equitable economic growth?")[572].

8.5.2. Institutional Reforms in Practice

If crises are believed to emerge primarily from embedded institutional imperfections, then a sustainable resolution lies in large-scale institutional reform. Reform of the international financial system emerged as a prominent issue only after the financial crisis in Mexico in 1994-95, as this interest increased in the aftermath of the Asian financial crisis in 1997-98[573]. The initial reform package introduced after the Mexican crisis was focused on data dissemination and

[571] Rodrik (2002:9)

[572] Rodrik (2002:8)

[573] Fischer (2003:2)

transparency[574]. Subsequently, performance of the countries in four other areas such as banking supervision[575], securities regulation, insurance supervision and payments system are assessed as part of the Financial Sector Assessment Program (FSAP), a joint effort of the IMF, the World Bank and national supervisory agencies, which aims to help strengthening financial systems.

On the other side, while the need for institutional reform has been acknowledged in proposals by policy advisors, economists and policy makers, it has been neglected in the practice of policy reform. The evidence for emerging markets regarding the timing of financial liberalization and institutional reforms displays that reforms to institutions occur mostly after liberalization is completed[576]. This also means that these reform measures have not been given high priority on the sequencing agenda. Furthermore, "reforms of political institutions have been almost completely neglected"[577], as the Washington Consensus does not address the political and social feasibility and sustainability of policy reforms.

8.6. Conclusion

There are different explanations about how financial crises occur. In the literature, these different approaches have been grouped under mainly three types of models: first, second and third generation models. These models have been developed in response to changing characteristics of the crises over time, especially in the 1990s. Every model has been developed in the aftermath of a new crisis in order to explain the dynamics of the crisis and desire to generalize main

[574] The IMF developed Codes of Good Practices on Transparency in Monetary and Financial Policies and on Fiscal Transparency.

[575] The Basel Committee's Core Principles for Effective Banking Supervision.

[576] Kaminsky and Schmukler, (2003:22)

[577] Ahrens (2000:8)

aspects. However, both theoretical and empirical analysis of the crises in this period in the literature point to different conclusions. Hence, these models have not been successful in generating a consensus, as apparent from controversial views in the literature. Even, there is no consensus in the literature as regards to the definition of crisis. Here, in this chapter, we have chosen the definition provided by the IMF.

On the other side, the approach to crises put forward by Acemoğlu et al. (2002) asserts that macroeconomic problems are symptoms of deeper institutional weaknesses. Furthermore, this idea is linked to the claim that the main problem in institutionally weak societies emerges from the inability to constrain the people controlling political power.

While there have been some attempts to institute a strong institutional background in developing countries which are more vulnerable to crises, under the framework of Augmented Washington Consensus approach, these efforts have been criticized on basis of the fact that they entail a long "to-do" list. Furthermore, the assertion led by Rodrik (2004:9) that "effective institutional outcomes do not map into unique institutional designs" has strong ground. Hence, institutional reforms that fit into specific requirements of individual countries have to be supported as a major remedy to prevent crises.

CHAPTER 9

AN EVALUATION OF THE TURKISH CRISES IN THE POST-1990 PERIOD ON THE BASIS OF INSTITUTIONAL FRAMEWORK

9.1. Introduction

Domestic institutional and political characteristics of individual countries become deterministic in terms of consequences of financial liberalization policies. Weaknesses in the institutional framework might lead to flaws in the financial liberalization process, which at the same time constitute the basis of sequencing mistakes of liberalization process. These flaws in the Turkish context have been weak banking system and macroeconomic instability in the forms of high inflation and public sector deficit. In other words, these problems were backed by weak institutional structure, which revealed itself by populist policies of the state and lax supervision and fraud.

Hence, it seems that institutional weaknesses and political dynamics were translated into macroeconomic problems[578] in Turkey. Governments use bureaucracy and economic policies for patronage and engage in corruption. The ensuing political instability is then translated into economic instability. Therefore, it can be argued that economic instability was mainly led by economic and political institutional weaknesses, which was mediated by a range of different macro and micro policies. The necessary institutional formation, which includes the harmony of agents, markets and a legal framework is quite important in the liberalization process. In retrospect, economic and political institutional weaknesses lies at the root of the problems in the

[578] The concept of linking institutional weaknesses to macroeconomic policies originally belongs to Acemoğlu et al. (2002)

economy and had to be corrected before liberalization reforms, which would also compensate for sequencing mistakes of financial liberalization reforms.

Thus, economic and political institutional weaknesses, on the one side, prevented Turkey from fully capitalizing the benefits of financial liberalization[579], while, on the other side, closely contributed to the emergence of successive crises in the 1990s and at the start of the new decade. It is claimed that countries with "weak democracies"[580], which are characterized by limited accountability and transparency of the state and other key political institutions, tend to suffer from negative side of financial globalization, which includes overdependence on short-term capital flows, speculative attacks and recurrent financial crises[581].

The traditional approach to crisis has been to blame bad macroeconomic polices and outcomes such as high inflation, large fiscal deficits etc. for crisis. Although there exists partial truth in these explanations, a more satisfactory account of repetitive unsustainable and poor macroeconomic policies in Turkey lies in the institutional context, i.e., stems from underlying set of weak institutions and political forces at work. Therefore, a key implication of our analysis is that deeper fundamentals such as weak institutional structure might be the root causes of crises in the post-1990 period in Turkey.

The crises of 1994, 2000 and 2001 in Turkey can be explained by factors such as an unsustainable fixed exchange rate regime, overvalued Turkish lira and large current account deficits that had to be financed by unsustainable international capital inflows. On the other

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[579] As Alper and Öniş (2001) share the same view, they focus on country's "democratic deficits" which is asserted to have undermined country's political and institutional capacity.

[580] This terminology belongs to Alper and Öniş (2001)

[581] Alper and Öniş (2001:1)

hand, it can also be argued that even without these unfavorable indicators, economic crises might have occurred due to weak economic and political institutions in Turkey. This approach derives from the idea proposed by Acemoğlu et al. (2002:3) that "institutionally weak societies not only grow less slowly in the long-run, but also experience greater volatility and other worse macroeconomic outcomes." What makes us to think about the role played by institutional structure is the successive crises in Turkey, and the fact that the same set of macroeconomic policies continually reemerge and subsequently collapse.

Therefore, the main point of our analysis is that economic liberalization reforms become less effective and sometimes fail without a credible commitment to development and an institutional foundation as its starting point. Hence, our analysis suggests that these poor macroeconomic policies should be regarded as a result of inefficient redistributive tools of politicians.

Furthermore, one of our main claims is that solution to instability and poor economic performance presented by international institutions may not be successful if the main problem is weak institutions leading to political conflict, highly inefficient redistribution. The prescriptions of the Washington Consensus proved to be insufficient and misguided in many cases. Hence, without institutional change, "distributional conflict is bound to resurface even if international institutions are in control of monetary policy"[582]. As argued by Ahrens (2000:6),

> The failure to explicitly address the problems associated with the states' capacity and capability of initiating and implementing a politically feasible and economically effective set of reform measures aggravated the transformational recession in most countries….The negligence to get the institutional environment right at the beginning of the transformation process implied that

[582] Acemoğlu et al. (2002:21)

private investors did not face stable expectations and that an efficient and socially accepted redirection of resources was hindered.

Hence, contrary to the emphasis in the literature on poor macroeconomic policies in the analysis of the Turkish crises, our approach takes economic and political institutional dimension as the starting point. The question of which macroeconomic policies matter for the crises in Turkey is important only after institutions are taken into account. Institutional weaknesses, at the same time, laid the basis of sequencing mistakes of financial liberalization process. It is important to note that crises episodes in Turkey mainly emerge from early exposure to financial globalization, as "financial globalization tends to magnify the populist cycles"[583]. That is to say, while the liberalization process had started in an environment of poor public sector management and rent seeking behavior of politicians, financial liberalization had further substantiated this structure, finally creating an environment conducive to crises.

In this chapter, we aim to question the role of economic and political institutional weaknesses in Turkey in leading to financial crises in the post-1990 period. We aim to identify what was exactly lacking in the institutional framework in Turkey before, during and after the liberalization process in terms of evaluating its implication on the economy. Government's populist policies and engagement in widespread corruption and fraudulent behavior in the supervision of the banking sector were instrumental in the deterioration of macroeconomic fundamentals and substantial risk-taking by the Turkish banking sector. Furthermore, financing requirements of public sector and the main intermediary role of the banking sector in the financing of fiscal deficits were the main characteristic of the post-liberalization period. In this framework, fragile structure of the financial system, in

[583] Alper and Öniş (2001:27)

particular, the banking sector in the aftermath of the financial liberalization will be evaluated in terms of creating a crisis-prone environment. For this purpose, the incentive structure for the banking sector and its impact on resource allocation with emphasis on medium-term implications including risk vulnerabilities will be examined. In that respect, the problems arising from the state owned banks, in particular, their large losses deriving from quasi-fiscal activities will be discussed.

Since our main concern is to reveal the underlying factors behind the crises in Turkey, the triggering events and macroeconomic policy mistakes as well as the pre-crisis macroeconomic environment will not be discussed in this study[584]. The analysis in this chapter covers the period until 1999, i.e. before the crises of 2000 and 2001 and starts from 1980 when data is available.

In this chapter, section 2 after this introduction reviews the related literature. Section 3 gives the general overview of the populist policies of the government with its consequent impacts on fiscal performance. Section 4 discusses the impact of the high budget deficits, in other words, financing requirements of the government on financial markets. Section 5 examines the regulatory and supervisory framework of the banking system in Turkey. Deposit insurance and moral hazard issues will be discussed in section 6. Distortions induced by public banks are examined in section 7. Section 8 analyzes the overall impact of all these weaknesses on the banking sector. An assessment of the financial risks that the banking system was exposed to is also provided in this section. Hence, section 4 and section 8 examine the impacts of the institutional weaknesses on the financial markets in Turkey. Section 9 concludes.

[584] For detailed analysis of the pre-crisis environment in Turkey and the evolution of the crises, see Serdengeçti (2002), Akyüz and Boratav (2002), Ekinci and Ertürk (2004), Alper and Öniş (2002), Celasun (2001), Boratav and Yeldan (2001)

9.2. Overall Assessment of Relevant Literature

There are many studies[585] that examine the post-financial liberalization performance in Turkey against the background of political and institutional environment of the liberalization years. Furthermore there have been a number of attempts[586] to explain the reasons behind crises episodes in Turkey in the post-1990 period, especially 2000 and 2001 crises by linking them to the capital account liberalization in 1989. Furthermore, in these studies, the approach has been to focus on triggering events and/or the macroeconomic environment in post-1989 period rather than establishing relevance to the whole financial liberalization policies in the 1980s together with the institutional and political structure.

One of the studies that tackles the problems in the banking sector in the pre-crisis period, particularly 2000/2001 crises is by Alper and Öniş (2003). It analyzes the regulatory and supervisory framework of the Turkish banking sector in the aftermath of the capital account liberalization with special emphasis on political and institutional factors. Impact of banking sector developments on the macroeconomic environment and developments in Turkey in the 1990s is the main concern of this study. Furthermore, the role of the IMF and the World Bank in pushing for reforms in the period preceding 2000 and 2001 crises is examined. However, there is no critical examination of the BWI's approach as regards to their delayed emphasis on this issue. Moreover, only the developments in the banking sector in the aftermath of capital account liberalization in 1989 are linked to the crises of 2000 and 2001, while we are also concerned much more broadly with the

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[585] Atiyas and Ersel (1996), Uygur (1993), Saracoğlu (1997), Altınkemer and Ekinci (1992), Arıcanlı and Rodrik (1990), Akyüz (1990), Akyüz (1993), Bayazıtoğlu et al. (1991), Celasun and Rodrik (1989)

[586] See for example Boratav and Yeldan (2001)

developments in the 1980s in regulatory and supervisory framework and banking sector in Turkey to analyze the crises in the post-1990 period.

Therefore, our approach is different from the previous studies on the subject, presenting a broader concern on the implications of the policies pursued in the 1980s.

9.3. Fiscal Expansionism and Budget Deficits

Turkish politics has, for many decades, been characterized by leader domination, lack of checks and balances, i.e. lack of transparency, pervasive lack of accountability, excessive centralization, inadequate control of the budgetary process, a lack of emphasis on the rule of law and inadequate management of the public institutions and of their human capital[587]. This, in turn, had some important consequences such as excessive uncertainty, short horizons for policy makers, mis-utilization of public funds and periodic crises in an environment of financial openness.

A typical populist cycle is characterized by fiscal expansionism especially that focuses on current expenditures, which have immediate positive impact on the current generation of voters (Figure 9.1). While this process seems to have benefits in the short-run, it has negative implications for the medium-term economic performance. More importantly, fiscal expansionism carries the risk of leading to crisis in an environment of appreciating real exchange rates through creating large current account deficits[588].

It is argued that while the first two populist cycles in Turkey were experienced in the late 1950s and the late 1970s in an environment of fixed exchange rates and capital account controls, the

[587] Alper and Öniş (2001:4) and OECD (2002:114)

[588] Alper and Öniş (2001:7)

third one or the first one in the neo-liberal era occurred during the 1987-93 period in which there were liberalized capital accounts and a managed exchange rate regime.

In the post-1987 period, besides the frequency of the elections[589], the highly fragmented party system became another source of instability through producing weak governments. The fragmented party system tended to reduce time horizon of governments and contributed to the populist cycle. The problem is that these governments have lacked the authority and willingness to perform a radical reform or restructuring program, which characterizes the Turkish economy in the post-1987 period[590]. Furthermore, the reorganization of the state bureaucracy has led to the weakening of the bureaucracy, which then was not able to prevent "populist expansionism" and the misuse or the misallocation of public funds, especially in the electoral contests in the post-1987 era[591].

On the other hand, the emergence of distributional pressures, which were previously absent due to restricted nature of the political regime, was fundamental to an understanding of the growing macroeconomic instability in the post-1987 period. The distributional demands were met in the face of pressing electoral constraints through wage rounds of 1989 and 1991, which led to a relative recovery of the unionized workers and the agricultural producers. Nevertheless, this put severe pressures on the budget[592].

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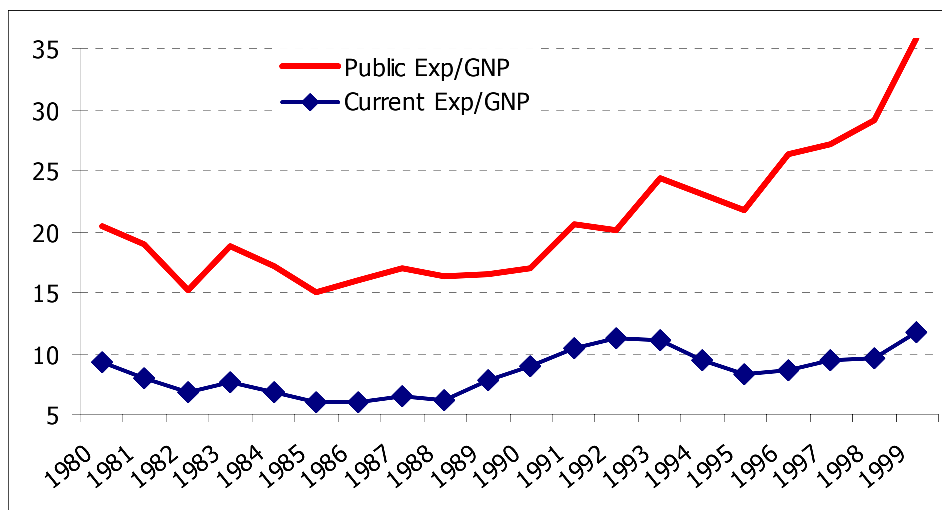
[589] General elections in November 1987, municipal elections in March 1989, general elections in 1991, municipal elections in March 1994, general elections in 1995, municipal and general elections in April 1999, general elections in November 2002, municipal elections in 2004.

[590] Öniş (1998b:505, 508)

[591] Öniş (1998b:502) and Öniş and Webb (1998:341-42)

[592] Öniş (1998b:500-501)

The dramatic increase in the share of public expenditures in GNP makes apparent the dynamics of the post-1987 populist cycle (Figure 9.1).



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.1: Public Expenditure/GNP

The outcome of the fragmented party system and populist cycles in an environment of capital account openness was distorted capital flows, i.e., attracting heavily short-term capital flows[593]. Furthermore, short-term capital flows in an environment of financial openness contributed to the populist cycles, as the pace of fiscal expansionism became heavily dependent on volatile and reversible short-term capital flows[594] (Figure 9.2).

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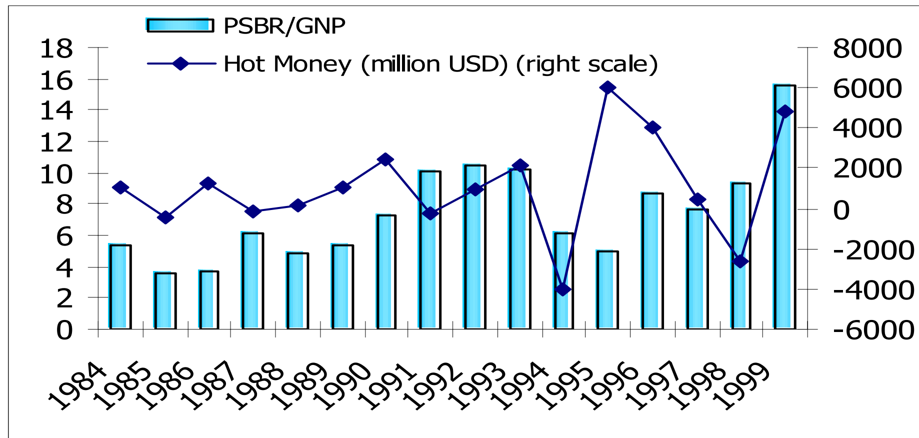
[593] Alper and Öniş (2001:11); Celasun et al. (1998 :25)

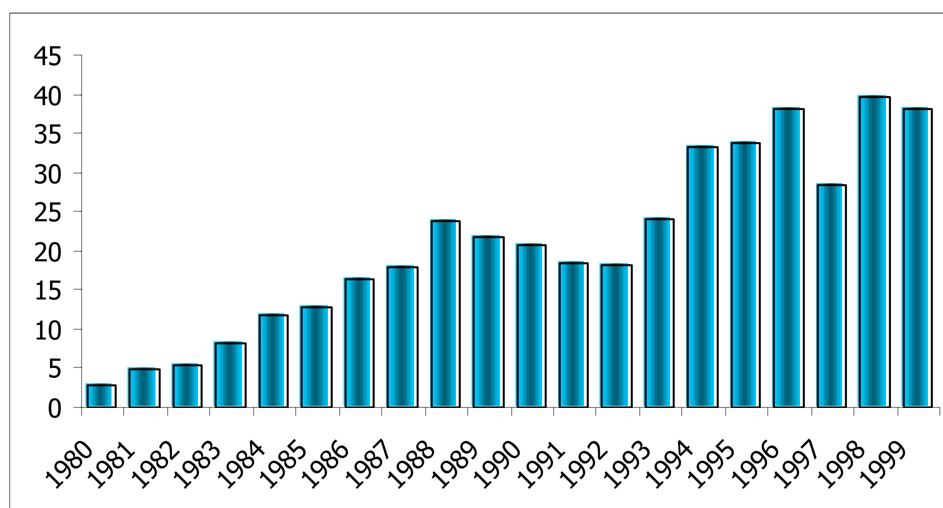
[594] Alper and Öniş (2001:8)



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.2: Public Sector Borrowing Requirement /GNP versus Hot Money

On the other hand, in the face of dependence on short-term capital inflows for financing purposes, the government had a policy of keeping domestic interest rates high to attract short-term capital inflows and discourage outflows, which led to build-up of domestic debt. Fiscal deficits were a fundamental source of instability. While some reduction had been achieved in some years, especially those that follow the years of crisis, this had never been achieved on a sustainable basis. In the second half of the 1990s, share of transfer payments in budgetary expenditures steadily increased, reflecting the major increase in the interest burden on the domestic public debt (Figure 9.3).



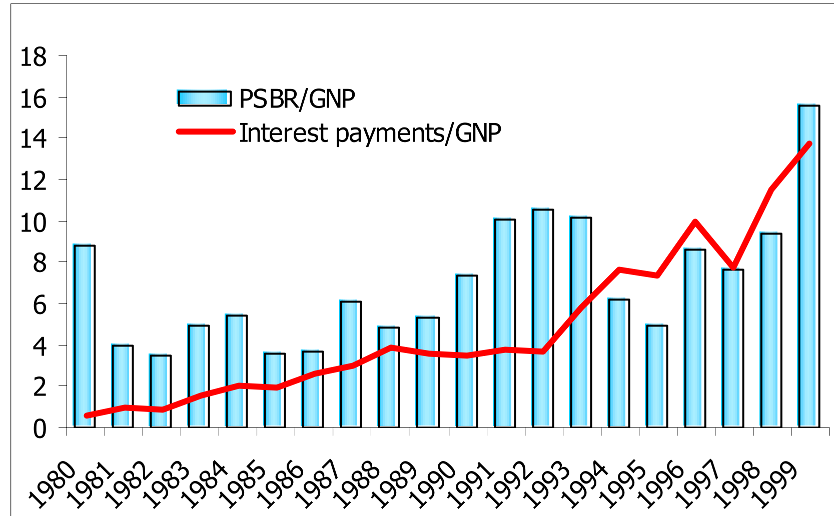
Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.3: Share of Interest Payments in Total Public Expenditures (Percent)

During the 1990s, interest rates on government debt exceeded the inflation rate, on average, by more than 30 percentage points. Therefore, while primary deficits in the first half of the last decade played an important role in pushing up the PSBR, interest payments became by far the most important component of fiscal deficits in the second half of the 1990s (Figure 9.4). This led the financial markets to remain shallow, and private investments and real output to contract[595]. Thus, throughout this period, increasing portion of tax revenues was allocated to interest payments. While 20 % of tax revenues were absorbed by interest payments on domestic debt at the end of 1980s, this ratio increased to 75 percent at the end of 1990s (Figure 9.5). As a result, public debt accumulated and the government had to rollover debt payments, basically interest payments, through new issues of debt instruments[596].

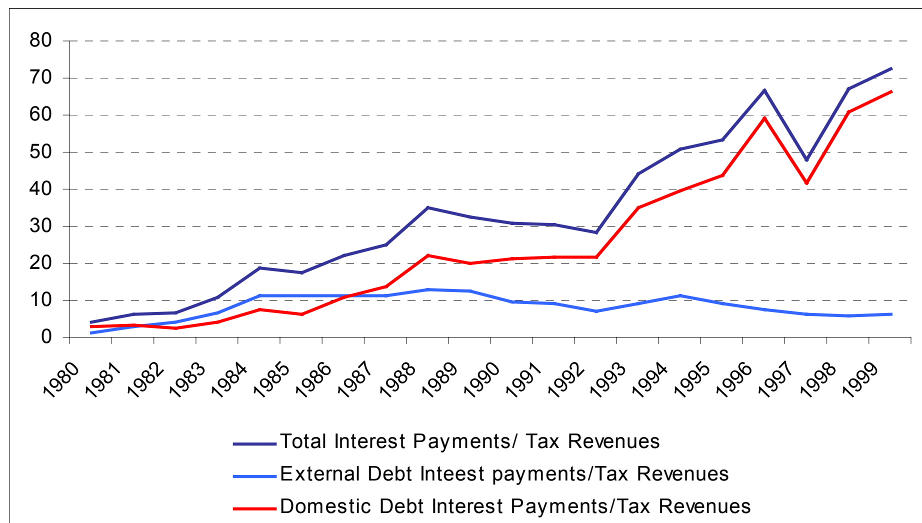
[595] Yeldan (1997:105) and Boratav and Yeldan (2001:5)

[596] Boratav and Yeldan (2001:6) call this situation as the engagement of the government in Ponzi financing.



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.4: Public Sector Borrowing Requirement and Interest Payments (in % of GNP)



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.5: Interest Payments/Tax Revenues Ratio (percent)

9.4. Financing Requirements of the Government in Shaping the Financial Markets

9.4.1. Banks as the Main Customer of Government Securities

The ever-growing debt repayments, initially driven by high deficits and later by high interest rates, led financing constraints of the public deficit to be the primary concern. A structural change occurred in the pattern of domestic debt financing with a shift from monetization to bond issues. Before 1980, deficit financing was heavily relied on direct monetization through the Central Bank short-term advances. Until 1985, this tradition mostly continued, as 60 percent of banknotes had been issued for the purposes of short-term advances. Then, this ratio gradually decreased to reach 20 percent by 1990[597]. Especially with the announcement of the new monetary program[598] by the Central Bank in 1990, monetization of the fiscal deficit was restrained by a protocol signed between the Central Bank and the Treasury. According to that protocol, the Treasury was granted a credit limit of 3.5 trillion TL (9% of budget revenues for 1991) with a very low interest rate, and market interest rates were to be charged for borrowings exceeding that amount. Accordingly, issues of the Treasury bonds and bills became the main instruments of domestic finance with the introduction of the auction market for public sector debt instruments in 1986 (See Table 9.1).

[597] Yeldan (1997:88)
[598] based on controlling the stock of money defined as Central Bank Money (CBM)

Table 9.1: Financing of Consolidated Budget Cash Deficit (Percentage Share) (Net)

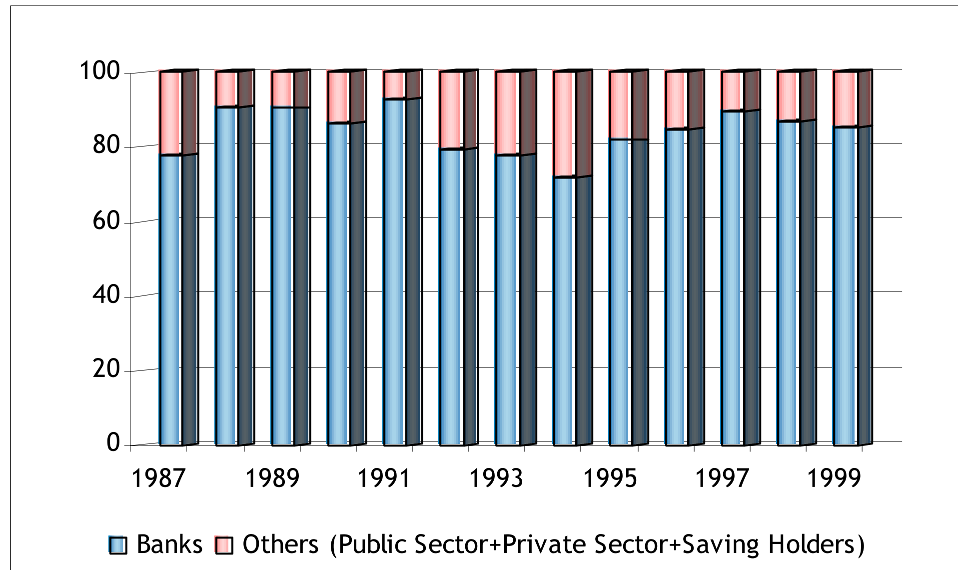
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
External Borrowing	11.7	67.9	-7.1	-49.3	32.5	-24.8	-0.4	-10.4	4.5	-5
Domestic Borrowing	17.9	93.8	50.8	39.7	41	79.6	71.2	70.5	71.6	85.7
Central Bank Advances	68.5	103.5	19.5	39.9	18.5	29.1	16	13.8	17.1	5.6
Other	1.9	-164.9	36.8	69.7	8	16.1	13.2	26	6.8	13.6
Total	100	100	100	100	100	100	100	100	100	100
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
External Borrowing	0.3	5.7	6.8	16.7	-44.2	-27	-10.6	-20.1	-27.2	5.1
Domestic Borrowing	72.1	45.1	66.3	41.5	114.4	96.1	84.1	112.8	120.5	107.1
Central Bank Advances	2.4	32.1	29.3	42	34.1	32.2	18.1	0	0	0
Other	25.1	17.1	-2.3	-0.3	-4.4	-1.2	8.4	7.3	6.7	-12.1
Total	100	100	100	100	100	100	100	100	100	100

Source: State Planning Organization (1990:55)

What is striking for our purposes is that the banking sector became the main customer of those securities[599], mostly with the contribution of the incentives introduced. For instance, government securities were granted tax exemptions and carried a stable and risk-free net yield higher than other types of securities[600]. More importantly, the fact that they could be used as collateral in the interbank money market and be held against the liquidity (disponibility) requirements raised their attractiveness for the banking sector. Therefore, the increase in the disponibility ratio after 1985 led commercial banks to raise the share of government securities in their portfolios. Furthermore, only the banks were allowed to be primary dealers in government bond market. Banks were holding quite high shares of the cash debt of the government, which reached almost 92 percent in 1992 (Figure 9.6).

[599] Moreover, although the yields on private bonds and shares on average were higher than the net rate of returns of the public debt instruments, since their margin of fluctuation had been very wide and erratic, commercial banks have shifted into government instruments (Yeldan, 1997:85).

[600] Akyüz (1990: 102)



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

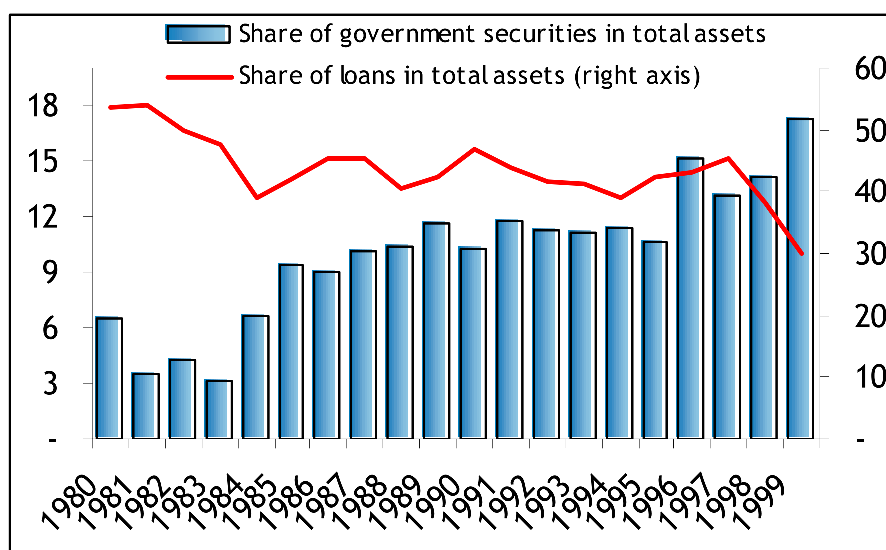
Figure 9.6: Domestic Borrowing by Buyers (percent)

Consequently, the reluctance of the unstable coalition governments to rein in fiscal profligacy or to reform weak institutions in the era following capital account liberalization in 1989 led the private banking sector to become the main mechanism for financing a growing public sector debt at high real interest rates.

9.4.2. Increasing Share of Government Securities in the Balance Sheets of Banks

Change in the composition of banks' assets in favor of government securities can be seen from Figure 9.7. Furthermore, the share of loans in total assets declined from about half of the banks' assets (54 percent) in 1980 to 30 percent in 1999, as the securities, mainly the government securities, became the next largest item among the assets of the banks after loans (Figure 9.7). Especially in recessionary periods, banks' claims on government securities as a percentage of total assets showed a continuous increase as occurred

during the 1997-1999 period. The regulatory treatment of government securities is viewed as the main reason behind this trend[601].



Source: Banks Association of Turkey; http://www.tbb.org.tr/turkce/40yil.htm

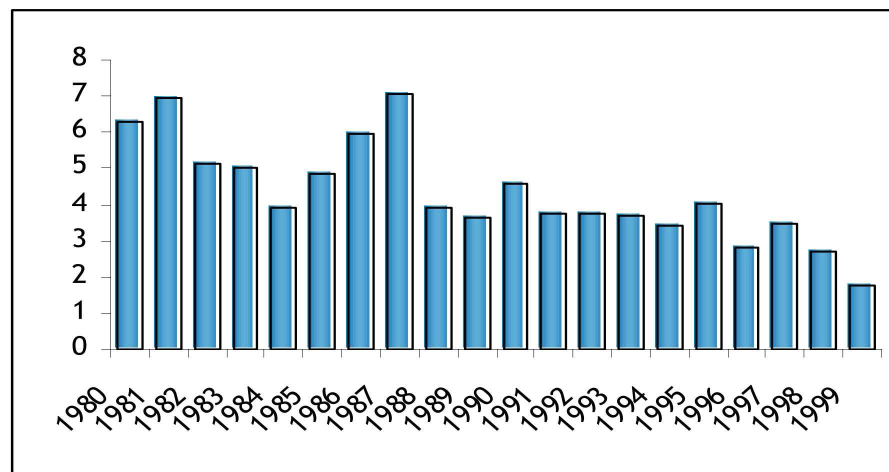
Figure 9.7: Share of Government Securities and Loans in Total Assets of Banks (percent)

Consequently, the sole function of the financial sector in Turkey throughout the years turned out to be transferring funds from the domestic and international markets to the Treasury.

On the other hand, the increasing financing requirements of budget deficit put great pressure on the financial markets and shaped the structure of the financial system to a great extent. For instance, the change towards increasing share of government securities in the portfolios of the banking sector had crowded out the already shallow markets. In other words, bank lending changed from lending to the corporate sector to the financing of the government. The change in the composition is quite striking in the ratio of loans to government securities, registering a decline from 6.8 in 1986 to 1.6 in 1999 (Figure

[601] Rojas-Suarez (2001:14)

8). Banks were extending comparatively little credit to investment for productive activities. Furthermore, "lending took place was often to related parties on unprofitable terms, as large industrial conglomerates owned most of the banks, which lacked necessary skills in assessing firms' creditworthiness"[602].



Source: Banks Association of Turkey; http://www.tbb.org.tr/turkce/40yil.htm

Figure 9.8: Ratio of Loans to Government Securities Portfolio

Therefore, financial structure of the economy in the post liberalization period was characterized by dominance of the public sector in the financial markets and banking sector as the main intermediary in the financing of fiscal deficits.

9.4.3. Impact of Financing Requirements of the Government on the Composition of Financial Savings in the Economy

High government budget deficits and its financing needs have also been instrumental in shaping the composition of financial savings in the economy since the beginning of the 1990s. First of all, ratio of securities within total assets rose from 6.4 % in 1980 to 17% in 1999 with

[602] OECD (2002:12)

most of the increase coming from public sector securities, predominantly Treasury bills and bonds (Figure 9.7).

At this stage, a comparison of the relative shares of public and private sector securities among total securities portfolio is quite helpful in terms of looking at the picture from a general perspective. Share of public securities showed a continuous increase since the beginning of 1990s. Until 1991, growth rate of outstanding private securities was faster than the government bonds. Nevertheless, as public sector deficits got larger, government bonds began to dominate the financial system. The share of private sector securities in total securities portfolio has shown a very dramatic decline as it fell to 14 % in 1999 from its peak of 43.9 % in 1991 (Table 9.2). Therefore, contrary to expectations, the financial liberalization process ended up with the increased share of public sector in the financial markets.

Table 9.2: Share of Public & Private Securities within Total Securities Stock (percent)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Private Securities	31.1	34.2	38.9	43.9	31	29.3	18	19.7	13.4	13.3	13.9	14
Public Securities	68.9	65.8	61.1	56.1	69	70.7	82	80.3	86.6	86.7	86.1	86
Government Bonds	40	46.1	45.3	31	44.2	49.6	31.9	34.2	38	50.8	42.2	72.6
Treasury Bills	20.8	15	13.2	22.9	21.6	16.9	41.7	42.1	46.4	33.8	42.7	11.9
Others	8.1	4.6	2.7	2.2	3.2	4.2	8.4	2.3	0.6	2.1	1.3	1.4

Source: Capital Market Board

9.5. Lax Supervision and Regulatory Forbearance

There were also weaknesses in the supervisory and regulatory framework of the banking sector. Until 1999, the Treasury, the Central Bank and the Capital Market Board were the main regulatory and supervisory bodies in the financial sector, with the Treasury acting as the principal institution responsible for bank supervision and regulation. However, due to conflicting objectives and poor coordination among

these bodies, there was inefficiency in tracking the soundness of the banking sector. In particular, there were few incentives that would push Treasury to regulate undercapitalized banks with excessive holdings of government securities due to objectives of eased deficit finance and roll-over of maturing debt. This regulatory structure also acted as a barrier for foreign banks to participate on a meaningful scale[603].

Furthermore, the general claim was that entry of new banks into the sector was on the basis of political criteria, i.e., granting of new bank licenses was determined primarily by political considerations during 1990s. It is quite instructive that all six banks that were allowed to enter into the banking sector during and immediately after the elections of 1991, have subsequently failed within a decade of their inception[604]. As Alper and Öniș (2002:12) have commented that 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".

The Minister for Economic Affairs, who was argued to be more exposed to the influence of bank lobbies and political pressures than the Treasury, was in charge of the decision to intervene in banks. Hence, the process was not transparent. Such regulatory forbearance led to moral hazard problem, i.e., insolvent but still operating institutions were encouraged to take excessive risks and deteriorate further, also sending signals to banks that there were no sanctions for misbehaviour[605]. Soral et al. (2003:1) assert that combination of weak

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[603] OECD (2002:79)

[604] Alper and Öniș (2002:11); OECD (2002:80)

[605] OECD (2002:80)

institutional framework and economic vulnerabilities create an environment for opportunistic behavior such as fraudulent activities in the financial sector.

9.5.1. Connected Lending

A dimension of the moral hazard was related to connected lending and equity holding by banks in industrial firms. The banking system was characterized by the connections between banks and large industrial firms, as almost all private banks belong to family owned industrial groups. Connected lending occurs as banks extend credit to group companies within limits, but these were not enforced rigorously[606]. Furthermore, banks were able to own equity in companies within the same group. In this mechanism, credit does not necessarily go to most productive use. This also does not prevent banks to abuse deposit insurance. In practice, groups that pursued aggressive growth strategies borrowed heavily from their banks, which has been a major problem for years. The problem was in fact that regulators did not control efficiently. Therefore, the combination of the problems of group lending and shareholding[607] led to major problems that Turkey experienced recently.

Soral et al. (2003) concluded on the basis of their analysis that there were manifestations of participation of a range of banks and ruined firms in bankruptcy for profit strategies. They give the definition provided by Akerlof and Romer (1993) for bankruptcy for profit, which is:

> firms have an incentive to go broke for profit at society's expense (to loot) instead of to go for broke (gamble on success).

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[606] In case of lending, the limits to affiliates were double the bank capital and for equity holders and related third parties, limits were 50 percent of the bank capital Denizer et al. (2000:12)

[607] See Denizer et al. (2000:12) for further discussion of these problems

> Bankruptcy would occur if poor accounting, lax regulation or low penalties for abuse give owners an incentive to pay themselves more than their firms are worth and then default on their debt obligations.

They assert that this definition exactly captures the situation in the Turkish banking sector before the crises of 2000/2001, where they documented falsified increases in equity capital of the Esbank, using intermediary firms to lend above the legally set limits to companies that are controlled by the Bank's owners (connected lending) and lending among banks that apparently reduce the exposures of the Bank to its own companies, leading to many insolvent banks. Soral et al. (2003) have claimed that when that kind of behavior is widespread, then, it can lead to a banking crisis.

Koğar (2004:151) also discusses on the basis of a report by BRSA that the banks that misuse depositor's money and/or extend credits to their own groups had ended up with insolvency and were transferred to SDIF between the period 1997 and 2001. Table 9.3 is quite informative in that respect. Among banks' resources used by groups before taken-over, 83 percent is by own groups. Moreover, loss is mostly (82 percent) led by connected lending and misuse of resources.

Table 9.3: Loss of Saving Deposit Insurance Fund (SDIF) Banks at the Time of Bailout and Sources by Own Groups

	Billion US Dollar	Share (%)
Total Sources Used by Groups	**11**	
Of which/		
From Own Banks	9.1	82.6
From Other SDIF Banks	1.9	7.4
Loss	**17.3**	
Of which due to the/		
Deterioration of financial position	3.2	18.7
Connected lending and misuse	14.0	81.3

Source: Banking Regulation and Supervision Agency

Moreover, according to a BRSA Progress Report-V issued on November 18, 2002 (Table 9.4), most of the loans of those insolvent banks were traced to their own group companies. It is argued in the BRSA Report (2002:16)

> loans extended to majority shareholders have a significant effect on non-performing loans. In fact, funds used by majority shareholders from their own banks and from other SDIF banks (except Pamukbank) amounted to USD 7.9 billion (calculated by the exchange rates as of the date of their utilization).

Table 9.4: Deposits and Losses of SDIF Banks and Funds used by the Majority Shareholders (USD Million)

				Receivables from Majority Shareholders			
Bank	**Total Deposit**	**Loss**	**Share %**	**Funds Used By Majority Shareholders**	**Funds Used from other Fund Banks (**)**	**Total**	**Reimbursement and Indemnification Amount(***)**
Bank Ekspres (*)	487	435	3,2	343	107	451	-
Bank Kapital	370	393	2,9	278	131	409	278
Bayindirbank	197	116	0,8	71	66	137	71
Demirbank (*)	2.828	648	4,7	-	52	52	-
Egebank	1.811	1.220	8,9	489	138	628	489
EGS Bank	600	545	4,0	293	1	294	293
Esbank	1.965	1.113	8,2	627	189	816	627
Etibank	1.521	698	5,1	436	255	690	436
Iktisat Bankasi (*)	1.894	1.954	14,3	726	42	768	726
Interbank	1.905	1.269	9,3	1.160	261	1.421	-
Kentbank	1.013	681	5,0	133	43	175	133
Sitebank (*)	75	53	0,4	8	0	8	-
Sumerbank	1.144	470	3,4	299	52	350	299
Tarisbank (*)	132	74	0,5	-	0	0	-
Toprakbank	1.063	880	6,4	534	71	605	534
T.Ticaret B.(*)	1.446	777	5,7	30	0	30	-
Ulusal Bank (*)	356	524	3,8	5	0	5	-
Yasarbank (*)	1.475	1.149	8,4	103	41	144	-
Yurtbank	752	656	4,8	719	196	915	719
Total	**21.034**	**13.654**	**100,0**	**6.255**	**1.645**	**7.900**	**4.605**

Note: Reimbursement and indemnification lawsuits are filed for the reimbursement of funds used by majority shareholders in their favor and losses incurred as a result.

(*)Reimbursement and indemnification lawsuits are not filed for these banks due to the fact that they are taken-over pursuant to Article 64 of Act Nr. 3182 and Article 14/3 of the Act Nr. 4389. However, necessary lawsuits regarding Interbank and Bank Ekspres ensuring the follow-up of the receivables for the funds used by the majority shareholders from their own banks have been filed.

(**)Execution-bankruptcy and personal responsibility proceedings are carried out in accordance with the Acts Nr. 6183 and Nr. 2004.

(***) Other receivables and losses which are not subject to reimbursement and indemnification are followed up in accordance with the Acts Nr. 6183 and Nr. 2004 besides through lawsuits on receivables and personal responsibility lawsuits

Source: "Banking Sector Restructuring Program Progress Report V, November 2002" Banking Regulation and Supervision Agency

Among the 20 banks transferred to SDIF during 1997-2002 period, the reason for 12 banks was connected lending as well as deterioration of their financial conditions (Table 9.5).

Table 9.5: Banks Taken Over by the SDIF

	1997	1998	1999	2000	2001	2002
Banks taken over	1	1	6	3	8	1

Source: "Banking Sector Restructuring Program Progress Report V, November 2002" Banking Regulation and Supervision Agency

Furthermore, ineffective bankruptcy law and court system also created impediments to quick restructuring efforts. For instance, it took eight years for the liquidation of the banks taken over after the 1994 crisis. Hence, the major problem was, mostly, the weak implementation of existing rules and regulations, rather than absence of them.

Hence, the creation of an independent regulatory agency with full licensing authority under the 1999 banking reform was a major step forward, but it became operational too late to prevent banking crisis from erupting in late 2000.

9.5.2. Deposit Insurance and Moral Hazard

Moral hazard problems arising from deposit insurance was one of the major reasons of the banking sector instability and fragility. Following the crisis in 1982, the bail out of depositors and takeover of the liabilities of five banks were good examples of implicit insurance[608]. Estimated cost of the liabilities of the five banks was about 2.5 percent of GDP in 1982. Deposit insurance on Turkish lira deposits was 100 percent up to a legally set maximum and 60 percent thereafter in the

[608] Denizer et al. (2000:11)

Banks Act No.3182 enacted in 1985. This coverage was extended to foreign currency accounts in 1992.

Subsequently, on May 5, 1994, the government introduced full guarantee[609] to all savings deposit holders to restore the confidence in the banking system[610]. This system contributed to overall financial stability through preventing bank runs and thus by reducing the probability of a systemic crisis. Although there was an improvement in the conjuncture during the period 1995-97, the authorities neither put a limit on deposit insurance, nor had any incentives to remove it. Therefore, full deposit insurance imposed costs through raising moral hazard problems: encourage excessive risk taking and misallocation of resources (due to adverse selection), reduce market discipline, little incentive of depositors to choose banks carefully or to monitor them in the expectation of a government (or IMF) bail-out. This has made it easier even for the weakest banks to raise funds from depositors. In some cases, low quality banks have engaged in practices of offering extra-high deposit rates and lending to over risky projects in the hope to grow out of their liquidity/solvency problems. These moral problems made a financial crisis more likely.

The safety net and the consequent costs required strong regulation and supervision[611]. On the other hand, full deposit guarantee coupled with ineffective supervision in the following years, increased the moral hazard problems and the inclination of banks towards taking more risks. As banks invested in excessively risky projects, together with supervisory and regulatory forbearance, these costs have increased more and became a danger for financial stability in Turkey. Hence,

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[609] The first legal arrangement regarding the protection of savings deposit is the Deposit Protection Law Nr. 2243 dated 1933.

[610] BDT (2000:4)

[611] Mishkin (2000)

excessive risk taking in the banking system mainly resulted from the lack of well-regulated and closely supervised banking system.

9.5.3. Distortions Induced by Public Banks

The share of public banks in the Turkish banking system has always been high. While public banks were founded for development and supportive purposes[612], they became the main vehicle for political rent distribution[613] following reform of the state economic enterprises in the early 1990s. Hence, the two major public banks, Ziraat Bank and Halk Bank were politically important institutions due to their role to materialize the process of rent distribution in the post-1994 crisis.

State banks extended subsidized credits to certain sectors of the economy, to serve political ends and have often charged interest rates below their funding costs. In other words, credit selection was often on the basis of political preferences. Moreover, access to subsidized loans for agricultural or small business investments was neither transparent nor fair. This eventually resulted in low profitability levels. Therefore, state banks had large amounts of nonperforming loans as a result of these operations. The stocks of these loans were about $20 billion in 1999, almost 13 percent of GDP (Table 9.6 and Figure 9.9).

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[612] "As in other countries, they complemented the market by providing credits to small agricultural units and small and medium size entrepreneurs, and by establishing an extensive network of branches in remote areas. Each public bank has targeted a specific group in its supportive duties: Ziraat Bank was specialised in agricultural credits and development; Halk Bank in small and medium sized entrepreneurs and artisans; and Emlak Bank in the construction sector." OECD (2002:81)

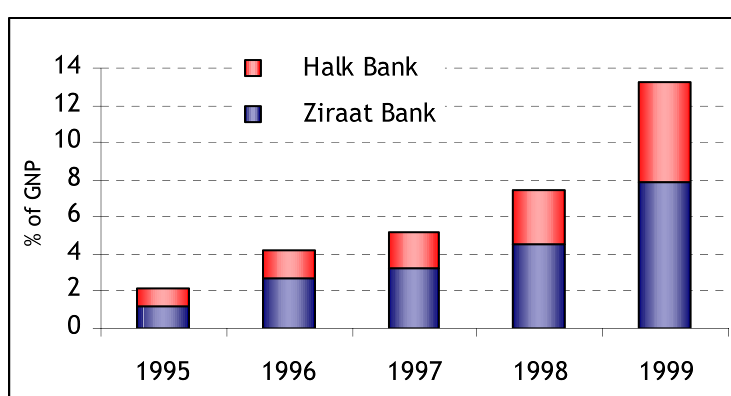
[613] See OECD (2002: Box 6) for the role of public banks: "Public banks often pursue objectives with respect to regional or sectoral development…Against this, credit allocation is often not based on careful analysis of the borrower, and after getting credits, borrowers have incentives to use them in more profitable areas than the intended sectors. Also, public banks tend to direct deposits into public debt finance rather than productive credits, and they can be misused by political parties to direct credits to favoured support groups. In short, public banks need to be regulated properly."

In the late 1990s, huge "duty losses", arising from uncompensated lending subsidies, posed a major threat to the health of the banking system. Duty losses represent loans granted to the Treasury by state banks, i.e. quasi-fiscal losses[614]. The Treasury periodically issued "non-cash" government securities to clear its liabilities with the banks. The duty losses of state banks accumulated and reached 30 percent of their total assets in 1999. They accumulated due to lending at below-the-market rates to sectors such as housing, agriculture and small business.

Table 9.6: Duty Losses of State Banks

	1995	1996	1997	1998	1999
TL Trillion					
Ziraat Bank	92.7	409.6	945.6	2395.6	6123.8
Halk Bank	76.5	221.8	570.5	1586.6	4232.0
Total	169.2	631.4	1516.0	3982.3	10355.8
US $ million					
Ziraat Bank	1518.0	3809.6	4618.1	7660.6	11338.3
Halk Bank	1252.7	2063.6	2786.2	5073.7	7835.6
Total	2770.7	5873.2	7404.3	12734.3	19173.9
Share in GNP					
Ziraat Bank	1.18	2.73	3.22	4.48	7.83
Halk Bank	0.97	1.48	1.94	2.96	5.41
Total	2.15	4.22	5.16	7.44	13.24

Source: Treasury and World Bank



Source: Treasury and World Bank

Figure 9.9: Duty Losses of State Banks (Share in GNP)

[614] Alper and Öniş (2002:10), OECD (2002:12).

The duty losses deteriorated the asset quality of state banks and financing of these duty losses increased the liquidity need of these banks. As the Treasury delayed to meet these obligations, the public banks were forced to finance their losses through short term financing, which was quite costly. State banks covered their financing requirement through offering deposit interest rates far greater than those of private banks. The main sources of liquidity for these banks were repo transactions, deposits, and interbank market, in which they borrowed in short maturities. As state banks had huge overnight borrowing requirements, their overnight exposure reached high levels that were exposing them to interest rate and liquidity disturbances. Thereby, the stock of duty losses and hence, the overnight borrowing requirements created a pressure on financial markets and led to an increase in interest rates. On the other hand, such interest rate hikes put pressure on the private banks, which had large maturity mismatches linked to open positions. This pattern terminated in the crises of 2000 and 2001.

The Treasury took the responsibility for the duty losses of the public banks amounting to US$ 20 billion (Table 9.6), only after the crisis had materialized in 2001. In other words, the reluctance of policy makers to tackle the issue in a timely manner resulted in very costly consequences for the whole economy.

Furthermore, public banks had to participate in deficit financing due to the large public sector borrowing requirement, leading to "crowding out" of credits available to the private sector. "While public banks accounted for 40 per cent of total banking sector deposits, they represented only 27 per cent of the loans by the end 2000"[615]. Hence,

[615] Moreover, there is anecdotal evidence that public bank loans were sometimes used by borrowers to buy repos, and with subsidised borrowing rates set at around 50 per cent, and nominal market interest rates at least double that, the incentives to do so were obvious.

the duty losses and distortions induced by the public banks transmitted pressures to the whole banking system.

9.6. Financial Risks Facing the Turkish Economy and Absence of Risk Management

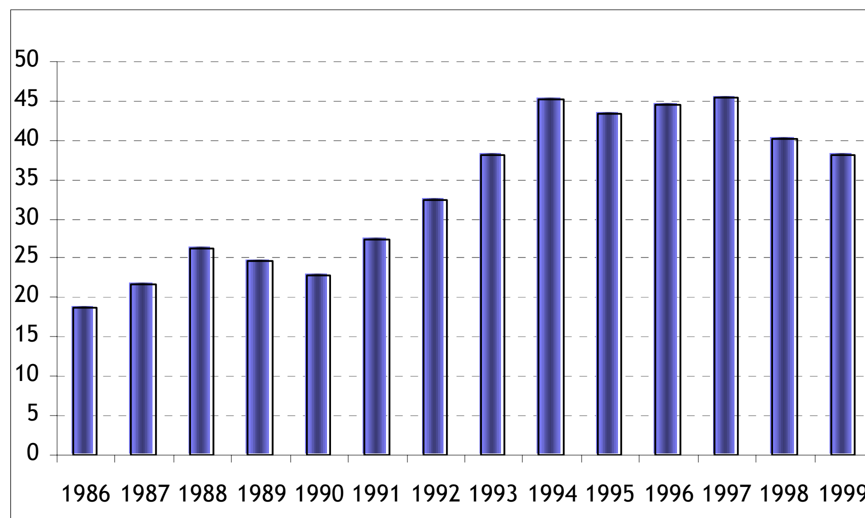
Under the framework of the institutional weaknesses both in the banking system and Turkish politics, the extent of fragility of the banking sector can be better analyzed through examining the major financial risks in the post-liberalization period.

Financial risk management capability is essential for banks to survive in a market-oriented environment. Nevertheless, the Turkish banks ignored the risk management, despite the fact that they became more exposed to liquidity, interest rate, credit and FX risks in the aftermath of 1989. They rather preferred profit from government securities and funded the high PSBR without hedging their risks. Hence, as government securities became a major source of revenue for the banking sector, this source altered the asset/liability structure of the banking sector by making the banks more vulnerable to risks, mainly interest and FX risk. Besides that, lack of efficient lending culture and connected lending habit in the Turkish banking sector that emerged due to weak institutional structure, weakened further their risk management. Therefore, one of the main problems of the banking sector before the crises in 1994 and 2000/2001 was the lack of effective risk management systems.

The risk exposure of domestic banks will be evaluated below in four groups namely exchange rate risk, interest rate risk, liquidity risk and credit risk. All these indicators clearly show the extent of the vulnerability of the banking sector in the pre-crises periods.

9.6.1. Exchange Rate Risk

Exchange rate risk mainly emerges from the mismatch between foreign currency denominated liabilities and assets. As can be depicted from Figure 9.10, coverage ratio of foreign exchange denominated assets to liabilities declined in the pre-crisis period, as happened before 1994 and 2001 crises in Turkey.



Source: Banks Association of Turkey, http://www.tbb.org.tr/turkce/40yil.htm

Figure 9.10: FX Assets/FX Liabilities of the Banking Sector

Dolarization of the banks' balance sheets can be observed from Table 9.7, which shows the increasing shares of foreign exchange in the asset and liabilities side of the banks' balance sheet. The shares of foreign exchange in the total assets and liabilities of the banking sector increased from the levels of about 18 percent in 1986 to around 40, even in some years to 50 percent.

Table 9.7: Share of Foreign Exchange in the Banking Sector Balance Sheet

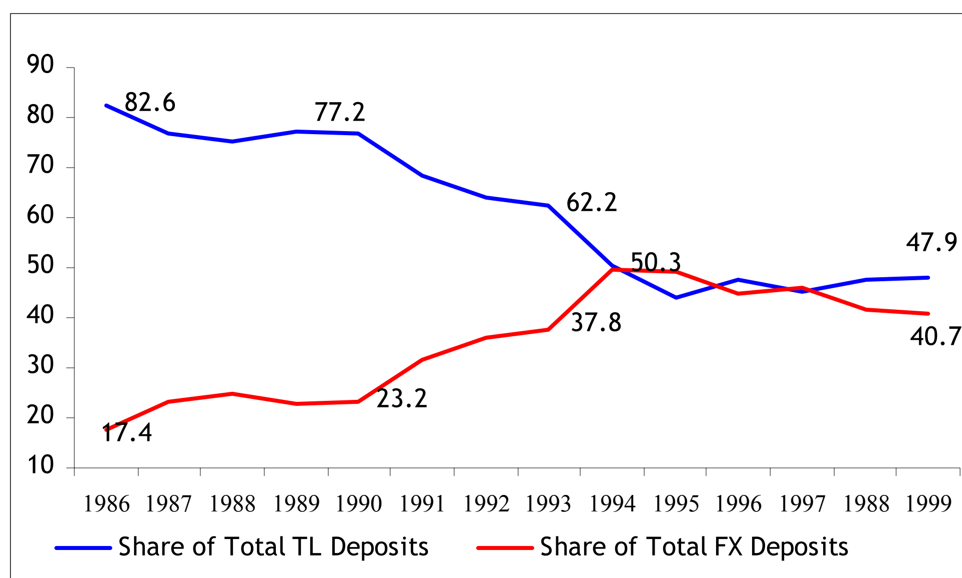
	Share of FX in Assets	Shares of FX in Liabilities
1986	18.7	18.0
1987	21.7	24.4
1988	26.3	25.8
1989	24.7	23.5
1990	22.8	26.1
1991	27.5	30.8
1992	32.3	37.3
1993	38.2	45.2
1994	45.2	46.8
1995	43.4	47.9
1996	44.6	47.7
1997	45.4	50.6
1998	40.1	47.2
1999	38.1	48.0

Source: Banks Association of Turkey

On the banks' liabilities side, foreign exchange liabilities of banks increased rapidly mainly through foreign exchange deposits. Currency substitution in Turkey has started with the liberalization of the foreign exchange regime in 1984. High inflation further added to growing use of foreign exchange as a hedge against inflation[616]. Meanwhile, Turkish residents were also allowed to hold foreign exchange deposit accounts in 1986. Implementation of positive real interest rates and depreciation of the TL resulted in a demand for foreign exchange accounts and declining share of other financial instruments in portfolios of the private sector. The extent of currency substitution can be easily viewed from Figure 9.11, as composition of deposits changed in favor of FX

[616] It is argued that "savers were induced to hold larger volumes of short term deposits, more than half of which in foreign exchange, and to purchase overnight repos which were held off balance sheet by banks. A large volume of savings never made it into the banking system, despite high real deposit and repo rates, and was kept "under the mattress" in the form of FX holdings and gold, or invested in real estate" (OECD, 2002:75).

deposits. FX deposits increased rapidly from 23 percent of deposits in 1987 to half of the deposits as of 1994 and kept this share afterward.



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

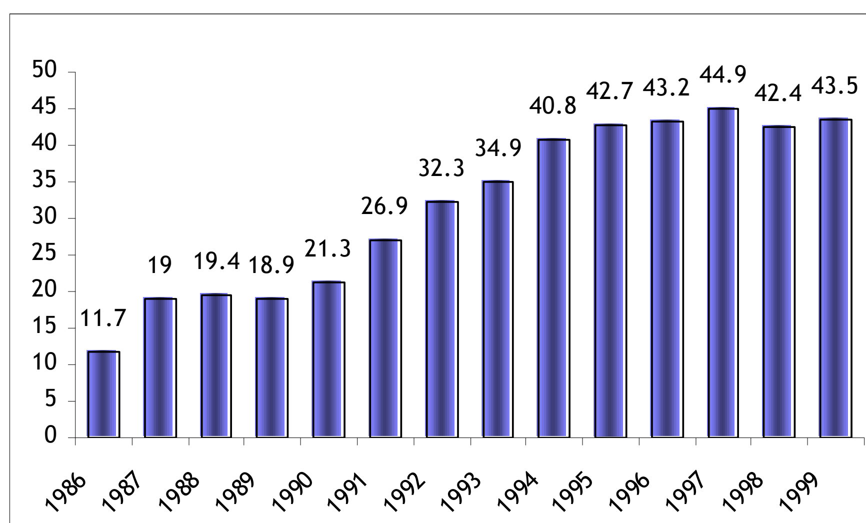
Figure 9.11: Share of FX & TL Deposits within Total Deposits

Although some new measures[617] were taken both to prevent the banks from taking excessive risks and to regulate the foreign exchange positions of the banks in 1986, this did not halt the enormous increase in foreign currency denominated accounts.

[617] These measures were: 1. All kinds of foreign exchange earnings of the banks, including earnings from exports and invisibles, became subject to the surrender requirement. 2.The liquidity requirement, which obliged banks to hold a specified portion of their short-term foreign liabilities in the form of liquid foreign assets, continued. 3. An exchange rate risk ratio, aiming to bring the foreign exchange assets and liabilities of the banks into balance was introduced. 4. Banks were required to extend at least 50 percent of their foreign exchange deposits as foreign currency credits to residents in order to promote foreign exchange generating activities. However, this rule was abolished in 1990. As the rapid growth of foreign exchange deposits made the implementation of monetary policy more difficult, subsequently, these deposits became subjected to legal reserve requirements in 1986. Initially, interest earnings from foreign exchange deposits were not subject to taxation. To halt currency substitution, a 5 percent withholding tax was introduced on these earnings as part of policy measures taken in February 1988. The withholding tax rate was increased to 10 percent in 1989. (Bayazıtoğlu et al., 1991:7).

Hence, a consequence of the reforms towards liberalization of the exchange rate regime in 1984 was rapid currency substitution and change in the asset and liability structure of banks.

While continuous currency depreciation was an integral part of the reforms, high real interest rates coupled with relative predictability of the exchange rate, in turn, attracted capital inflows. Such inflows were largely intermediated by banks. Furthermore, appreciation of the Turkish lira also channeled banks to borrow in terms of foreign exchange (see Figure 9.12). They converted foreign exchange loans to TL and invested in high yielding government securities, which later would be converted back to FX to repay the liability. When real return on government securities are taken into account, open foreign exchange positions obviously provided a significant amount of profit for banks, if the real exchange rate appreciated in the meantime.



Source: Central Bank of Turkey; http://www.tcmb.gov.tr/

Figure 9.12: Ratio of Foreign Exchange Liabilities (FX Deposits & FX Loans) to Total Liabilities (percent)

Nevertheless, this situation increased vulnerability of the banking sector to depreciation of the Turkish lira. Hence, adverse exchange rate movements carried major risks, as risk-taking banks were mostly positioned much in the same direction, keeping open short-term FX positions and holding longer-term Turkish lira instruments.

The banking system's net open positions amounted to more than 90 percent of capital by November 1993, compared with the typical prudential limit of about 20 percent of capital in many countries[618]. It is noted by Denizer (2000:11) that in early 1994, open positions of the banking sector reached 120 percent of their capital. In the pre-crisis periods, 1993 and 2000, Turkish lira had appreciated encouraging open positions, which increased vulnerability of the banking system to movements in the exchange rate. In other words, banks capitalized the opportunities provided by holding TL denominated government securities through borrowing in foreign currencies. Open positions became a major problem of all private banks in the 1990s, making them extremely vulnerable to speculative attacks[619](Table 9.8).

Koğar (2005:136) argues that being specific to the period preceding the 2000/2001 crises, banks' on-balance sheet FX position was exceeding prudential limit, while they seemed to cover their FX liabilities with off-balance sheet activities. This situation is quite striking in terms of showing the extent of vulnerability as well as looseness of supervisory environment.

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[618] IMF (2002:82)

[619] Alper and Öniş (2002:10). The aggregate open position of the banking system was $2.9 billion (48 percent of total capital of the banking system) in 1992 and it went up to $4.6 billion (68 percent of capital) in 1993 (Denizer, 2000:11).

Table 9.8: Open Foreign Exchange Positions of Banks[1]

Values in USD billions	1995	1996	1997	1998	1999
Net Open Positions (NOP)[2]	0.4	1.2	1.8	2.6	2.8
Ratios (in %)					
Open Positions/Total Assets	4.5	3	5.3	7.2	9.9
Open Positions/Net Worth	50.8	33.8	56.2	81	168.4
Net Open Positions/Total Assets	0.6	0.1	0.2	0.3	2.1
Net Open Positions/Capital Base	10.5	29.9	31.4	33	35

Source: Banks Association of Turkey, Central Bank of Turkey, Treasury
[1] Positive values indicate that FX liabilities exceed FX assets.
[2] Defined as (Total Assets + Forward Purchases) – (Total Liabilities + Forward Sales) in FX, including exchange indexed transactions.

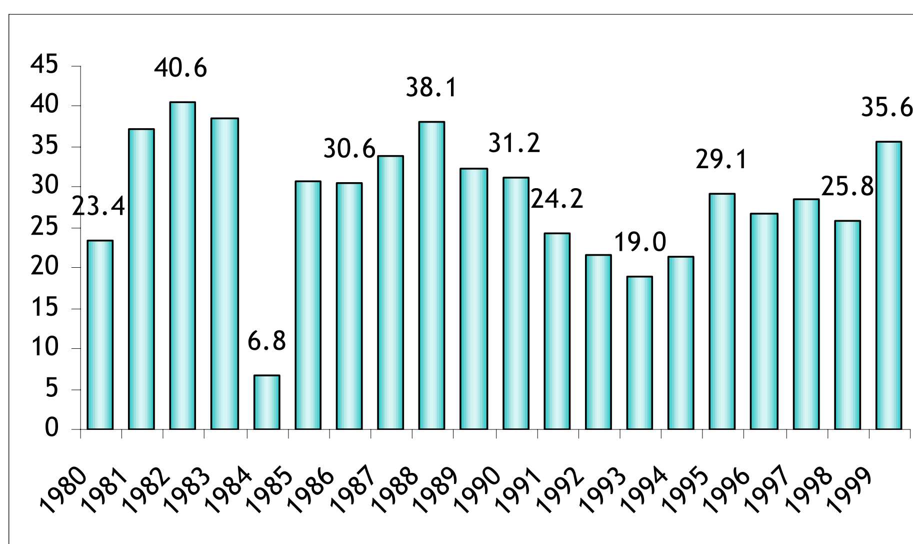
9.6.2. Interest Rate Risk

Banks preferred to finance long-term assets (government securities) with short-term borrowings, which had overnight-to-one month maturity range. This created a maturity mismatch between assets and liabilities of the banks. Maturity mismatch of the banking sector creates vulnerability to increases in interest rate. Banks faced substantial risks in their interest rate exposures due to maturity mismatch. Because when interest rates go up, value of banks' assets go down incurring large losses and costs of short-term liabilities increase, leading to large amount of costs overall. Furthermore, in such a situation, since maturity of assets is longer, banks have no chance to cover the short-term liabilities through generating revenues in the asset side. Hence, banks ran considerable risks in terms of potential capital and income losses from interest rate fluctuations.

On the liabilities side of the banks' balance sheet, while average maturity of the deposits was 230 days in 1988, it followed a declining trend afterward, even falling to 127 days in 1999. Since deposits had a high share in total liabilities, even reaching 68 percent in 1996, their financing requirements in a rather short period was important in terms

of risks they created. Banks were also sensitive to any sharp rise in the interest rates, which would raise their costs.

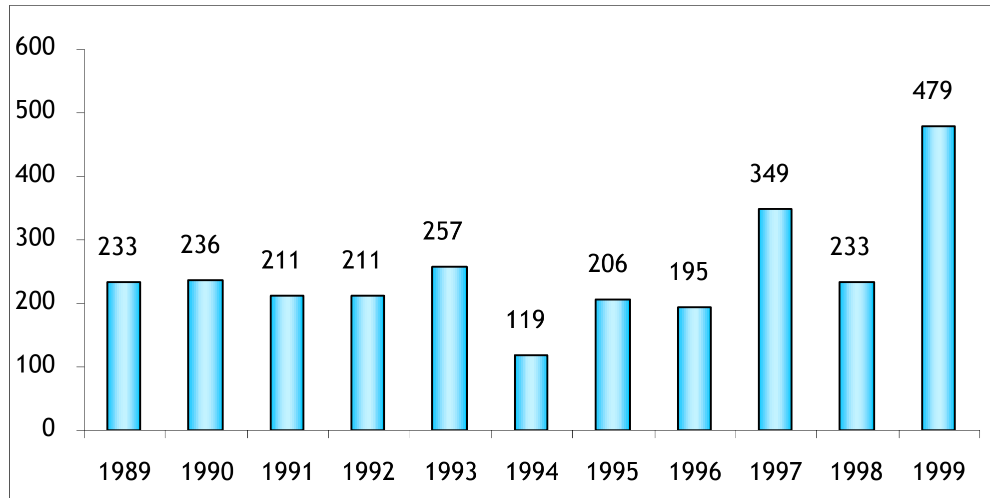
Short maturity structure of deposits can also be viewed from Figure 9.13, which shows small share of deposits with six months or longer maturity within total deposits. This share in general declined in the post-1988 period, from 38 percent in 1988 to 10.9 percent in 2000.



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.13: Share of Deposits with 6 Months or Longer Maturity in Total Deposits (percent)

On the asset side of the banks' balance sheet, when maturity structure of the securities portfolio is concerned, the asset side had always longer maturities compared to liabilities. This was mainly due to longer maturity of the government securities. This can be depicted from Figure 9.14 which shows average maturity of government cash securities, which were around 8.5 months and 15 months in 1993 and 1999, both of which representing pre-crisis years.



Source: State Planning Organization http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/

Figure 9.14: Average Annual Maturity of Domestic Borrowing (days)

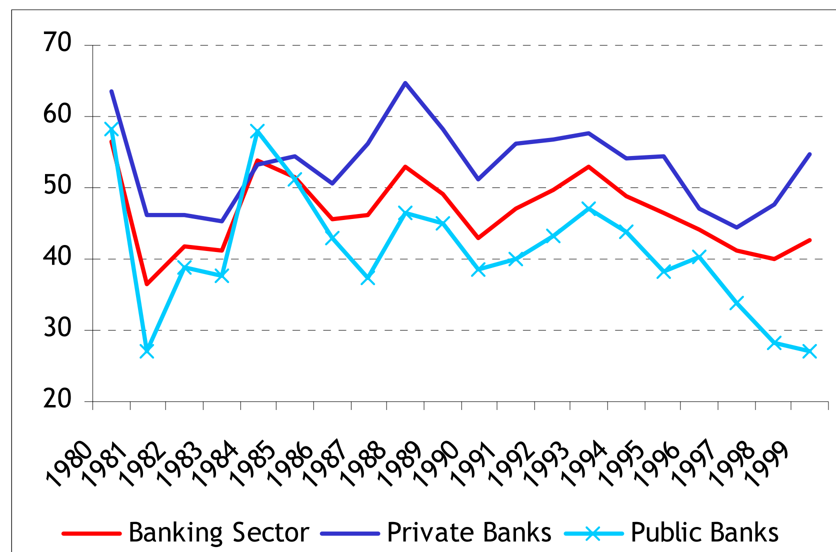
Maturity mismatch has been exacerbated by off-balance sheet holdings of government securities funded by overnight repurchase agreements with bank customers. The volume of repos, encouraged by favourable tax and regulatory treatment, rose sharply after 1997 (off-balance sheet positions).

It is reported by OECD (2002:25) that on the basis of a simple "maturity gap" analysis, by end-2000, the combined on and off-balance sheet maturity gap was some TL100 quadrillion, so that a 10 percentage point interest rate increase could cause losses equivalent to the whole of banks' capital.

Especially prior to the 2000 crisis, Turkish banks were particularly exposed to maturity mismatches stemming from large investments in government securities financed with short-term external borrowing.

9.6.3. Liquidity Risk

Liquidity structure of a bank is important in terms of its solvency. Chronic liquidity problems, illiquidity as a last step of a bank's financial stress, might conclude in insolvency. In Turkey, share of liquid assets has shown a continuous decline from 1993 (Figure 9.15), pointing to a deterioration in the liquidity structure of the banks. A careful examination on the basis of state and private banks points to a sharp deterioration in the position of state banks in the period after 1997 due to heavy burden of duty losses. Private banks remained more liquid as compared to state banks, as can be seen from Figure 9.15.



Source: Banks Association of Turkey; http://www.tbb.org.tr/turkce/40yil.htm

Figure 9.15: Liquid Assets/(Deposits + Non-Deposit Funds)

The most serious liquidity problems arise from the system's vulnerability to systemic shocks. This constituted a significant risk for banking sector liquidity. As banks' liquidity was highly dependent on international capital, inflows were short term throughout the 1990s in response to the perceived risk of investing in Turkey. In other words, such flows carried the risk of being easily reversible when there is a

sudden change in market sentiment[620]. This happened at the end of 2000.

9.6.4. Credit Risk

Credit risk has been one of the major concerns for regulators in Turkey due to highly concentrated ownership structure of private banks. Koğar (2005:145) argues that credit risk is accepted as the largest risk in banks' balance sheets. Factors leading to credit risk are cited as follows: national and international economic conditions, shocks, lending boom, insufficient credit analysis, sectoral concentration, connected lending, domestic and foreign currency composition of credits and fixed rate credits with long-term maturities.

A number of important measures were taken regarding credit risk, including a broader definition of credit to include forwards, option contracts, similar derivatives and shareholding interests, as well as revised lending limits made parallel to EU regulations. There were clear attempts by the authorities towards the problem of connected lending associated with strong links between banks and holding companies. While on the one hand, ceilings on connected bank lending were not restrictive enough, on the other hand, even these levels were weakly enforced. Hence, prudential limits on connected lending credits were easily evaded. Then, the problem of nonperforming loans emerged as a major problem of the Turkish banking sector[621].

Economic cycles of the economy are closely related to the credit risk, as boom periods are associated with excessive credit extensions without allocation of necessary provisions for non-performing loans. Loan asset quality can be weak during very fast credit growth, as it

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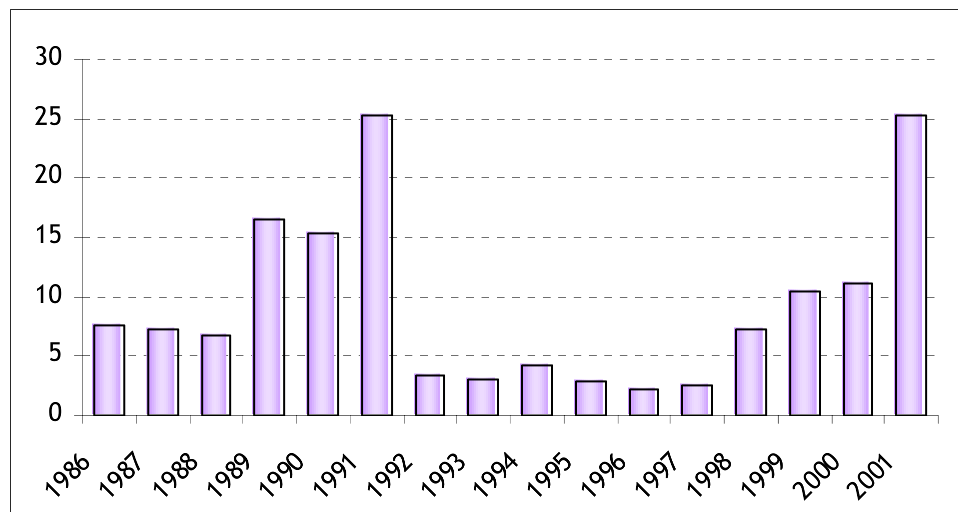
[620] OECD (2002:27)

[621] Alper and Öniş (2002:12-13)

does not allow time to make careful credit risk evaluations. Credit boom in 1995-1997 period in Turkey, which mainly consisted of credits to banks' group firms, i.e. connected lending practices, had started to generate problems beginning from 1998. Therefore, the ratio of non-performing loans to total loans started to increase in 1998 as can be viewed from Figure 9.16. However, banks generally tend to hide non-performing loans in the balance sheets in order to avoid allocating provisions, which directly affects profitability and capital adequacy structure of the banks. Hence, the jump in 2001 reflects to some extent the impact of external auditing and supervision by BRSA in that year, which classified many credits as NPL rather than "live"[622].



Source: Banks Association of Turkey

Figure 9.16: Non-Performing Loans Ratio (Gross NPL/Loans+Gross NPL)

[622] Koğar (2004:150)

9.6.5. Capital Adequacy Ratio (CAR)

In October 1989, in the face of increasing risks in the banking sector, capital adequacy ratio (CAR)[623] was adopted in line with the Bank for International Settlements (BIS) guidelines so that banks keep enough capital with respect to their risky assets. This ratio increased from 5 percent in 1989 to 8 percent in 1992, by 1 percentage point increments each year. With 1992 amendments to the Capital Markets Law, capital adequacy standards for securities markets operations were specified by the Capital Market Board. Furthermore, international standards were set for classification of loans and provisions for non-performing loans in 1989[624]. In addition, steps to strengthen on-site and off-site supervision were taken.

As a matter of fact, Turkey was among the first countries that adopted the BIS Capital Adequacy Ratio in 1989. Many amendments to this regulation took place since then, until the most recent version that incorporated measurement of market risk into the ratio, i.e., revised CAR issued on January 31, 2002 to replace an earlier version.

However, although Turkish banks seemed to comply with minimum capital adequacy ratio of 8 percent before the 2000 and 2001 crises, Koğar (2004:157) asserts that this does not reflect the reality. Because capital adequacy requirements didn't incorporate market risks and consolidated capital ratios, until 2000. It is argued that if they were included in the calculation, capital adequacy ratio would be much

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[623] Capital adequacy ratio which was discussed extensively in the previous section, in general terms, measures the amount of a bank's capital in relation to the amount of its risk weighted credit exposures. The risk weighting process takes into account, in a stylised way, the relative riskiness of various types of credit exposures that banks have, and incorporates the effect of off-balance sheet contracts on credit risk. The higher the capital adequacy ratio a bank has, the greater the level of unexpected losses it can absorb before becoming insolvent.

[624] The CBRT (2002:18)

lower or even negative for some banks[625]. The high levels of investment in government securities, which were classified as risk free; and inadequate loan loss provisioning practice due to tax disincentives were the factors leading to overstatement of CAR, exposing banks to a potential capital erosion in case of a realization of the risks they carried. Hence, capital adequacy ratio can not be trusted to assess the soundness of the banking system[626].

Table 9.9: Capital Adequacy Ratio[1] of Turkish Banks

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
State Banks	7.1	9.5	8.4	8.3	10.0	8.4	6.8	7.0	7.6	8.2	8.2
Private Banks	3.3	3.6	5.4	6.9	7.7	7.2	7.2	8.4	10.1	10.3	11.5
Foreign Banks	4.8	4.7	7.9	10.2	13.3	14.2	10.5	11.6	11.6	11.6	11.1
Investment Banks	8.8	8.1	20.1	20.2	29.7	25.2	17.6	12.8	10.7	10.1	13.2
BANKING SECTOR	5.5	6.5	7.9	8.6	10.4	8.9	8.0	8.2	9.1	9.4	10.1
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
State Banks	7.1	6.3	8.8	5.9	5.1	4.7	6.0	4.2	4.1	3.1	8.5
Private Banks	11.2	10.0	9.5	10.6	11.7	11.3	10.9	12.8	12.9	13.7	5.6
Foreign Banks	14.3	13.3	11.9	19.6	14.5	14.2	10.8	12.9	12.6	9.6	20.0
Investment Banks	11.8	11.0	9.9	4.8	7.1	12.0	15.1	18.1	18.9	24.4	20.2
BANKING SECTOR	9.6	8.6	9.4	8.5	8.9	8.9	9.4	8.9	5.9	6.9	7.2

[1] (Shareholders' Equity + Total Income) / Total Assets

Source: Turkish Banking Association http://www.tbb.org.tr

9.7. Conclusion

Turkey could be regarded as a prime candidate for financial crisis due to several reasons. First, it followed the wrong sequencing of reforms in the sense that financial liberalization had been undertaken against the background of weak institutions for bank supervision and governance, and macroeconomic instability. In the face of massive capital flows into the banking system in the aftermath of liberalization, banks' capacities were not adequate to manage market risks properly and to process information about credit quality. Hence, the banking system was exposed to high levels of liquidity, interest rate, credit

[625] According to Koğar (2004:158), "capital adequacy ratio can be treated as the "necessary but not sufficient" condition for the sound and solvent banking system".

[626] See Rojas-Suarez (2001) for an extensive discussion of these inefficiencies related to capital adequacy ratio.

(reflecting extensive forms of connected lending) and foreign exchange risks. This occurred due to insufficient checks and balances on their activities led by weak prudential oversight and implementation. When combined with banks' weak risk management, this situation led to high foreign exchange exposures in the banking system. These conditions made them vulnerable to the shifts in international investor sentiment and set the conditions for the crises. Fragility of the banking system was one of the root causes of the crises of 1994, 2000 and 2001.

The most prominent of these deficiencies were the following: highly generous deposit insurance scheme, politically subordinate supervisory institutions, political intervention to regulatory process and the bias towards keeping failing banks in the system. The main phenomenon was that as all the large groups in Turkey have banks, supervision on connected lending was not effective. Besides the major problem of moral hazard, which induced those banks to increase their risky activities, the regulatory system failed to enforce the exit of weak banks. Such an environment allowed fraudulent activities to become widespread, contributing to the eruption of the crises of 2000/2001.

Secondly, resource allocation by the financial system was profoundly distorted by a set of policy and institutional failures. Weak and short-lived coalition governments in the 1990s further exacerbated these failures. Financial asset prices and the lending decisions were distorted by increasing financing requirements of the government. Public banks distributed credits often on non-economic criteria leading to significant losses in real terms. This strategy led to crisis and instability. These observations support the idea that the weakness of the banking sector and fiscal imbalances are interrelated phenomena in

Turkey, both of which also were at the basis of the crises of 2000 and 2001[627].

Thirdly, political stability is important for the overall success of economic reform. Hence political constraints have to be taken into account while evaluating the viability of technocratic solutions. In Turkey, during 1990s, 11 different governments have been in power in the political arena. Political structure with fragmented party system and weak coalition governments brought about a pervasive lack of accountability and lack of transparency, which were the key elements of this political structure. The lack of political and economic stability and continuous uncertainty has contributed to the crises episodes in Turkey.

Although until 1999[628], coalition parties in Turkey led to instability and conflict, the coalition government that has emerged from election of April 1999 seemed to display a high degree of cohesion despite very different ideological orientation of each party. On the other hand, since the two dominant parties in the coalition were essentially the parties representing losers[629] from the reform process, these parties' reluctance to continue the reform process and to give up the old populist redistribution resulted in loss of credibility that sent negative signals to domestic and external market players[630]. Hence, it can be concluded that characteristics of the Turkish political system were quite deterministic in terms of the two consecutive crises of 2000 and 2001. More particularly, policy makers' reluctance to tackle the problems in the banking sector regulation especially in the context of

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[627] For a similar view on this point, see Alper and Öniş (2001:16).

[628] Alper and Öniş (2001:17) identify the year 1999 as the turning point in Turkey's political course.

[629] MHP have its electoral base from rural areas and DSP from the urban poor (Alper and Öniş, 2001:18).

[630] Alper and Öniş (2001:18)

public banks such as "duty losses" of SOEs in public banks gave rise to the crises of 2000 and 2001.

Consequently, Turkish experience with financial sector reform shows the negative consequences of undertaking financial liberalization without macroeconomic stabilization and strong economic and political institutional background.

CHAPTER 10

ANALYSIS OF INTERVIEW AND SURVEY RESULTS

10.1. Introduction

In this chapter, the analysis of the results of the survey, which has been implemented to senior economists, high level bureaucrats and academicians will be provided. This analysis is supported with the views of some high level bureaucrats[631] who were interviewed. Some part of this interview was discussed in Chapter 4. In this chapter, the remaining part of the interview that overlap with the questions in our survey will be examined.

Survey questions cover almost all the major arguments and hypothesis discussed in this thesis: mainly, sequencing and pace of liberalization reforms including that of capital account liberalization; weaknesses of the banking sector led by financial liberalization, inefficient prudential regulation and supervision, reasons of implementation failures of regulation and supervision of the banking sector and its link to crises in the Turkish economy since 1990s; deposit insurance scheme and political interference; connection between financial liberalization and post-1990 crises in Turkey; role of international financial institutions in shaping the liberalization reforms in Turkey. The main objective of the survey is to draw on the opinions

[631] Interviews have been conducted with Mahfi Eğilmez, Selçuk Demiralp on November 24, 2005; with Ercan Kumcu on November 25, 2005 in İstanbul; with Faik Öztrak on November 21, 2005 in Ankara; and with Işın Çelebi on January 16, 2006 in Ankara. In 1989, Işın Çelebi was Minister of Economy; Selçuk Demiralp was General Directorate of Banking and Exchange Department at the Treasury; Mahfi Eğilmez was Deputy Undersecretary of the Treasury; Ercan Kumcu was Deputy Governor of the Central Bank, Faik Öztrak was General Directorate at the State Planning Organization. See Appendix A for the full set of interview questions.

of academicians, high-level bureaucrats and senior economist related to the issues mentioned above.

Interview questions on the other hand, aim, first of all, to reveal the underlying reasons of the way financial liberalization reforms were sequenced in Turkey and assess the appropriateness of this sequencing for the Turkish conjecture. Secondly, they aim to tackle the question of whether the crises in 2000 and 2001 could have been avoided and to discuss the specific role of prudential regulation and supervision of the banking sector in that perspective. A related objective is to examine the 2000/2001 crises in the context of disorderly sequencing and role of international organizations.

The organization of the chapter is as follows: The structure, design and implementation of the survey will be discussed in the next section. Section 3 will provide the distribution of the respondents by institutions and by title. In section 4, responses to the survey together with responses to the interview questions will be analyzed. Section 5 concludes.

10.2. Survey Design

The survey included 33 questions in 4 parts. 12 questions have been adopted from questionnaire designed by Ames and Demetriades (2001). Questions are related to sequencing and pace of financial liberalization policies, impact of financial liberalization on the financial system, efficiency of financial institutions in risk assessment and management, government insurance and moral hazard, role of financial liberalization policies and existing regulatory and supervisory framework in leading to crises in the post-1990 period, assessment of prudential regulation and supervision in the 1990s and at present, and policies of the international financial institutions. Most of the questions

are designed as closed-end. Only 3 questions have an open-ended option at the end of question (See Appendix B).

The questionnaire with a cover letter was sent through e-mail to all participants. The respondents were requested to send the questionnaire to the author through e-mail after filling in the survey. Only the English version of the questionnaire was sent to participants. The questionnaire was carried out during November 2005-January 2006 period. While the questionnaire was sent to 78 people, we have obtained 43 responses. Hence, the response rate was 55 percent.

10.3. Description of the Respondents

Sampling method is non-probabilistic purposive sampling method. Respondents were selected from the Central Bank of Turkey, State Planning Organization, Banking Regulation and Supervision Agency, the IMF, the World Bank, the OECD, Middle East Technical University, Boğaziçi University, Bilkent University and some financial institutions such as Garanti Bank, HSBC, Şekerbank, İşbank, Akbank, Oyakbank, Türk Sınai Kalkınma Bankası, Denizbank, Fortis Bank, Goldman Sachs, Deutsche Bank. Participants to the survey are selected from the people currently holding position such as the member of Board of Governors, General Manager/Manager, Chief Economist and Economist in institutions other than universities. Moreover, there were respondents from academicians of Boğaziçi University, Bilkent University and Middle East Technical University.

Table 10.1 gives the distribution of the respondents by institutions. Participants from the Central Bank, the SPO and BRSA account for almost 40 percent of all participants. Around 40 percent of the participants were from fund management companies, commercial banks and investment banks. The rest consisted mostly of

academicians, while participants from international financial institutions account for only 4.7 percent of all participants.

Table 10.1: Distribution of the Survey Participants by Institutions

Institution	Number of Respondents	Percent
Central Bank of Turkey	9	20.9
Banking Regulation and Supervision Agency	5	11.6
State Planning Organization	3	7.0
University (Boğaziçi, Bilkent, METU)	8	18.6
Fund Management Institutions	5	11.6
Banks*	9	20.9
Investment Banks	2	4.7
International Financial Institutions	2	4.7
Total	**43**	**100**

* Garanti Bank, Denizbank, İşbank, Fortis Bank, Şekerbank, Oyakbank, Akbank, HSBC

Table 10.2 gives the distribution of the participants by their title. Share of senior managers and economists each is 30 percent. The rest is shared between academicians and economists with 19 and 21 percent, respectively.

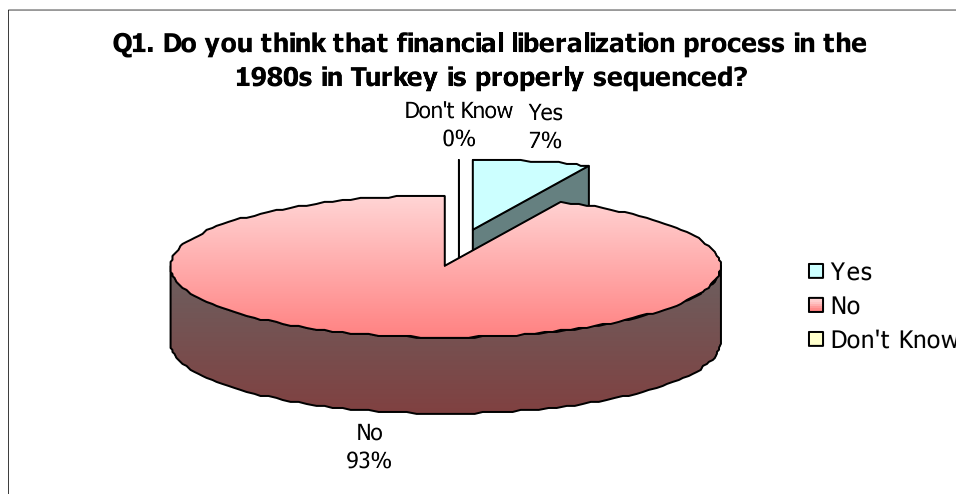
Table 10.2: Distribution of the Survey Participants by Title

	Percent
Senior Manager	30
Senior Economist	19
Economist	30
Academician	21
Total	**100**

10.4. Assessment of Survey and Interview Results

10.4.1. Sequencing and Pace of the Financial Liberalization Policies

Figure 10.1 presents the views of the respondents as regards to sequencing of financial liberalization process in Turkey in the 1980s. A very big majority of the respondents (about 93 percent) believe that financial liberalization process in the 1980s was not properly sequenced in Turkey. This outcome is in compliance with the result reached in Chapter 3 where Turkey's sequencing experience was assessed.



Number of responses: 43

Figure 10.1: Sequencing of Financial Liberalization Process

Table 10.3 gives the evaluation of the respondents as regards to pace of capital account liberalization in Turkey. While pace of capital account liberalization is evaluated as rapid by a very big majority of the respondents (about 93 percent), only 64 percent of the respondents believe that pace of domestic financial liberalization was rapid. The rest of the respondents to question 2 mostly evaluate domestic financial liberalization as a gradual process. This outcome as well is in line with our assessment in Chapter 3.

Table 10.3: Pace of Liberalization Process in Turkey

	Slow	Gradual	Rapid	Don't Know
Q2. Domestic financial market liberalization	14.3	19	64.3	2.4
Q3. Capital account liberalization in 1989	0	7.1	92.9	0

Number of Responses to both questions: 42

<u>Interview Question 12</u>: *Was there any concern or discussion as regards to the sequencing and timing in Turkey when liberalization reforms were implemented?*

<u>Interview Question 13</u>: *Do you think that financial liberalization process in Turkey is properly sequenced?*

Liberalization reforms in the early 1980s were introduced within an orthodox stabilization program, which had as its primary objective achieving stabilization and long-term adjustment rather than liberalization. Thus, it seems that sequencing of liberalization was not the primary concern during the first reform days in the early 1980s. Hence, our questions mostly pertain to capital account liberalization decision in 1989.

One of the interviewees claimed that proper sequencing[632] was not regarded as the way it is described today. It seems that although there were some concern expressed by bureaucrats related to the sequencing issue, especially during capital account liberalization, those concerns did not fit exactly to the proper sequencing framework we propose in this study. In other words, concerns in those days were not mainly directed to the issues of macroeconomic stability and prudential

[632] Our definition of "proper sequencing of economic liberalization reforms" is as follows: First of all, the priority should be given to macroeconomic stability in the liberalization process, as fiscal discipline is ensured first. At the same time, institutional reforms should be undertaken before implementation of liberalization reforms. For the success of financial liberalization, strong banking regulation and supervision is necessary. Then, domestic financial liberalization should take place before capital account liberalization and trade liberalization. As regards to the sequencing of the trade and capital account liberalization reforms, capital account liberalization should be left to the last step.

regulation and supervision of the banking system as a precondition for successful capital account liberalization. Furthermore, interviewees claim that since the general trend in the world economies in those days was de-regulation, sequencing issue was not regarded as important as it is today. On the other hand, almost all of the interviewees believed that financial liberalization was not properly sequenced, when evaluated by today's definition of proper sequencing.

<u>Interview Question 14</u>: *Do you know whether sequencing of the liberalization policies was put on the table as a major issue by the BWI any time in the 1980s, in particular in 1989?*

A common response by the interviewees to this question was that the IMF or the World Bank did not mention sequencing issues any time during the 1980s, as they approached deregulation very favorably. In other words, there was no attempt by the IMF to remind the weaknesses of the banking sector and macroeconomic instability as major impediments to financial liberalization policies. Interviewees drew attention to the fact that in the second half of the 1980s, Turkish-IMF relations were not formally attached to a stabilization program. However, when the IMF was asked for opinion related to capital account liberalization decision in 1989, they did not warn Turkey about sequencing issues.

<u>Interview Question 15</u>: *How do you assess the pace of capital account liberalization?*

Capital account liberalization was evaluated as rapid one by most of the interviewees. One of the interviewees declared that he does not favor gradual approach to capital account liberalization at all. Hence, even though capital account liberalization was evaluated as rapid by this interviewee, he does not propose gradual liberalization of the

capital account liberalization, i.e. sequencing of capital account liberalization.

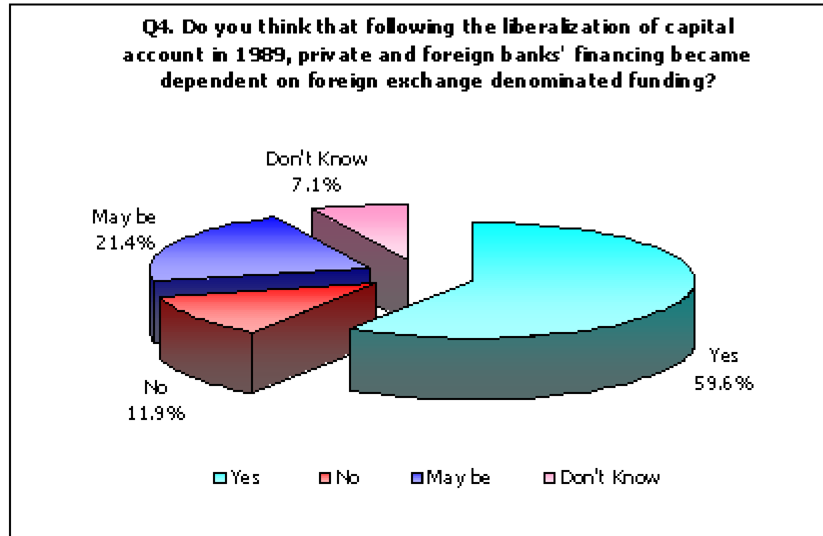
Hence, it seems that the major concern among interviewees is related more to the issue of sequencing of the capital account liberalization policies rather than its pace.

Interview Question 16: *Why was capital account liberalization undertaken in just one step rather than a phased approach?*

This question should be tackled after first considering whether there was any concern as regards to a phased approach. On the basis of the interviews and as discussed also in Chapter 4 concerning timing of capital account liberalization, it can be concluded that phased approach was out of concern. In other words, as capital account liberalization was not discussed widely among bureaucrats, and can be described as a one-man decision, gradual capital account liberalization was not under consideration in those days.

10.4.2. Impact of Financial Liberalization on Financial System

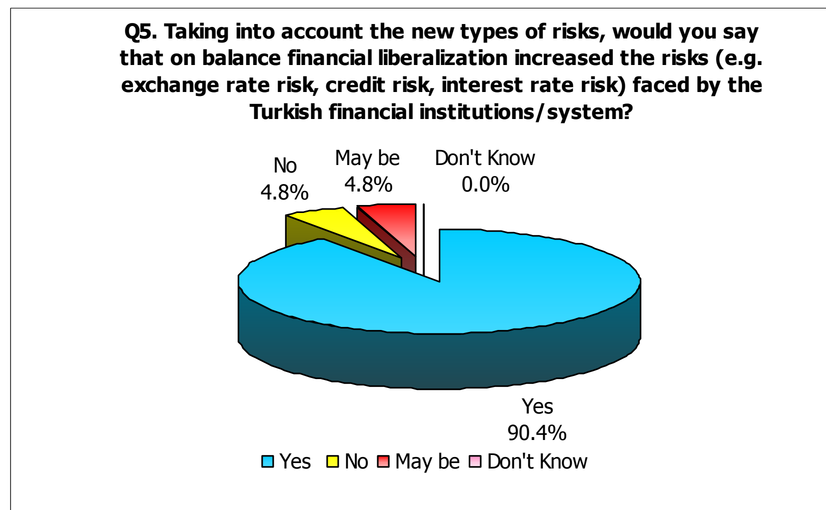
In this section, the purpose is to question the situation of the financial sector in the aftermath of the capital account liberalization. As seen in Figure 10.2, only about 60 percent of the respondents think that financing of the private and foreign banks became dependent on foreign exchange denominated funding in the aftermath of capital account liberalization in 1989, while 21 percent is indifferent.



Number of responses: 42

Figure 10.2: Financing Structure of the Private and Foreign Banks in the Period Following Capital Account Liberalization

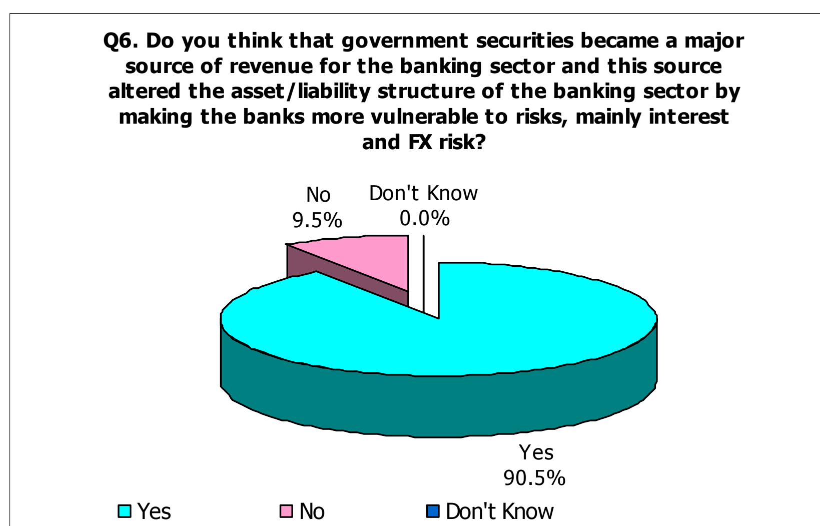
Figure 10.3 gives the distribution of the responses, which evaluates risks faced by the Turkish financial institutions in the face of financial liberalization. A substantial majority of respondents (about 90 percent) consider that financial liberalization increased the risks faced by the financial system in Turkey. This assessment is again in compliance with our assessment of the risks faced by the Turkish financial system in Chapter 9.



Number of responses: 42

Figure 10.3: Risks Faced by Turkish Financial Institutions in the Aftermath of Financial Liberalization

Figure 10.4 evaluates opinions in relation to a fundamental source of weakness of the Turkish financial sector. A significant majority of the respondents (90 percent) agree that government securities became a major source of revenue for the banking sector, while deteriorating the asset/liability structure of the banking sector. This view is also compatible with the arguments in Chapter 9.



Number of responses: 41

Figure 10.4: Dominance of Government Securities in the Portfolios of the Turkish Financial Institutions in the Aftermath of Financial Liberalization

10.4.3. Efficiency of Financial Institutions in Risk Management

Table 10.4 gives distribution of the responses that evaluate efficiency of risk management system of the Turkish financial institutions. About 74 percent of the respondents evaluate the risk management system of the Turkish financial institutions as adequate. Share of respondents who believe that the Turkish financial institutions did not have human capital and expertise to adequately manage the risks are about 44 percent, which is more than who believe they did.

Being conditional to the answers given to question 8, among those who believe that Turkish financial institutions were equipped with the human capital and expertise capable of adequate management of the risks, 90 percent think that this human capital and expertise did not adequately manage the risks. In other words, human capital and expertise of the Turkish financial institutions did not manage risks adequately, although they were capable of fulfilling this task.

Table 10.4: Efficiency of Risk Management System of the Turkish Financial Institutions

	Yes	No	May be	Don't Know
Q7. Did Turkish financial institutions have in place the risk management system required to manage the new types of risks that financial liberalization has brought about?	7	74.4	16.3	2.3
Q8. Do you think that Turkish financial institutions were equipped with the human capital and expertise to adequately manage the risks associated with the intermediation of large amounts of foreign financial capital?	25.6	44.2	23.3	7

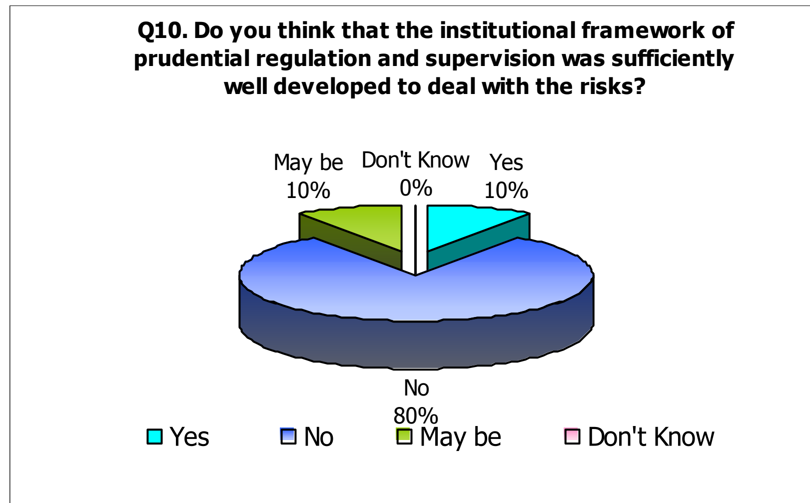
Number of Responses to both questions: 43

From those who answered "yes" to question 8	Yes	No	May be	Don't Know
Q9. Do you think that human capital and expertise of the Turkish financial institutions had adequately managed the risks?	0	90	0	10

Number of Responses: 10

10.4.4. Assessment of the Regulatory and Supervisory Framework in the Pre-Crises Period in Turkey

As can be seen in Figure 10.5, about 80 percent of respondents think that institutional framework of prudential regulation and supervision was not sufficiently developed to deal with the risks. When this question is considered together with answers given to questions 7, 8 and 9 above, i.e. Table 10.4, although most of the respondents evaluate risk assessment capability of Turkish financial institutions as weak, they believe that institutional framework of prudential regulation and supervision was well developed.



Number of responses: 41

Figure 10.5: Adequacy of the Institutional Framework of the Prudential Regulation and Supervision to Deal with the Risks

Table 10.5 presents the distribution of the answers given to the question whether tighter prudential regulation could have mitigated the risk-taking problem in the banking system. Only 52 percent of the respondents believe that it could. Those, who believe that it could not, have a share of 21 percent. Those who are indifferent have a significant share of all responses, which is 26 percent.

Table 10.5: Role of Tighter Prudential Regulation in Alleviating the Risk Taking Problem

Question	Answer	%
Q11. Do you think that tighter prudential regulation could have mitigated the problem of excessive risk taking in the banking system?	Yes	52.4
	No	21.4
	May be	26.2
	Don't Know	0

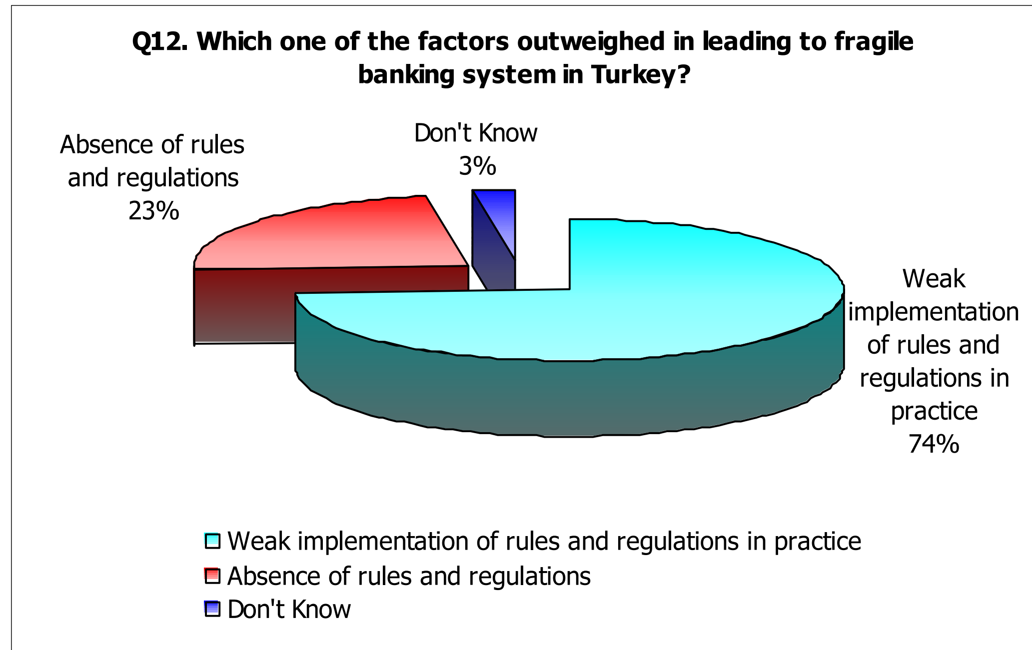
Number of Responses: 42

Hence, while most of the respondents find the institutional framework of prudential regulation and supervision as sufficiently well developed, it seems that they do not see the solution to excessive risk taking in the banking system through tighter regulations.

10.4.5. Assessment of the Factors Leading to Fragile Banking System in Turkey

Country experiences indicate that in many countries, prudential regulation seems, in practice, to seriously lag behind the process of financial liberalization, as discussed in Chapter 5. Furthermore, a more detailed analysis of the country experiences in Chapter 5 has revealed that although many countries seem to have established the legal framework, banking regulation and supervision remains weak due to implementation failures, which end up with severe financial crisis.

We have argued in Chapters 6 and 9 that implementation failures were the dominant factor behind fragile banking system in the Turkish case as well. Hence, Question 12 was asked to learn the respondents' view as regards to the reasons behind the fragile banking system in Turkey. Most of the respondents, about 74 percent, believe that weak implementation of the rules and regulations in practice, was the dominant factor explaining the fragility of the banking system rather than the absence of rules and regulations. This also supports our main argument on this issue.



Number of responses: 39

Figure 10.6: Leading Factors Behind Fragile Banking System

Among those who believe that implementation failures of the rules and regulations were the dominant factor behind fragile banking system, a very large proportion of the respondents, 86 percent, think that direct involvement of the political authority in the regulatory process was a major reason behind these implementation failures. About 59 percent of the respondents consider that persistence of chronic governance failures has played a major role. The strong opposition of powerful lobbies is seen among the major reasons by 48 percent of the respondents. A relatively smaller proportion of the respondents, about 17 percent, views insufficient training and expertise of bank supervisors as a reason for weak implementation.

Only 1 respondent made specific comments to explain the reasons of implementation failures. This respondent expressed fiscal dominance and failure to collect supervisory authority in one

organization, as the other factors that explain weak implementation of bank regulation and supervision in Turkey.

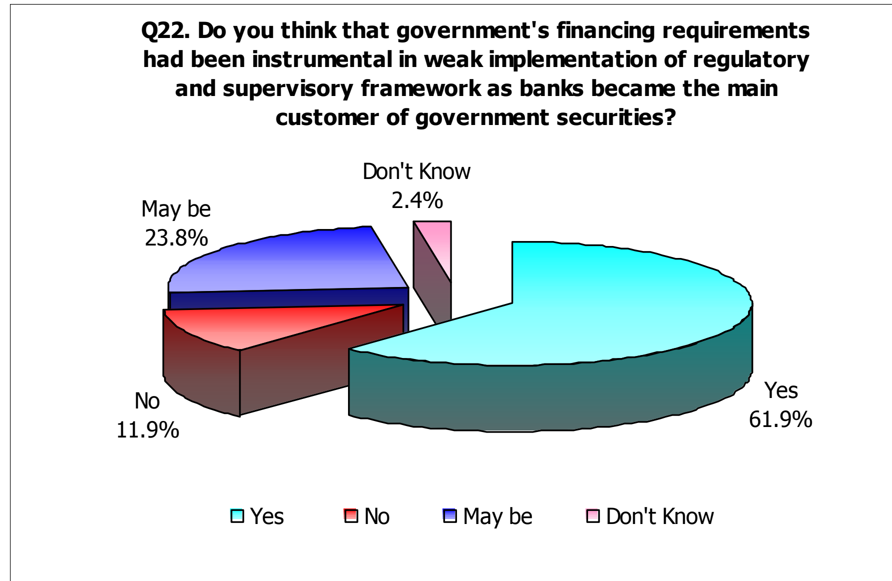
These responses are also in line with our analysis in Chapter 6 explaining the reasons for implementation failures in Turkey.

Table 10.6: Reasons of Implementation Failures

From those who answered "Weak Implementation of Rules and Regulations" to Question 12					
Q13. Which of the following factors explain why serious implementation failures occurred in regulation and supervision of the Turkish banking sector, despite adoption of rules. (may select more than one answer)					
Direct involvement of the political authority in the regulatory process	Great opposition of powerful lobbies	Persistence of chronic governance failures	Insufficient training and expertise of bank supervisors	Other	Don't Know
86.2	48.3	58.6	17.2	6.9	3.4

Number of responses: 29

Figure 10.6 presents the responses to another important question for the present thesis. We have, in Chapter 6, proposed that the Treasury had very little incentive to regulate the banks whose holdings of government securities provided cheap financing of the government deficit. This claim is supported by the survey results as well, with 62 percent of respondents sharing this view. As 24 percent of the respondents remain indifferent, 12 percent do not view government's financing requirements as a reason of weak implementation of regulatory and supervisory framework.



Number of responses: 42

Figure 10.7: Role of Government's Financing Requirements in Weak Implementation of Regulation and Supervision

***<u>Interview Question 21</u>**: What was the main reason behind weak implementation of the regulatory and supervisory framework in Turkey?*

One of the interviewees mentioned that there were plans in 1988 to establish an independent regulatory and supervisory authority under the leadership of the World Bank. However, it is mentioned that in those years, the general view was in the direction of establishing this independent regulatory authority within the Central Bank. The interviewee has stated that this proposal turned into a power struggle between the Central Bank and the Treasury. He asserted that bureaucrats in the Treasury influenced and convinced the government to reject this proposal. Interviewees agree that intervention of the political authority into the regulatory framework distorted the latter's autonomy. On the other hand, the government did not want to leave this power of controlling the banks to another authority. One of the

interviewees claimed that control over banks gave such a power to the government, it even led to struggle among Ministers. Hence, the general belief was that direct involvement of the government in the regulatory and supervisory process constitutes the basis of implementation failures of the rules and regulations in the banking system.

According to survey results presented in Table 10.7, 55 percent of the respondents believe that there was supervisory and regulatory forbearance in the pre-crises period in Turkey. Almost 93 percent of the respondents believe that connected lending and lack of effective supervision regarding classification and provisioning for bad debts played a major role in the emergence of banking insolvency. 83 percent of the respondents agree that lack of effective entry and exit procedures prevented healthy exit of the insolvent banks from the system. These results are generally in line with the drift of our argument in Chapter 9.

Table 10.7: Weaknesses in the Regulatory and Supervisory Framework

	Yes	No	May be	Don't Know
Q19. Do you think that there were supervisory and regulatory forbearance in Turkey in the pre-crises period?	55	12.5	25	7.5
Q20. Do you think that extensive lending to interrelated entities and the lack of effective supervision regarding classification and provisioning for bad debts had a major role in leading to banking insolvency?	92.9	0	7.1	0
Q21. Do you think that the drawbacks and inefficacy of the regulatory authorities on the procedures of the bank entry and absence of effective bank exit procedures generated difficulties for the problematic banks' healthy exit from the system before they become too big to fail?	82.9	0	14.6	2.4

Number of responses to Questions 19, 20, 21 are 40, 42, 41 respectively.

10.4.6. Connection between Financial Crises and Financial Liberalization

On the basis of the results presented in Table 10.8, as regards to the question whether financial market liberalization was a significant factor behind the 1994 crisis, about 53 percent of the respondents believe that it was significant, while 41 percent of the respondents

consider that it was not. In other words, share of those who consider this factor as significant and not significant are very close. When the same question was asked for the 2000 and 2001 crises, this picture changes in favor of those who believe it was significant, with a 59 percent share.

Table 10.8: The Link between Financial Liberalization and Crises

	Very significant	Significant	Not significant	Don't Know
Q14. Do you think that financial liberalization (domestic market+capital account) was a significant factor behind the 1994 crisis?	7.3	46.3	41.5	4.9
Q15. Do you think that financial liberalization (domestic market+capital account) was a significant factor behind the crises of 2000 and 2001?	9.5	50	40.5	0

Number of Responses to Question 14 and 15 respectively: 41, 42

***Interview Question 17**: The crises in the post-1990 period in Turkey have been strongly associated in the literature with the capital account liberalization in 1989. Do you make connection between crises episodes in the 1990s with capital account liberalization decision in 1989 and in particular, sequencing and timing?*

Almost all of the interviewees do not establish a direct one-to-one relationship between capital account liberalization and crises in Turkey. They generally believe that capital account liberalization was not the major source of the crises in the 1990s in the Turkish economy. They declare that even when the Turkish economy had not liberalized its capital accounts, probability of experiencing those crises would have been quite large. Hence, their approach is to evaluate capital account liberalization as a major contributory factor to the crises through raising vulnerability of the Turkish economy to shocks, but not as the single major reason behind the crises in Turkey.

***Interview Question 18**: Do you think that the crises since the mid-1990 could have been avoided if there was a more careful timing and sequencing of financial liberalization?*

Most of the interviewees believe that crises could not be avoided. On the other hand, they generally believe that if Turkey had followed the line of proper sequencing we defined, vulnerability to crises would be much lower. In other words, they think that impact of the crises would not be as deep as it has been.

10.4.7. Government Insurance and Moral Hazard

On the basis of the answers given to question 16 (see Table 10.9), the majority of the respondents, 83 percent, believe that financial institutions enjoyed implicit guarantees by the government prior to the crises of 2000/2001. Among those people who answered "yes" to question 16, 83 percent believe that implicit guarantee by the government encouraged financial institutions to take excessive risks prior to the crises of 2000/2001. These results also support our propositions in Chapter 9.

Table 10.9: Implicit Guarantees by the Government

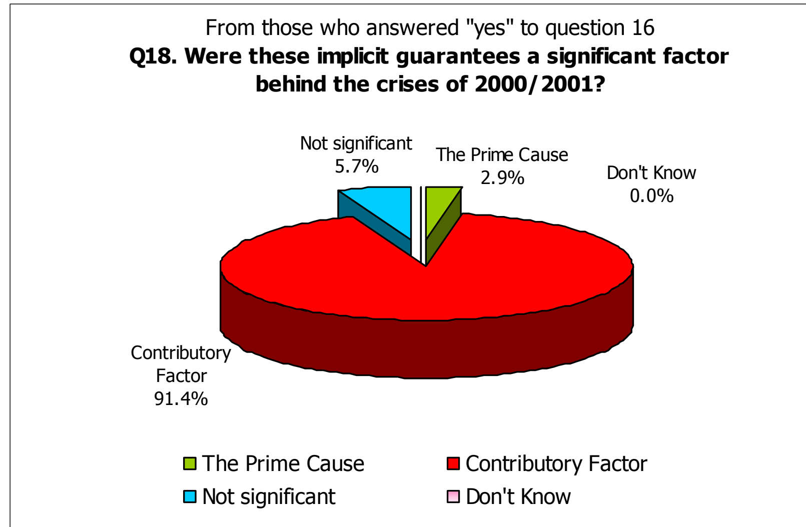
	Yes	No	May be	Not significant
Q16. Do you think that financial institutions enjoyed implicit guarantees (deposit insurance, bail-out guarantee etc.) by the government in Turkey prior to the crises of 2000/2001?	83.3	0	11.9	4.8

Number of Responses: 42

From those who answered "yes" to question 16	Yes	No	May be	Don't Know
Q17. Do you think that implicit guarantees (deposit insurance, bail-out guarantee etc.) by the government in Turkey encouraged financial institutions to take excessive risks prior to the crises of 2000/2001?	82.4	2.9	14.7	0

Number of Responses: 34

Again, among those who believe that financial institutions enjoyed implicit guarantees by the government, a significant majority, 91 percent, believe that implicit guarantees were a significant factor behind the crises of 2000 and 2001 (Figure 10.7).



Number of Responses: 35

Figure 10.8: Implicit Guarantees and Crises of 2000/2001

10.4.8. Connection between Financial Crises and Prudential Regulation and Supervision

Table 10.10 presents responses related to the questions whether it could have been possible to avoid crises in Turkey and the role of prudential regulation and supervision in this respect. 55 percent of the respondents believe that crises since mid-1990s could have been avoided. While this share declines to 41 percent when the same question is asked conditional to proper implementation of prudential regulation and supervision of the banking sector. In other words, not all of the respondents, who believe that crises would have been avoided, think that this could have been achieved through implementation of prudential regulation and supervision of the banking sector. On the other hand, the share of those who remain indifferent to questions 23 and 24 cannot be ignored with 36 percent and 49 percent respectively.

Table 10.10: Prevention of the Financial Crises in Turkey

	Yes	No	May be	Don't Know
Q23. Do you think that the crises since mid-1990s could have been avoided?	54.8	7.1	35.7	2.4
Q24. Do you think that it would have been possible to prevent crises in Turkey through proper implementation of prudential banking regulation and supervision?	41.5	9.8	48.8	0

Number of Responses to Question 23 and 24 respectively: 42, 41

Among the respondents who believe that crises could have been avoided through prudential regulation and supervision of the banking sector, only 47 percent believes that current framework of the banking regulation and supervision is sufficient to prevent future crises (Table 10.10).

According to responses given to question 26 as presented in Table 10.11, most of the respondents, 83 percent, believe that international investors and lenders were the primary beneficiary from the rescue packages. Domestic banks are also considered as the primary beneficiary by 67 percent of the respondents. Domestic corporations are viewed as primary beneficiary by only 22 percent of the respondents. 19 percent of the respondents give the names of those whom they believe are the primary beneficiaries: government, depositors due to full deposit guarantee, labor force and non-bank local investors.

Table 10.11: Current Framework of the Prudential Regulation and Supervision

From those who answered "yes" to question 24	Yes	No	May be	Don't Know
Q25. Do you think that the current framework of the banking regulation and supervision in Turkey is sufficient to prevent future crises?	47.1	0	47.1	5.9

Number of Responses: 17

Q26. Who do you think was the prime beneficiary from the rescue packages (by the IMF) that were put together after the crisis? (may select more than one answer)				
Domestic corporations	Domestic Banks	International investors/lenders	Other	Don't Know
22.2	66.7	83.3	19.4	2.8

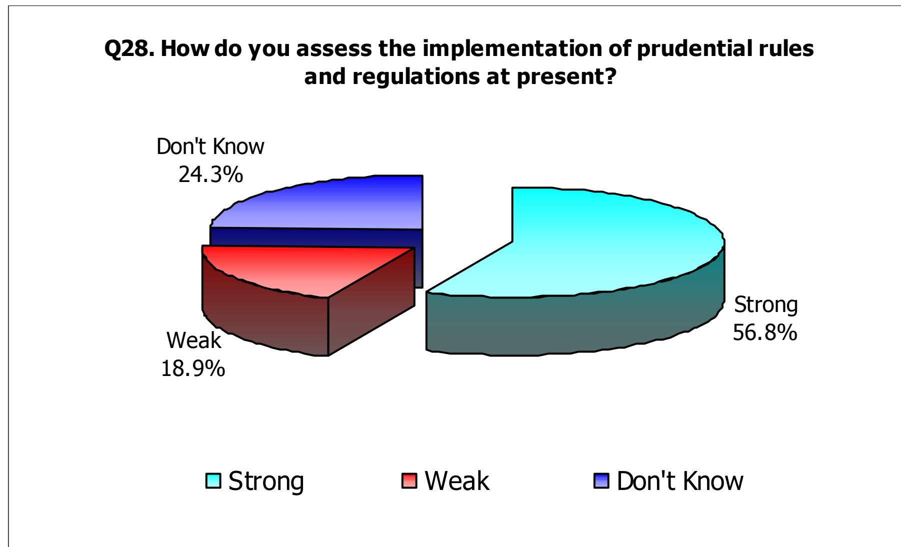
Number of responses: 35

<u>Interview Question 19</u>: Do you think that the 1994, 2000, and 2001 crises in Turkey could have been avoided, if there was sufficient concern about the establishment of an aggregate banking regulatory framework?

Interviewees mostly believe that strong banking sector would alleviate the impact of the shocks to the economy. In other words, vulnerability to shocks would be much less. On the other hand, they do not believe that only a strong banking sector would be sufficient to prevent crises.

10.4.9. Assessment of Current Supervisory and Regulatory Environment

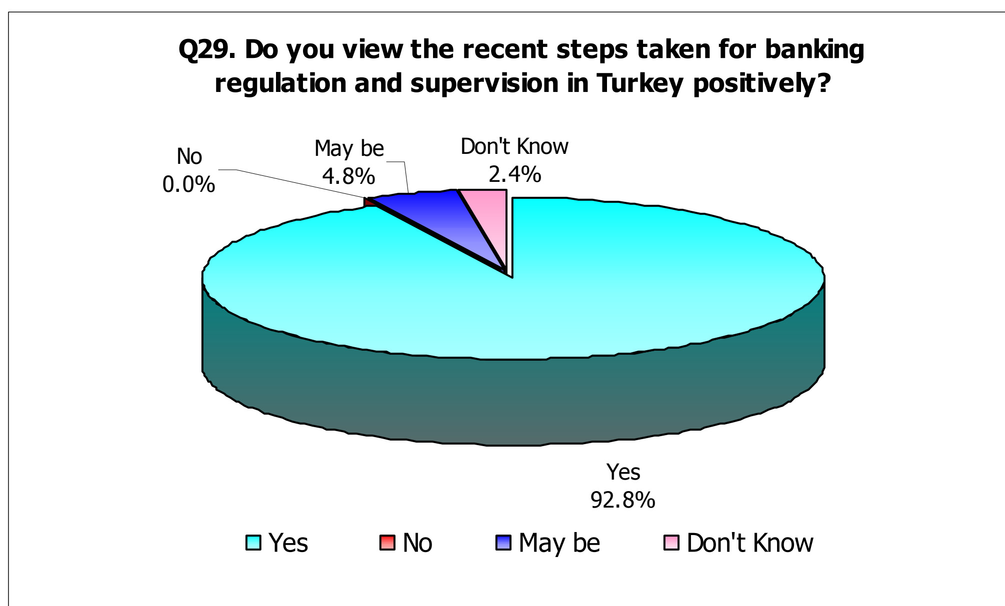
Figure 10.8 gives survey results that ask for an assessment of the implementation of prudential rules and regulations at present. 56 percent of the respondents assess the implementation of prudential rules and regulations at present as strong while about 19 percent find it weak. Those who do not know represent a significant majority (24 percent).



Number of Responses: 37

Figure 10.9: Implementation of Prudential Rules and Regulations

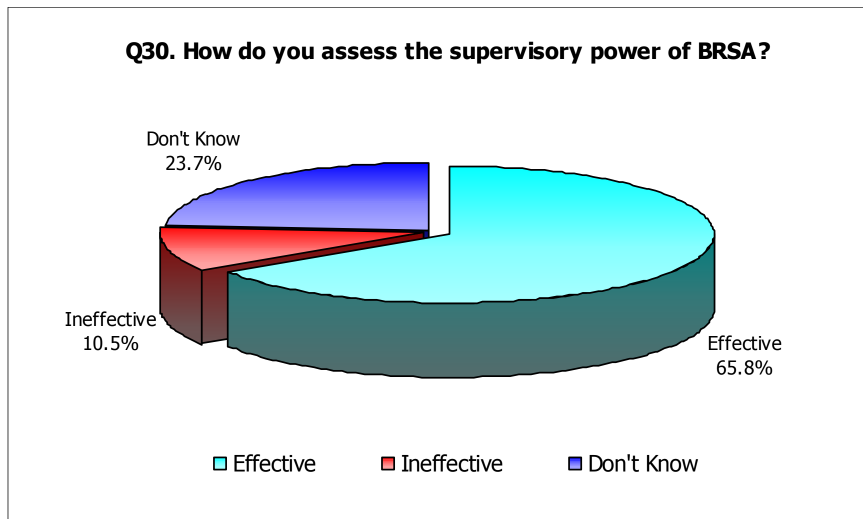
A big majority of the respondents evaluate recent steps taken for banking regulation and supervision in Turkey as positive developments. Furthermore, none of the respondents expressed a negative view on this issue, i.e., they all regarded recent developments as progress (Figure 10.19).



Number of Responses: 42

Figure 10.10: Recent Steps in Banking Regulation and Supervision

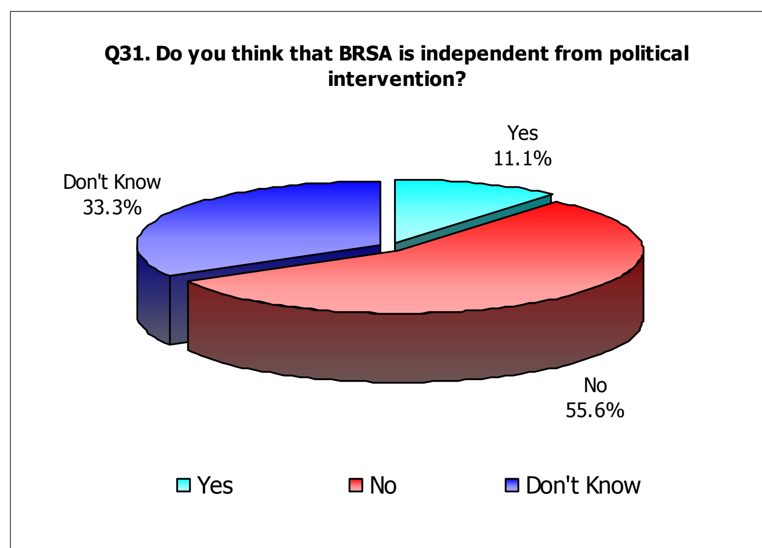
An important result that is revealed by the survey is that supervisory power of the BRSA is found to be effective by a majority (about 66 percent). Those who do not have any idea is more than those who find its supervisory power as ineffective.



Number of Responses: 38

Figure 10.11: Supervisory Power of the BRSA

On the other hand, only 10 percent of the respondents believe that BRSA is independent of political authority. About 56 percent of the respondents believe that BRSA is not independent (Figure 10.11).



Number of Responses: 36

Figure 10.12: Independence of the BRSA

10.4.10. Assessment of the Policies of the IMF and Other International Financial Institutions

Table 10.12 presents results of the responses to questions related to the policies of the IMF and other international financial institutions. 35 percent of the respondents believe that the "best practices" advocated by the international agencies are best ones for promoting well functioning banks. Those who are indifferent to this belief are 40 percent of the respondents.

A slight majority of the respondents (52 percent) think that the IMF and the World Bank do not always produce accurate and objective assessments of the economic environment in Turkey. Those who believe that they do, are only 29 percent of the respondents.

Those who believe that the IMF programs had indirectly contributed to greater crisis risks by promoting premature and inappropriate capital account liberalization constitute 45 percent of the respondents. 27 percent remain indifferent, while those who believe this is not the situation account for 22 percent of the respondents.

Table 10.12: Assessment of the Policies of the International Financial Institutions

	Yes	No	May be	Don't Know
Q27. Do you think that the best practices currently being advocated by international agencies (BIS, IMF, World Bank) are the best ones for promoting well-functioning banks?	35	15	40	10
Q32. Do you think that the IMF and the World Bank always produced accurate and objective assessments of the economic environment in Turkey (in their publications, country reports etc)?	28.6	52.4	14.3	4.8
Q33. Do you think that the IMF programs had indirectly contributed to greater crisis risks by promoting capital account liberalization inappropriately and prematurely in developing countries?	45	22.5	27.5	5

Number of Responses to Question 27, 32 and 33 respectively: 40, 42, 40

***<u>Interview Question 20</u>:** Do you think that the IMF and the World Bank always produced accurate and objective assessments of the economic environment in Turkey (in their publications, country reports etc.)?*

All of the interviewees stated that they do not believe that assessments of the IMF are objective all the time. Especially one interviewee declared that since the second half of the 1990s, the IMF has gone under the influence of the US Treasury. It is asserted that currently, the US policies shape the IMF policies. Hence, our interviewees regard assessments as being far from objective.

10.5. Conclusion

The questionnaire has been designed to cover almost all critical aspects of the thesis with the primary aim of learning the opinion of selected professionals on these issues. Conclusions reached on the basis of the analyses in the thesis mostly coincide with the views of the majority of the respondents to the survey.

Major results that come out of the survey which are in line with the main findings of the analyses in the thesis can be summarized as follows: The financial liberalization process in Turkey is inappropriately sequenced, while the pace of capital account liberalization is viewed as rapid by most respondents. The risks faced by financial institutions increase in the face of financial liberalization. As the government securities became a major source of revenue for the financial sector, this structure deteriorated the asset liability structure of the banking sector. Most of the respondents to the survey believe that there were implementation failures rather than an absence of rules and regulations behind the fragile structure of the banking sector. Furthermore, direct involvement of the political authority in the regulatory process and persistence of the chronic governance failures are viewed as the leading factors behind these implementation failures. Financing requirements of the government are also viewed as a factor that was instrumental in weak implementation of regulatory and supervisory framework. Furthermore, supervisory and regulatory forbearance, connected lending, lack of effective supervision regarding classification

and provisioning for bad debts, lack of effective entry and exit procedures and implicit guarantees by the government are viewed as major factors behind weaknesses of the banking system.

Interview results also point to similar conclusions: It is believed by majority of the interviewees that financial liberalization was disorderly sequenced. Direct involvement of the political authority in the regulatory framework is viewed as a major impediment behind weak implementation of the rules and regulations in the banking sector. Furthermore, it is asserted that the government did not want to give up this authority until a crisis forced it to do so.

On the basis of the survey results and the opinions expressed by interviewees, it seems that financial liberalization is not viewed as a major reason behind crises in Turkey in the 1990s. On the other hand, interviewees were also asked their views on the relationship between sequencing of financial liberalization and financial crises. They believe that disorderly sequencing increased the vulnerability to crises and deepened the impact of the crises on the Turkish economy.

Furthermore, proper implementation of prudential regulation and supervision is not viewed as a strong measure against crises by the survey respondents. There is stronger support among the interviewees for proper implementation of prudential regulation and supervision as a measure to prevent crises. On the other hand, they do not claim that the crises could have been avoided.

Recent progress in banking prudential regulation and supervision is recognized positively by a majority of the survey respondents. Furthermore, majority of the survey respondents assess the supervisory power of the BRSA as effective and independent from political intervention.

CHAPTER 11

CONCLUSION

This study basically analyzed timing, sequencing and pace of the financial liberalization experience of the Turkish economy in the 1980s and has evaluated the implications of this experience for the crises that have confronted the Turkish economy since the 1990s. In particular, we have aimed to evaluate the Turkish crises of the 2000 and 2001 from a perspective which is different from the standard "crisis literature". In our perspective, the Turkish crises of 2000 and 2001 are not directly and specifically linked to capital account liberalization decision in 1989, as in the "crisis literature". Rather, the factors behind these crises have been traced back to the whole liberalization process with a special emphasis on the strength of the financial system, the effectiveness of prudential supervision and regulation and the characteristics of political forces at work.

Sequencing of the Financial Liberalization Reforms

One of the major concerns in this study has been to evaluate financial liberalization reforms in Turkey in terms of its sequencing. One of our main hypotheses is that even if the proposed policies are correct in terms of the prospects of a country, it does matter when, how and in which order they would be imposed.

We draw attention to the general ignorance of policy makers about the importance of sequencing issue. We also emphasize the point that while sequencing of liberalization policies was universally a major issue in the 1980s, then, a long break was given to the discussion of these issues both in the literature and by the BWI. The latter, have, however, continued to advocate implementation of simultaneous and

very fast reforms and pushed countries towards implementing financial liberalization policies.

There are different views as regards to the sequencing of liberalization reforms, especially sequencing of financial liberalization with respect to other liberalization reforms. The general consensus in the literature advocates that the priority should be given to macroeconomic stability, as well as institutional reforms. For the success of financial liberalization, strong banking regulation and supervision is necessary. Domestic financial liberalization should take place before capital account liberalization and trade liberalization. As regards to the sequencing of the trade and capital account liberalization reforms, it is suggested that capital account liberalization should be the last step.

On the other hand, while the literature has been mostly focused on the sequence of trade and capital account liberalizations with respect to each other, the initial steps, which are macroeconomic stability and prudential regulation and supervision, have not received adequate attention. Furthermore, while the importance of these issues had already been mentioned in the reports of the World Bank in the late 1980s, they are also neglected surprisingly by the BWI as well in their policy suggestions to countries. Rather, the BWI have continued to push developing countries for financial liberalization reforms, being aware of the inadequacies in these countries and the possibilities of the failure of reforms.

We regard macroeconomic stability, in particular fiscal discipline as a major precondition for successful financial liberalization in contrast to this ignorance in the literature and the BWI until very recently. We also regard prudential regulation and supervision as a major step of sequencing of financial liberalization. In this perspective, we criticize the "sequencing literature" dominated by the BWI, in that

it neglects the importance of prudential regulation and supervision as part of sequencing, but instead focuses on its importance as a measure to prevent crisis.

While the BWI in the aftermath of the Asian crisis have begun to put more emphasis on the issues of prudential regulation and supervision as well as institutional reforms, they continued to insist on financial liberalization reforms in developing countries, emphasizing their long-term benefits. Although they included prudential regulation and supervision as part of sequencing in 1991, they paid insufficient attention to it for much of the 1990s. Hence, we criticize BWI for their advocacy of financial liberalization despite its adverse effects and their insistence on "wrong sequencing".

The Turkish experience of neo-liberal model of development did not arise out of voluntary choice but was the outcome of a major balance of payments crisis in the late 1970s, requiring the urgent financial assistance of the BWI. In Turkey, domestic financial market was liberalized and capital account was opened up under conditions of chronic and high inflation and large fiscal imbalances. Apart from the unstable macroeconomic environment, reforms to ensure soundness of the financial system such as improvements in the legal and supervisory frameworks have been largely neglected. In other words, in Turkey, institutional development of the regulatory and supervisory system was not parallel to the deregulation of the financial sector. Although there have been attempts towards upgrading the prudential framework for the financial sector and implementing a number of measures to bring prudential regulations close to international best practices, the financial sector has always functioned with fundamental deficiencies in the regulatory framework. Hence, strong banking system through prudential regulation and supervision was not instituted and

"stabilization first" step was also skipped before the initial and subsequent stages of financial liberalization.

Timing of Capital Account Liberalization

At this stage, another aim of the study has been to shed some light on the reasons behind the timing of capital account liberalization in Turkey. On the basis of the interviews conducted, it was concluded that capital account liberalization was a final destination, which was projected since the first days of the Özal government. The timing of capital account liberalization corresponded to a period in which Özal lost much of his public support and was preparing himself to be President. In other words, it was the last days of Özal as Prime Minister. He probably wanted to achieve this objective before he became President.

The alleged benefits of capital account liberalization also seem to have played a major role in speeding up this process. Loss of public support for Özal could in part be attributed to the low rate of growth and high inflation experienced during 1988 and 1989. Furthermore, the large public sector borrowing requirements also necessitated new sources of funding. All of these factors seem to have played a part in triggering the capital account liberalization decision. The expected recovery in economic indicators following liberalization was seen as a remedy to regain public support.

The role of external actors, in this case the IMF, has been limited. The IMF only played a supportive role through confirming that the decision was in line with its policies and suggestions. On the other hand, although the timing of the decision was not correct in terms of sequencing proposed by the IMF, there was no warning by the IMF about the strengthening of the banking sector and improving macroeconomic fundamentals in spheres like inflation and fiscal deficit.

It seems that domestic decision makers have shaped and taken the decision of capital account liberalization, while the interaction of economic and political factors has played a major role in its timing.

Crises of 2000 and 2001

The third major concern in this study has been to explain the successive crises in Turkey, and the fact that almost the same set of macroeconomic policies continually re-emerges and then collapse. It is argued that successive crises occurred over a short period of time (1994, 2000, 2001) had their origins in key decisions taken during the 1980s.

Turkey could easily be regarded as a prime candidate for financial crisis due to several reasons. First, it followed the wrong sequencing of reforms. Financial liberalization had been undertaken against the background of weak institutions for bank supervision and regulation, and macroeconomic instability. Particularly, the problem was that although capital account was fully liberalized almost a decade after the program's initiation, this decision was taken in an environment of high degree of macroeconomic instability and the weak institutional framework of banking regulation and supervision which lack the incentives to implement the existing rules and regulations efficiently. In other words, the main problem does not lie in capital account liberalization but in its timing and sequencing.

We believe that fundamental factors such as disorderly sequencing and wrong timing of the capital account liberalization have produced a suitable environment for the generation of triggering events that led to financial instability and crisis. Furthermore, they have also strengthened and contributed to the negative impact of other factors which would produce instability and crisis. In other words, wrong sequencing is part of the factors that have led to crisis.

In the face of massive capital flows into the banking system in the aftermath of liberalization, banks' capacities were not adequate to manage market risks properly and to process information about credit quality. Hence, the banking system was exposed to high levels of liquidity, interest rate, credit (reflecting extensive forms of connected lending) and foreign exchange risks. This occurred due to insufficient checks and balances on their activities led by weak prudential oversight and implementation. When combined with banks' weak risk management, this situation led to high foreign exchange exposures in the banking system. These conditions made them vulnerable to the shifts in international investor sentiment and set the conditions for crises. Hence, fragility of the banking system was one of the root causes of the crises of 1994, 2000 and 2001.

Among the deficiencies of the banking system, the most important were highly generous deposit insurance scheme, politically subordinate supervisory institutions, political intervention to regulatory process and the bias towards keeping failing banks in the system. The main phenomenon was that the large groups in Turkey have all banks, and supervision on connected lending was not effective. Besides major problem of moral hazard, which induced those banks to increase their risky activities, the regulatory system failed to enforce the exit of weak banks. Such an environment allowed fraudulent activities, which ended up with the crises of 2000/2001, as they became widespread.

Secondly, resource allocation by the financial system was profoundly distorted by a set of policy and institutional failures. Weak and short-lived coalition governments in the 1990s further exacerbated these failures. Financial asset prices and the lending decisions were distorted by increasing financing requirements of the government. This strategy led to crisis and instability. Public banks distributed credits often on non-economic criteria leading to significant losses in real

terms. These observations support the idea raised by Alper and Öniş (2001:16) that the weakness of the banking sector and fiscal imbalances are interrelated phenomena in Turkey, both of which were also at the basis of the crises of 2000 and 2001.

Thirdly, political stability is important for the overall success of economic reform. Hence political constraints have to be taken into account while evaluating the viability of the technocratic solutions. In Turkey, during 1990s, 11 different governments have been in power. Political structure with fragmented party system and weak coalition governments brought about a pervasive lack of accountability and lack of transparency, which were the key elements of the political structure. The lack of political and economic stability and continuous uncertainty has also contributed to the crises episodes in Turkey.

Consequently, the Turkish experience with financial liberalization shows the negative consequences of liberalization without macroeconomic stabilization as well as economic and political institutional reforms. The highly fragmented party system and successive coalition governments lacking the capacity and the incentives necessary for undertaking fiscal stabilization and regulation of the banking sector[633] that characterized the 1990s have also played a part in the eruption of crises.

This conclusion points to another fact that there exists a strong resistance against implementing reforms up to the point where a major economic crisis makes a drastic change inevitable. In other words, "unless the financial system reaches a point of complete collapse", which is a crisis, resistance remains intact[634]. Improvements in the form of prudential regulatory and supervisory frameworks typically follow rather than precede crises.

[633] Öniş (2003:8)
[634] Alper and Öniş (2002:3)

The reasons why politicians, being aware of the large costs of financial crises, delay the establishment of prudential supervisory frameworks is a critical issue and can be traced to pervasive implementation failures, as well as the factors such as technical knowledge imperfection, inadequate resources and knowledge, and insufficient training and expertise of bank supervisors. Easier implementation of financial liberalization as compared to banking regulation and supervision, governance capabilities of the government, ability of certain interest groups to block reforms, politically subordinate supervisory institutions, and direct involvement of the political authority in the regulatory process can be cited among the political reasons.

In the Turkish experience, the direct involvement of the political authority in the regulatory process and the low priority attached to bank regulation on the part of the regulatory authority in the presence of multiple and conflicting objectives seem to have played a prominent role. Although the weakness of bank regulation was quite apparent from various bank failures in 1982 and 1994 crises, the authorities did not take adequate regulatory action. Therefore, it can be concluded that unless a crisis undermines the dominance of domestic actors, domestic political factors and institutional weaknesses outweigh the external factors in explaining the degree of implementation.

The Turkish experience is also in line with international experience in another respect. It supports the view that international institutions such as the IMF have little power to ensure the proper implementation of the reforms following the introduction of the legal framework.

Following Acemoğlu et al. (2002), we assert that macroeconomic problems are symptoms of deeper institutional weaknesses. On the other hand, the attempts to institute a strong institutional background

in developing countries which are more vulnerable to crises, under the framework of Augmented Washington Consensus approach are criticized on basis of the fact that they entail a long "to-do" list. Furthermore, the assertion led by Rodrik (2004:9) that "effective institutional outcomes do not map into unique institutional designs" has strong ground. Hence, institutional reforms that fit into specific requirements of individual countries have to be supported as a major remedy to prevent crises.

The questionnaire was aimed at learning the opinion of various professionals on the critical issues covered in the thesis. The views expressed by the respondents were on the whole in line with the findings in the rest of the thesis.

Major outcomes of the survey can be summarized as follows: The financial liberalization process in Turkey was inappropriately sequenced, while capital account liberalization occurred rather abruptly. Implementation failures rather than absence of the rules and regulations were largely responsible for the fragile structure of the banking sector. Direct involvement of the political authority in the regulatory process and persistence of the chronic governance failures were the leading factors behind these implementation failures. Supervisory and regulatory forbearance, connected lending, lack of effective supervision regarding classification and provisioning for bad debts, lack of effective entry and exit procedures, implicit guarantees by the government were the major reasons behind the weaknesses of the banking system. The respondents do not, however, view financial liberalization as a major factor behind Turkish crises in the 1990s. Moreover, proper implementation of the prudential regulation and supervision is not viewed as a strong measure to prevent crises by the survey respondents. Although they do not believe that crises could have been avoided, the interviewees provide strong support for proper

implementation of prudential regulation and supervision as a measure to prevent crises.

Recent progress in banking prudential regulation and supervision is viewed positively by a majority of the survey respondents who also regard the supervisory power of the BRSA as effective and independent from political intervention.

Interview results generally reinforce these conclusions. The majority of the interviewees believe that financial liberalization was disorderly sequenced. Direct involvement of the political authority to the regulatory framework is viewed as a major impediment behind weak implementation of the rules and regulations in the banking sector. Furthermore, it is asserted that the government did not want to give up its authority in this field until a crisis forced it to do so. Interviewees believe that disorderly sequencing increased the vulnerability to crises, and deepened the impact of the crises on the Turkish economy.

Empirical findings suggest that the nature of the banking crises is more associated with the institutional structure of the financial system rather than macroeconomic conditions of the economy. It is concluded that once a solid institutional structure of the banking system is established, worsening macroeconomic conditions need not lead to a banking crisis. Thus, in order to prevent banking crises, the policymakers should focus more on the institutional factors, such as moral hazard problem, capital regulations and restrictions on bank activities. On the other hand, if these conditions are not met, then worsening macroeconomic conditions most probably lead to a banking crisis. In this empirical analysis, only institutional factors related to the banking sector are taken into consideration, due to difficulty of obtaining cross country data concerning political institutional factors.

While this conclusion supports the view that weakness of the banking system has played a major role in leading to 2000 and 2001 crises in Turkey, since we were not able to include political institutional factors into the analysis as well as other institutional factors, we do not claim that it would have been possible to prevent crises in Turkey through proper implementation of prudential banking regulation and supervision.

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APPENDICES

APPENDIX A

INTERVIEW QUESTIONS:

What was your occupation in 1989?

Bureaucrat ☐ Member in the Cabinet ☐

Member of the Parliament ☐ Other ☐

PART 1: CAPITAL ACCOUNT LIBERALIZATION IN 1989

2) What are your views on how capital account liberalization came up to the policy agenda?

3) Do you know whether it was planned in any economic program of the government, for example at the beginning of 1989 or any time before?

4) What do you think were the main policy objectives and political factors pushing the government towards taking this decision? Which factors in your view was the overriding factor for the decision of the government, economic or political?

5) Why do you think that the government was so determined in implementing the capital account liberalization in 1989?

6) Do you know whether it was discussed within the government bureaucracy?

    a. If yes, who were involved?

    b. If yes, what was the approach of the bureaucrats?

7) Were you personally consulted?

8) What was your own view on the subject?

9) What is your position on the debate that liberalization reforms in 1989 were based on a broad consensus or one-man decision?

10) Was there any serious concern expressed in the bureaucracy as regards to capital account liberalization being undertaken in an environment of macroeconomic instability and fragility of the banking sector?

a. If yes, by whom?
b. If yes, did issues about banking regulation and supervision come on to the agenda when the 1989 decision was made?
c. If no, why do you think that the macroeconomic instability -high inflation and budget deficit- and weaknesses in the banking sector in that period were not seen as major impediments to capital account liberalization?

11) Do you know whether there was any dialogue on the subject with the World Bank and the IMF?

a. If yes, was this at the initiative of the government or the BWI?
b. If it was the BWI's, what was the latter's approach? Did they advise against it? Did they question its timing? Did they encourage or urge to implement the decision gradually?

12) How do you assess the reaction of the Turkish public opinion to the 1989 decision? In your view, was there any serious opposition from politicians or business environment or any other major segments of society?

PART 2: SEQUENCING OF FINANCIAL LIBERALIZATION REFORMS

Our definition of "proper sequencing of economic liberalization reforms" is as follows: First of all, the priority should be given to macroeconomic

stability in the liberalization process, as fiscal discipline is ensured first. At the same time, institutional reforms should be undertaken before implementation of liberalization reforms. For the success of financial liberalization, strong banking regulation and supervision is necessary. Then, domestic financial liberalization should take place before capital account liberalization and trade liberalization. As regards to the sequencing of the trade and capital account liberalization reforms, capital account liberalization should be left to the last step.

13) Was there any concern or discussion as regards to sequencing and timing in Turkey when liberalization reforms were implemented?

14) Do you think that financial liberalization process in Turkey is properly sequenced?

15) Do you know whether sequencing of the liberalization policies was put on the table as a major issue by the BWI any time the 1980s, in particular in 1989?

16) How do you assess the pace of capital account liberalization?

17) Why was capital account liberalization undertaken in just one step rather than a phased approach?

PART 3: FINANCIAL LIBERALIZATION AND CRISES

18) The crises in the post-1990 period in Turkey have been strongly associated in the literature with the capital account liberalization in 1989. Do you make connection between crises episodes in the 1990s with capital account liberalization decision in 1989 and in particular, sequencing and timing?

19) Do you think that the crises since the mid-1990 could have been avoided if there was a more careful timing and sequencing of financial liberalization?

20) Do you think that the 1994, 2000, and 2001 crises in Turkey could have been avoided, if there was sufficient concern about timing-

sequencing and the establishment of an aggregate regulatory framework?

21) Do you think that the IMF and the World Bank always produced accurate and objective assessments of the economic environment in Turkey with regards to domestic and capital account liberalization (in their publications, country reports)?

22) What was the main reason behind weak implementation of the regulatory and supervisory framework in Turkey?

APPENDIX B

SURVEY FORM

A. GENERAL INFORMATION

A.1. Name of your institution:

A.2. What is your current occupation

☐Member of the Board of Governance

☐Manager/General Manager

☐Academician

☐Chief Economist

☐Economist

☐Other, please specify

B. FINANCIAL LIBERALIZATION POLICIES AND BANKING REGULATION SUPERVISION

Our definition of "proper sequencing of economic liberalization reforms" is as follows: First of all, the priority should be given to macroeconomic stability in the liberalization process, as fiscal discipline is ensured first. At the same time, institutional reforms should be undertaken before implementation of liberalization reforms. For the success of financial liberalization, strong banking regulation and supervision is necessary. Then, domestic financial liberalization should take place before capital account liberalization and trade liberalization. As regards to the sequencing of the trade and capital account liberalization reforms, capital account liberalization should be left to the last step.

1. Do you think that financial liberalization process in the 1980s in Turkey is properly sequenced?

☐Yes

☐No

☐Don't Know

2. How do you assess the pace of domestic financial market liberalization in Turkey in the early 1980s?

☐Slow

☐Gradual

☐Rapid

☐ Don't Know

3. How do you assess the pace of capital account liberalization in Turkey in 1989?

☐Slow

☐Gradual

☐Rapid

☐Don't Know

4. Do you think that following the liberalization of capital account in 1989, private and foreign banks' financing became dependent on foreign exchange denominated funding?

☐Yes

☐No

☐May be

☐Don't Know

5*. Taking into account the new types of risks, would you say that on balance financial liberalization increased the risks (e.g. exchange rate risk, credit risk, interest rate risk) faced by the Turkish financial institutions/system?

☐Yes

☐No

☐May be

☐Don't Know

6. Do you think that government securities became a major source of revenue for the banking sector and this source altered the asset/liability structure of the banking sector by making the banks more vulnerable to risks, mainly interest and FX risk?

☐Yes

☐No

☐Don't Know

Please answer the questions from 7 to13 for the period from the capital account liberalization in 1989 to 2000/2001crisis:

7*. Did Turkish financial institutions have in place the risk management system required to manage the new types of risks that financial liberalization has brought about?

☐Yes

☐No

☐May be

☐Don't Know

8*. Do you think that Turkish financial institutions were equipped with the human capital and expertise to adequately manage the risks associated with the intermediation of large amounts of foreign financial capital?

☐Yes

☐No

☐May be

☐Don't Know

If you don't answer "Yes" to question 8, please pass to question 10

9. Do you think that human capital and expertise of the Turkish financial institutions had adequately managed the risks?

☐Yes

☐No

☐May be

☐Don't Know

10. Do you think that the institutional framework of prudential regulation and supervision was sufficiently well developed to deal with the risks?

☐Yes

☐No

☐May be

☐Don't Know

11*. Do you think that tighter prudential regulation could have mitigated the problem of excessive risk taking in the banking system?

☐Yes

☐No

☐May be

☐Don't Know

12. Which one of the factors outweighed in leading to fragile banking system in Turkey?

☐Weak implementation of rules and regulations in practice

☐Absence of rules and regulations

☐Don't Know

If you don't answer "weak implementation of rules and regulations" to question 12, please pass to question 14

13. Which of the following factors explain why serious implementation failures occurred in regulation and supervision of the Turkish banking sector, despite adoption of rules. (may select more than one answer)

☐Direct involvement of the political authority in the regulatory process

☐Great opposition of powerful lobbies

☐Persistence of chronic governance failures

☐Insufficient training and expertise of bank supervisors

☐Other, please specify

☐Don't Know

C. FINANCIAL LIBERALIZATION POLICIES AND CRISES

14*. Do you think that financial liberalization (domestic market+capital account) was a significant factor behind the 1994 crisis?

☐Very Significant

☐Significant

☐Not Significant

☐Don't Know

15*. Do you think that financial liberalization (domestic market+capital account) was a significant factor behind the crises of 2000 and 2001?

☐Very Significant

☐Significant

☐Not Significant

☐Don't Know

16*. Do you think that financial institutions enjoyed implicit guarantees (deposit insurance, bail-out guarantee etc.) by the government in Turkey prior to the crises of 2000/2001?

☐Yes

☐No

☐May be

☐Don't Know

If you don't answer "Yes" to question 16, please pass to question 19

17*. Do you think that implicit guarantees (deposit insurance, bail-out guarantee etc.) by the government in Turkey encouraged financial institutions to take excessive risks prior to the crises of 2000/2001?

☐Yes

☐No

☐May be

☐Don't Know

18*. Were these implicit guarantees a significant factor behind the crises of 2000/2001?

☐The Prime Cause

☐Contributory Factor

☐Not significant

☐Don't Know

19. Do you think that there were supervisory and regulatory forbearance in Turkey in the pre-crises period?

☐Yes

☐No

☐May be

☐Don't Know

20. Do you think that extensive lending to interrelated entities and the lack of effective supervision regarding classification and provisioning for bad debts had a major role in leading to banking insolvency?

☐Yes

☐No

☐May be

☐Don't Know

21. Do you think that the drawbacks and inefficacy of the regulatory authorities on the procedures of the bank entry and absence of effective bank exit procedures generated difficulties for the problematic banks' healthy exit from the system before they become too big to fail?

☐Yes

☐No

☐May be

☐Don't Know

22. Do you think that government's financing requirements had been instrumental in weak implementation of regulatory and supervisory framework as banks became the main customer of government securities?

☐Yes

☐No

☐May be

☐Don't Know

23*. Do you think that the crises since mid-1990s could have been avoided?

☐Yes

☐No

☐May be

☐Don't Know

24. Do you think that it would have been possible to prevent crises in Turkey through proper implementation of prudential banking regulation and supervision?

☐Yes

☐No

☐May be

☐Don’t Know

If you don't answer "Yes" to question 24, please pass to question 26

25. Do you think that the current framework of the banking regulation and supervision in Turkey is sufficient to prevent future crises?

☐Yes

☐No

☐May be

☐Don’t Know

26*. Who do you think was the prime beneficiary from the rescue packages (by the IMF) that were put together after the crisis? (may select more than one answer)

☐Domestic corporations

☐Domestic Banks

☐International Investors/Lenders

☐Other, Please specify

☐Don’t Know

27. Do you think that the best practices currently being advocated by international agencies (BIS, IMF, World Bank) are the best ones for promoting well-functioning banks?

☐Yes

☐No

☐May be

☐Don’t Know

28. How do you assess the implementation of prudential rules and regulations at present?

☐Strong

☐Weak

☐Don't Know

29. Do you view the recent steps taken for banking regulation and supervision in Turkey positively?

☐Yes

☐No

☐May be

☐Don't Know

30. How do you assess the supervisory power of BRSA?

☐Effective

☐Ineffective

☐Don't Know

31. Do you think that BRSA is independent from political intervention?

☐Yes

☐No

☐Don't Know

D. POLICIES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

32*. Dou you think that the IMF and the World Bank always produced accurate and objective assessments of the economic environment in Turkey (in their publications, country reports etc)?

☐Yes

☐No

☐May be

☐Don't Know

33. Do you think that the IMF programs had indirectly contributed to greater crisis risks by promoting capital account liberalization inappropriately and prematurely in developing countries?

☐Yes

☐No

☐May be

☐Don’t Know

Note: Questions with asteriks have been adopted from Ames K. and Demetriades P. (2001), "Financial Liberalization and the South Korean Financial Crisis:Some Qualitative Evidence", Department of Economics, University of Leicester, Discussion Papers in Economics with No.01/3

APPENDIX C

Type of Risks

The risks, that banks are exposed to, can be named such as credit risk, liquidity risk and market risk (including interest rate, exchange rate, equity price and commodity price risks) depending on their portfolio choices, sizes and linkages with other financial and non-financial institutions.

1. Market Risk: It represents the exposure of banks to any interest or foreign exchange movements.

i. Interest Rate Risk: Interest rate risk includes repricing risk, basis risk, yield curve risk, option risk and price risk. Excessive interest rate risk can threaten banks' liquidity structure, earnings, yield curve risk, option risk and price risk.

Maturity mismatch, which is defined as the holding of long-term illiquid assets against short-term liabilities, generates liquidity and interest rate risks.

ii. Foreign Exchange Risk: It emerges as a result of differences between foreign exchange liabilities and foreign exchange assets. If foreign exchange liabilities do not cover foreign exchange assets, then this situation is called as "short position". When banks hold illiquid foreign currency denominated assets to meet their foreign exchange liabilities, then banks could still be subject to foreign exchange risk, even when the volume of open positions is in the regulatory limits.

Currency mismatch is defined as the dominance of foreign currency denominated liabilities over domestic currency denominated assets. This makes banks' balance sheets more vulnerable to any exchange rate shock.

2. Liquidity Risk: It is the potential threat to meet obligations in due date because of the insufficiency of cash flows. Liquid assets refer to cash and its equivalents that readily convertible to cash without significant loss. The timely coverage of assets to liabilities is an important indicator for the liquidity. The factors leading to liquidity risk can be counted as maturity mismatch between assets and liabilities, decrease in the asset quality, increase in the non-performing loans, decline in interest earnings and profits, increase in the cash demand due to unexpected deposit withdrawals or contagion effects of external factors.

3. Credit Risk: It arises from problems in the recollection of credits, constituting almost 70 percent of the total risks in bank's balance sheets, creating a major source of vulnerability during periods of distress in many countries. There are three types of credit risk, namely consumer risk, corporate risk, sovereign or country risk.

The factors that triggers credit risk can be counted as lending boom, deterioration of the asset quality, lending concentration on specific industries, concentration on certain types of credits, connected lending, currency and maturity mismatch and inadequate provisioning.

Source: IMF (2002:11) and Koğar (2005:29-31)

APPENDIX D

TURKISH SUMMARY

Bu çalışmada temel olarak, 1980'lerde Türkiye ekonomisinde uygulanan finansal serbestleşme politikalarının zamanlaması, sıralaması ve hızı incelenerek 1990 sonrasında Türkiye ekonomisinde yaşanan krizler üzerindeki etkilerinin değerlendirmesi amaçlanmaktadır. Diğer bir deyişle, Türkiye ekonomisinde yaşanan 2000 ve 2001 krizleri standart "kriz literatüründen" farklı bir açıdan değerlendirilmek istenmektedir. Dolayısıyla, 2000 ve 2001 krizleri "kriz literatüründe" olduğu gibi doğrudan 1989'daki sermaye hareketlerinin serbestleştirilmesine bağlanmamaktadır. Bu krizlerin ardındaki sebepler 1980'lerden itibaren gerçekleştirilen finansal serbestleşme süreciyle ilişkilendirilmekte ve özellikle finansal sistemin sağlamlığı, bankacılık sektörü düzenleme ve denetleme sisteminin etkiliği ve politik unsurlar üzerinde durulmaktadır.

Finansal Serbestleşme Reformlarının Sıralaması

Bu çalışmadaki temel amaçlardan biri Türkiye'deki finansal serbestleşme reformlarının sıralamasını değerlendirmektir. Temel hipotezlerimizden biri, uygulanan politikalar bir ülke için gerekli olsa da, ne zaman, nasıl ve hangi sırada uygulandığının önem taşıdığı hususudur.

Bu çalışmada özellikle reformların sıralaması konusunun politika yapıcılar tarafından genel olarak ihmal edilmesine dikkat çekilmek istenmektedir. 1980'lerde reformların sıralaması konusu önemle üzerinde durulan bir konu iken, daha sonra hem literatürde, hem de

Bretton Woods Kuruluşları (BWK) tarafından tartışılmasına uzun bir ara verilmiştir. Diğer taraftan, finansal serbestleşme politikalarının uygulanması konusunda BWK'lar tarafından ülkeler teşvik edilmeye devam edilmiştir.

Serbestleşme politikalarının sıralaması konusunda, özellikle finansal serbestleşmenin diğer serbestleşme politikalarına göre sıralamasına ilişkin olarak farklı yaklaşımlar mevcuttur. Ancak, makroekonomik istikrar ve kurumsal reformlara öncelik verilmesi konusunda literatürde genel bir fikir birliği mevcuttur. Finansal serbestleşme politikalarının başarısı için güçlü bir bankacılık düzenleme ve denetleme sisteminin olması gereklidir. Yerli finansal piyasaların serbestleşmesinin, sermaye hareketleri ve ticaret serbestleşmesi öncesinde yapılması önerilmektedir. Sermaye hareketlerinin serbestleşmesinin ise en son sıraya bırakılması tavsiye edilmektedir.

Literatürde genellikle ticaret ve sermaye hareketlerinin birbirine göre sıralamasına odaklanılmışken, makroekonomik istikrarın ve sağlam bir bankacılık düzenleme ve denetleme sisteminin başlangıç aşamasında tesis edilmesi gerektiği hususlarına yeterince önem verilmemiştir. Aslında bu konunun önemi üzerinde Dünya Bankası tarafından 1980'lerin sonunda yayınlanan raporlarda durulmakla birlikte, daha sonra özellikle BWK tarafından gelişmekte olan ülkelere önerilen politika uygulamalarında ihmal edilmiş olması şaşırtıcıdır.

Bu çalışmadaki yaklaşımımız, makroekonomik istikrarı özellikle mali disiplini başarılı bir finansal serbestleşmenin önemli koşulları olarak kabul etmektir. Ayrıca güçlü bir bankacılık düzenleme ve denetleme sisteminin tesisini finansal serbestleşmenin önemli bir adımı olarak kabul etmekteyiz. Bu bağlamda çoğunlukla BWK'lar tarafından şekillenen "reformların sıralaması literatürünü" eleştirmekteyiz. Özellikle BWK'lar, bankacılık düzenleme ve denetleme sisteminin reformların sıralamasındaki önemi yerine, krizleri önlemek konusundaki

önemi üzerine odaklanmışlardır. Asya krizi sonrasında BWK tarafından bankacılık düzenleme ve denetleme sistemi ve diğer kurumsal reformlar üzerinde daha fazla durulmaya başlanmasına rağmen, finansal serbestleşme reformlarının gelişmekte olan ülkeler tarafından en kısa zamanda uygulaması konusundaki ısrarları devam etmiştir. Özellikle bankacılık düzenleme ve denetleme sisteminin önemi 1991'de sıralamanın bir parçası olarak belirtilmekle birlikte, 1990'ların çoğunda ihmal edilmiştir. Dolayısıyla BWK, finansal serbestleşme politikalarının uygun koşullarda uygulanmadığı takdirde olumsuz yönlerini bilmelerine rağmen, bu politikaların uygulanması konusunda ısrarcı olmaya devam etmeleri, diğer bir deyişle "yanlış sıralama" uygulatmaları nedenleriyle bu çalışmada eleştirilmektedir.

Türkiye'de neoliberal politikalar bir tercih sonucu değil, 1970'lerin sonundaki ödemeler dengesi krizinin bir sonucu olarak uygulanmaya başlanmıştır. Türkiye'de ilk olarak yurtiçi finansal piyasalar serbestleştirilmiş, sermaye hareketleri serbestleştirilmesi ise yüksek kronik enflasyon ve yüksek bütçe açıklarının olduğu bir makroekonomik ortamda gerçekleştirilmiştir. İstikrarsız makroekonomik ortamın yanında, finansal sistemin sağlamlığını garanti edecek, düzenleme ve denetleme sisteminde iyileşmeleri sağlayacak reformlar büyük ölçüde ihmal edilmiştir. Diğer bir deyişle, Türkiye'deki düzenleme ve denetleme sisteminin gelişimi finansal sektörün serbestleşmesine paralel olmamıştır. Bankacılık düzenleme ve denetleme sistemini uluslararası standartlara paralel hale getirmeye yönelik girişimler olsa da, finansal sistem, düzenlemelerdeki temel eksikliklerle beraber işlemeye devam etmiştir. Dolayısıyla, güçlü bir bankacılık sistemi ve makroekonomik istikrarın sağlanması gibi önemli adımlar finansal serbestleşmenin ilk ve ileriki aşamalarında ihmal edilmiştir.

Sermaye Hareketlerinin Serbestleştirilmesinin Zamanlaması

Bu çalışmanın amaçlarından bir diğeri de sermaye hareketlerinin serbestleştirilmesi kararının ardındaki sebeplerin aydınlatılmasıdır. Yapılan mülakatlar neticesinde sermaye hareketleri serbestleştirilmesinin Özal hükümetinin ilk günlerinden itibaren planlandığı anlaşılmaktadır. Zamanlaması ise Özal'ın kamuoyu desteğini büyük ölçüde yitirdiği ve Cumhurbaşkanı olmaya hazırlandığı bir döneme denk gelmiştir. Diğer bir deyişle, bu dönem Özal'ın Başbakan olarak son günlerine rastlaması sebebiyle, Özal'ın büyük olasılıkla bu amacı Cumhurbaşkanı olmadan gerçekleştirmek isteği anlaşılmaktadır.

Sermaye hareketlerinin serbestleştirilmesi sonrasında elde edilmesi beklenen faydaların da bu sürecin hızlanmasında önemli rol oynadığı düşünülmektedir. Özal'ın kamuoyu desteğini kaybetmesinin sebeplerinden biri 1988 ve 1989 yıllarındaki düşük büyüme oranlarıdır. Ayrıca bu dönemdeki yüksek kamu kesimi borçlanma gereği yeni finansman ihtiyacını gerektirmektedir. Dolayısıyla, serbestleşmeyi takiben ekonomik göstergelerde olması beklenen iyileşme kamuoyu desteğini tekrar kazanmanın bir yolu olarak görülmüştür. Tüm bu unsurların sermaye hareketlerinin serbestleştirilmesinde rol oynadığı düşünülmektedir.

IMF gibi dışsal unsurların rolünün sınırlı kaldığı anlaşılmaktadır. IMF, uygulanan politikaları onaylayarak sadece destekleyici bir rol oynamıştır. Diğer taraftan aslında bu kararın zamanlaması IMF tarafından önerilen sıralamaya uymamaktadır. Ancak, IMF tarafından sermaye hareketlerinin serbestleştirilmesi öncesinde bankacılık sektörünün güçlendirilmesi, ayrıca enflasyonun düşürülmesi ve mali disiplinin sağlanması gerektiğine ilişkin uyarılar yapılmamıştır.

Sonuç olarak, sermaye hareketlerinin serbestleştirilmesi kararının alınmasında yerli politika yapıcıların kararı şekillendirdiği ve aldığı

düşünülmektedir. Ayrıca, bu kararın alınmasında ekonomik ve politik unsurların bir arada etkili olduğu düşünülmektedir.

2000 ve 2001 krizleri

Bu çalışmanın bir diğer amacı Türkiye'de ardı ardına gerçekleşen krizleri, diğer bir deyişle aynı makroekonomik koşulların sürekli tekrar ortaya çıkması ve sonunda krizle sonuçlanması gerçeğini açıklamaktır. Bu çalışmadaki temel savlarımızdan biri Türkiye'de 1990 sonrasında birbiri ardına nispeten kısa bir dönemde gerçekleşmiş olan krizlerin (1994, 2000 ve 2001) temellerinin 1980'lerde alınan kilit politika kararlarında yattığıdır.

Türkiye'nin finansal krizler için aday bir ülke olarak değerlendirilmesi mümkündür. Öncelikle, Türkiye'de reformların sıralaması doğru yapılmamıştır. Finansal serbestleşme reformları makroekonomik istikrarsızlığın ve zayıf bankacılık düzenleme ve denetleme sisteminin olduğu bir ortamda gerçekleştirilmiştir. Aslında temel problem sermaye hareketlerinin serbestleşmesinden ziyade, sermaye hareketlerinin reformlara başlandıktan neredeyse 10 yıl sonra serbestleştirilmiş olmasına rağmen makroekonomik istikrarsızlığın ve zayıf bankacılık düzenleme denetleme sisteminin olduğu bir ortamda gerçekleştirilmiş olmasında yatmaktadır.

Bu çalışmada serbestleştirme reformlarının yanlış sıralanmasının ve sermaye hareketlerinin yanlış zamanlanmasının finansal istikrarsızlık ve krizleri tetikleyecek uygun bir ortamın oluşmasına katkıda bulunduğu savunulmaktadır. Ayrıca, istikrarsızlık ve krize sebep olabilecek diğer unsurların etkisini artırdığı ve güçlendirdiğine inanılmaktadır. Diğer bir deyişle, reformların yanlış sıralanması krize sebep olan faktörlerin bir parçasıdır.

Finansal serbestleşme sonrasında bankacılık sistemi yüksek düzeyde likidite, faiz, kredi ve döviz kuru riskine maruz kalmıştır. Bu durum büyük ölçüde mevcut düzenleme ve denetleme sisteminin etkin bir şekilde uygulanmamasından kaynaklanmıştır. Dolayısıyla, bankacılık sistemi yatırımcı güveninde meydana gelebilecek bir değişikliğe hassas hale gelmiş ve kriz için uygun koşulları oluşturmuştur. Bankacılık sisteminin kırılganlığı 1994, 2000 ve 2001 krizlerinin temel sebeplerinden biridir.

Bankacılık sisteminin zayıflıkları temel olarak mevduat garantisi, düzenleme ve denetleme sistemine politik müdahalenin olması ve batık bankaların sistemde tutulmaya devam edilmesi gibi unsurlardan kaynaklanmıştır. Temel problemlerden biri diğeri de Türkiye'deki büyük firmaların hemen hepsinin bankasının olması ve bankaların bağlı olduğu firmaya borç vermesinin (connected lending) etkin bir şekilde denetlenememesinden kaynaklanmaktadır. Bu ortam bankaların aşırı risk almalarını teşvik ederek 2000 ve 2001 krizlerinin temel sebeplerinden birini oluşturmuştur.

İkinci olarak, finansal sistem tarafından yapılan kaynak paylaşımı bazı politik ve kurumsal eksiklikler sebebiyle bozulmuştur. 1990'lardaki güçsüz ve kısa ömürlü koalisyon hükümetleri bu eksiklikleri daha da artırmıştır. Finansal varlık fiyatları ve borç verme kararları hükümetin artan finansman ihtiyacı karşısında bozulmuştur. Bu strateji kriz ve istikrarsızlığa sebep olmuştur. Kamu bankalarının, ekonomik kriterleri gözetmeden kredileri vermesi reel anlamda ciddi kayıplara sebep olmuştur. Bu gözlemler Alper ve Öniş tarafından (2001) öne sürülen bankacılık sektörünün zayıflığı ve mali dengesizliklerin Türkiye'de ilişkili konular olduğu görüşünü desteklemektedir. Bu iki unsur aynı zamanda 2000 ve 2001 krizlerinin ardındaki temel sebeplerdendir.

Üçüncü olarak, politik istikrar ekonomik reformların başarısı açısından önemlidir. Teknokratik çözümlerin olabilirliğini politik

kısıtlamaları göz önünde bulundurarak değerlendirmek gerekmektedir. Türkiye'de 1990'larda on bir farklı hükümet göreve gelmiştir. Dağınık parti sistemi ve zayıf koalisyon hükümetlerinin oluşturduğu politik yapı şeffaflık ve hesap verebilirliğin olmadığı bir ortamı beraberinde getirmiştir. Politik ve ekonomik istikrarsızlık, süregiden belirsizlik Türkiye'deki krizlere katkıda bulunmuştur.

Türkiye'nin finansal serbestleşme deneyimi, kurumsal reformların yapılmadığı ve makroekonomik istikrarın sağlanmadığı bir ortamda gerçekleştirilen serbestleştirmenin olumsuz etkilerini göstermektedir. Dolayısıyla, finansal sistem krize maruz kalana kadar reformlara karşı bir direniş olmaktadır. Düzenleme ve denetleme sistemindeki reformlar ve iyileşmeler, krizleri takip etmektedir.

Türkiye deneyiminde siyasal otoritenin bankacılık düzenleme ve denetleme sürecine doğrudan dahil olması, ayrıca, düzenleme ve denetleme otoritesinin birden fazla ve birbiriyle çelişen amaçlarının bulunması, bankacılık düzenleme ve denetleme sistemine gereken önemin verilmesini engellemiştir. Aslında bankacılık sisteminin zayıflığı 1982 ve 1994 krizlerinde yeterince ortaya çıkmış olmasına rağmen, yetkililer gerekli önlemleri almamıştır. Kurumsal yasal düzenlemelerin uygulama eksikliklerini açıklamada yurtiçi politik unsurlar ve kurumsal zayıflıklar dışsal unsurlardan daha baskın olmaktadır. Diğer bir deyişle, IMF gibi uluslararası kurumların yasal zemin oturtulduktan sonra reformların etkin uygulanmasını sağlamakta oldukça az güçleri vardır.

Acemoğlu ve diğerleri (2002)'de öne sürülen fikirlere paralel olarak makroekonomik problemlerin zayıf kurumsal yapının bir sonucu olarak ortaya çıktığını öne sürmek mümkündür. Kurumsal yapının zayıf olduğu ekonomilerde temel problem, politik gücü elinde bulunduran insanların kontrol edilememesinden kaynaklanmaktadır.

Anket çalışmasıyla, tezde tartışılan temel konulara ilişkin olarak konunun uzmanlarının görüşleri alınmak istenmiştir. Ankete verilen cevaplar büyük ölçüde tezin temel bulgularıyla örtüşmektedir. Mülakat sonuçları da ankette ulaşılan sonuçları destekler niteliktedir.

Ampirik çalışma sonuçlarına göre bankacılık krizleri, finansal sistemin kurumsal yapısıyla, makroekonomik göstergelerle olduğundan daha fazla ilişkilidir. Yapılan çalışma sonucunda, güçlü kurumsal yapıya sahip bankacılık sistemi kurulduktan sonra bozulan makroekonomik koşulların bankacılık krizine sebep olmayabileceği sonucuna ulaşılmıştır. Ancak, bankacılığa ilişkin kurumsal zayıflıklar düzeltilmediği sürece bozulan makroekonomik koşulların bir bankacılık kriziyle sonuçlanmasının muhtemel olduğu saptanmıştır. Ampirik analizde, veri kısıtı dolayısıyla sadece bankacılık sistemine ilişkin kurumsal unsurlar kullanılmış, politik kurumsal yapıyı içeren unsurlara yer verilmemiştir.

Ampirik analiz neticesinde ulaşılan sonuç, Türkiye'deki bankacılık sisteminin kırılganlığının 2000 ve 2001 krizlerine önemli ölçüde katkıda bulunduğu hipotezini desteklemekle birlikte, politik kurumsal unsurların analize dahil edilememesinden dolayı, Türkiye'deki krizlerin güçlü bir bankacılık sistemi ile engellenebileceği sonucuna ulaşılamamaktadır.

VITAE

Aytül Ganioğlu was born in Ankara on March 22, 1972. She received her B.S. degree in Economics in 1994 and M.S. degree in Economics in 1996 from Middle East Technical University. She worked as research assistant during 1996-1997 period in the Department of Economics at Middle East Technical University and during 1997-1998 period in the Department of Economics at Boston College. She obtained her M.A. degree in Economics from Boston College in 1998. Since 1999, she has been working at the Central Bank of Turkey.