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ΠΕΡΙΕΧΟΜΕΝΑ

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ΠΕΡΙΛΗΨΗ

Η εργασία αυτή αναλύει τον Τουρκικό Τραπεζικό τομέα πριν και μετά την έλευση του Διεθνούς Νομισματικού Ταμείου (ΔΝΤ) κατά την περίοδο 1998-2010. Το πρώτο μέρος εξετάζει τη διακύμανση των πέντε βασικών μακροοικονομικών δεικτών, συνολικής ανεργίας, το Ακαθάριστο Εγχώριο Προϊόν, Εθνικό ΔΤΚ, το ακαθάριστο χρέος και των καθαρών εξαγωγών αγαθών και υπηρεσιών για την περίοδο που αναφέρεται. Η μακροοικονομική αστάθεια ήταν σημαντική κινητήρια δύναμη της τραπεζικής κρίσης. Η κρίση ξέσπασε όταν η Τουρκία ήταν μετά από συναλλαγματικών ισοτιμιών με βάση το πρόγραμμα αποκλιμάκωσης του πληθωρισμού οδήγησαν και μηχανικής από το ΔΝΤ. Το ΔΝΤ έχει ασχοληθεί με τη μακροοικονομική διαχείριση της τουρκικής οικονομίας τόσο πριν όσο και μετά την κρίση.

Το δεύτερο μέρος αναλύει το τουρκικό τραπεζικό σύστημα, πριν και μετά την έναρξη της ανταλλαγής επιτοκίου με βάση το πρόγραμμα αποπληθωρισμού υπό την καθοδήγηση και τον έλεγχο του ΔΝΤ. Τουρκικά Τραπεζικό Σύστημα, δεν ήταν μόνο ένας από τους κύριους παράγοντες αλλά και το κλειδί ενεργοποίησης των κρίσεων του 2000 και του 2001, που συνεχίστηκε για τρία χρόνια. Το εύθραυστο τραπεζικό σύστημα έχει τις ρίζες της στην υψηλή δανειακών αναγκών του δημόσιου τομέα και ο τρόπος που χρηματοδοτούνται. Οι κανονισμοί που αποβλέπει κυρίως στην αναδιάρθρωση των κρατικών τραπεζών, την επίλυση της κατάστασης των ανθυγιεινών τραπεζών σύμφωνα με την SDIF, την ενίσχυση ιδιωτικών τραπεζών και παρέχοντας ένα καλύτερο πλαίσιο για τη ρύθμιση των τραπεζών. Ως αποτέλεσμα, υπήρξαν δύο διαφορετικά είδη διχοτόμησης: Ιδιωτικός έναντι κρατικών τραπεζών και εντός των ιδιωτικών τραπεζών. Η Βασιλεία II προσέφερε ένα σημαντικό σημείο αναφοράς για αυτούς να ακολουθήσουν. Τα αποτελέσματα της οικονομικής και λειτουργικής αναδιάρθρωσης του τραπεζικού συστήματος έχουν παρατηρηθεί, όπως η βελτίωση των δεικτών κερδοφορίας στο σύνολο του τομέα.

1. Introduction

Turkey experienced a severe economical and political crisis in November 2000, and again in February 2001. The crisis erupted when Turkey was following an exchange-rate based disinflation programme led and engineered by the IMF. Over 2001 the GDP contracted by 7.4% in real terms, whole sale price inflation soared to 61.6%, and the currency lost 51% of its value against the major foreign monies. The burden of adjustment fell disproportionately on the laboring classes as the rate of unemployment rose steadily by 2 percentage points in 2001 and then another 3 percentage points in 2002. Real wages fell abruptly by 20% upon impact in 2001 and could not recover since then as of today.
The IMF has been involved with the macro management of the Turkish economy both prior and after the crisis, and provided financial assistance of $20.4 billions, net, between 1999 and 2003. Following the crisis, Turkey has implemented an orthodox strategy of raising interest rates and maintaining an overvalued exchange rate. The government was forced to follow a contractionary fiscal policy, and promised to satisfy the customary IMF demands: reduce subsidies to agriculture, privatize, and reduce public sector in economic activity.

1.1 The “IMF Program”

The rapid increase of private sector debt —both by the financial and non-financial sectors alike, reveals the true essence of the IMF-engineered adjustment mechanisms following the currency and banking crises of February 2001. The underlying characteristics of the Turkish post-crisis adjustments ultimately relied on maintaining high real rates of interest in anticipation of increased foreign capital inflow into the domestic economy. Coupled with an overall contractionary fiscal policy, the programme found the main source of expansion in speculative inflows of foreign finance. Persistent offerings of high rates of interest against the back-drop of lower inflation and fiscal primary surplus targets were the main attributes of the IMF programme as implemented both by the three-party coalition government under Bulent Ecevit (until November, 2002) and by the AKP government (post-November, 2002).
The aforementioned elements of this adjustment path were clearly stated, in fact, in the Turkey Country Report prepared by the IMF staff in late 2001. The Table below makes a reference to that 2001 report which had laid out the macroeconomic targets of the post-crisis adjustment path as envisaged by the IMF. It is very illuminating to note that the targets of the 2001 IMF Report encompassing 2002 through 2006 have eventually become the official targets of both governments over that period. The targeted rate of real GNP growth, for instance, was persistently set at 5% for each coming year, despite the observed rapid expansion of the economy in rates often exceeding 7% in the preceding year! This choice was clearly no coincidence. Likewise, the inflation targets of the “independent” central bank each year followed the path envisaged in the 2001 IMF Report, beginning with 20% of 2003 to 5% in 2006 (Note that the Turkish CB has declared the onset of its official inflation targeting monetary regime in January 1, 2006).
Furthermore, the very sanctimonious primary surplus target of the public sector at 6.5% as a ratio to the GNP clearly finds its origins in the aforementioned report.

Macroeconomic Targets of the 2001 IMF Program

	2002	2003	2004	2005	2006
GNP Real Growth Rate	3.0	5.0	5.0	5.0	5.0
Non-Interest Budget balance / GNP (%)	6.5	6.5	6.5	6.5	6.3
Inflation Rate	35.0	20.0	12.0	8.0	5.0
Nominal Rate of Interest on Domestic Debt	69.6	46.0	32.4	27.4	23.9
REAL Rate of Interest on Domestic Debt	25.6	21.7	18.2	18.0	18.0

Source: IMF, 2001 Turkey Country Report (www.imf.org)

That being said, what remains noteworthy is the IMF's choice of a very high and persistent real interest rate targeted at 18% throughout the programming horizon. The real interest rate target is persistently kept at its very high level despite the falling trajectory of the inflation rate. The persistence of the high level of real interest rate against falling inflation rates seem to find a resonance in the adjustment path assumed by the IMF staff in the immediate post-2001 crisis. It is clear that the main adjustment mechanism of the post-crisis IMF programme was embedded in maintaining a significantly high rate of real interest. The high interest rates attracted short term finance capital; and the relative abundance of foreign exchange led to overvaluation of the Turkish Lira. Cheapened foreign exchange costs led to an import boom both in consumption and investment goods. Achievement of the fiscal contraction under severe entrenchment of public non-interest expenditures, in turn, was a welcome event further boosting the hungry expectations of the financial arbiters.

In sum, contrary to the traditional stabilization packages that aimed at increasing interest rates to constrain the domestic demand, the new orthodoxy aimed at maintaining high interest rates for the purpose of attracting speculative foreign capital from the international financial markets. The end results in the Turkish context were the shrinkage of the public sector in a speculative-led growth environment, deteriorating education and health infrastructure which necessitate increased public funds urgently, and the consequent failure to provide basic social services to the middle and the poor classes. Furthermore, as the domestic industry intensified its import dependence, it was forced toward adaptation of increasingly capital-intensive, foreign technologies with adverse consequences on domestic employment.

Gerald Epstein, co-director of the Political Economy Research Institute at the University of Massachusetts, finds that despite little evidence of the success of inflation targeting in promoting economic growth, employment creation or poverty reduction, the IMF is increasingly using loan conditions and technical assistance to push its use. There is an urgent need for viable alternatives that focus on employment generation, poverty reduction, export promotion and investment enhancement to be given more attention.

1.2 Structure of the Financial Sector as of 2010

The Turkish financial sector has shown remarkable progress in the period following the 2001 crisis. The improved macroeconomic conditions in the country, the increased fiscal discipline of the government and the restructuring of the institutional setting for the financial system were among the domestic causes of this development. Very favorable international liquidity conditions, international institutions' influences and the reforms in global banking standards were also profoundly effective factors during this transformation. Banking constitutes the major component of Turkey's financial sector.

In 2010, banks' balance sheets comprised 88.3% of the balance sheets of the sector (Table 1).

The total asset size of the financial sector, which maintained its growth in 2009, grew by 14% compared to the end of the previous year and reached TL 944 billion by the end of 2009.

Table 1: **Distribution of the Balance Sheet Size of the Financial Sector (%)** [1]

	Ratio
Banks	88.3
Securities Mutual Funds	3.1
Insurance Companies	3.3
Leasing Companies	1.6
Factoring Companies	1.1
Pension Funds	1.0
Consumer Finance Companies	0.5
Intermediary Institutions	0.6
Real Estate Investment Funds	0.5
Securities Investment Funds	0.1
Total	100.0

Source*: CBRT Financial Stability Report, May 2010.*

(1) End-2009 data.

The catastrophic crises in 2000 and 2001 paved the way for a structural reform process in Turkey. Since the weaknesses in the banking sector were considered to be a major cause for the crises, efforts to restructure the Turkish economy were particularly focused on the banking sector. Extensive research

was conducted in the immediate post-crisis era to analyze the crises and to evaluate these efforts. The most recent period up to 2010, some results of the restructuring and transformation had surfaced. Hence, this paper will analyze the developments in the banking sector before and after the advent of the International Monetary Fund.

1.3. Historical Background

In the last twenty years Turkey has witnessed four crises: 1994, 1998-99, 2000- 01, and finally the current global financial crisis. In the periods preceding the first three episodes, during which from peak to trough the output losses were 6.5, 5, and 6 percent respectively, economic fundamentals were extremely weak. This fact, especially the weak fiscal position, put a severe constraint on the implementation of countercyclical policies to contain contractionary effects of the first three crises.
Besides its global character, the most important difference of the current crisis from a domestic economic policy response perspective, is the economic conditions prevailing in Turkey on the eve of the crisis. Economic fundamentals were much stronger: the fiscal position was in good shape, the financial sector was strong, real interest and inflation rates were at their lowest levels in the last twenty years or so. Although there were some remaining vulnerabilities, they were less problematic comparing to the past.
Throughout the 1980s and 1990s, Turkey relied heavily on foreign investment for economic growth, with trade above 40% of GNP. The Turkish government and banking systems lacked the financial means to support meaningful economic growth. The government was already running enormous budget deficits, and one of the ways it managed to sustain these, was by selling huge quantities of high-interest bonds to Turkish banks. Continuing inflation (likely a result of the enormous flow of foreign capital into Turkey) meant that the government could avoid defaulting on the bonds in the short term. As a consequence, Turkish banks came to rely on these high-yield bonds as a primary investment. [2]

Notwithstanding the significant improvement in most of the macroeconomic indicators, the Turkish economic policymakers did not take countercyclical measures up to March 2009, even though the contraction of the economy had started as early as August 2008 and the downward cycle had been visible earlier (the output loss from peak to trough, based on a conservative estimate, is expected to be 7.5 percent). When Turkey decided to take some fiscal stimulus measures in March 2009, it was too late, and the magnitude of the stimulus package was rather small and not properly targeted.

1.3.1. Turkish Banking Sector through the years

In the 1980s, the planned economy with its heavily restricted banking sector left its place to the hanges affected by the attempts of liberalization in the Turkish economy, in sync with the rising “neoliberalism” in the world. Despite considerable improvements, the lack of an institutional structure was a major impediment. The 1990s were marked by high inflation, increasing public expenditures and excessive public sector borrowing.
In this decade the government turned mainly to commercial banks, which in turn relied on short-term capital inflows, for deficit financing. Banks had little function as financial intermediaries; their main business was to lend to the government at high rates and borrow from abroad by exposing themselves to serious currency risk. State banks, which constituted a significant portion of the banking sector, were also largely used by the government to accomplish political objectives. They suffered duty losses for which they engaged in short-term borrowing at high interest rates, subjecting them to interest rate risk.
A confidence breakdown, the ensuing capital flight and the consequent rush to foreign currency led to the collapse of the IMF-supported exchange rate anchor program of 1999. The heavy depreciation of the currency resulted in the severe 2001 crisis, affecting especially the banks with serious open positions. As a result of this crisis, the banking sector had to go through immense restructuring, with the total cost of the process amounting to 35.9 per cent of GDP in 2001 (Steinherr et al. 2004).
There was at least one good side to this devastating crisis. It provided regulators with the suitable environment to initiate a structural reform process. The Banking Regulation and Supervision Agency (BRSA) implemented a series of fundamental regulations on many issues including foreign exchange exposure, connected lending practices and capital adequacy standards. State banks were relieved of the burden of duty losses and some measures were taken to enhance their efficiency. The convergence of the regulatory framework to international standards and the proactive policies of the regulators were

among the main reasons for the current soundness of the financial sector. Basel-II was the international benchmark for determining the regulatory framework.

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise, should a major bank or a series of banks collapse. In theory, Basel II attempted to accomplish this by setting up risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability. Basel II uses a "three pillars" concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline.

Redefining the risk groups of certain balance sheets assets and increasing the provisions for certain off-balance sheet items and credit card installments are some examples of the proactive measures taken by the regulators in order to control banks' asset growth and risk taking. Regulations were accompanied with improving macroeconomic conditions and the tight fiscal practices of the government on the domestic front. Meanwhile, favorable global liquidity conditions prevailed in international markets.

In the post-crisis period, the number of banks in Turkey decreased until 2006 and has stayed at 50 since then. Their asset and liability structure reflects financial deepening and increased intermediation activities. Profitability has been on the rise since 2005, and is now quite high compared to most European countries. Capital Adequacy Ratio (CAR) has been declining, mostly due to stricter regulations and the increasing share of loans in assets in recent years, though it is above the required minimum of 8 percent and the CARs of most European countries.
The duration between the crisis and 2004 can be described as the *recovery and stabilization period* due to the intense restructuring activities that characterize it. In this period, the banking sector was consolidated through mergers and made leaner through reductions in the numbers of branches and employees. This was also a recovery phase during which asset portfolios were rehabilitated and the capital base was strengthened.
Starting with 2004, the Turkish banking sector entered a *growth period*. Total assets as percentage of GDP increased substantially and reached 71.5 in 2008. The numbers of branches and employees started to escalate in 2004. Securitization and syndication credits received by them surged in this period as well. These years were also marked with a sudden increase in foreign bank entry. The share of assets owned by foreign banks increased nearly tenfold between 2000 and 2008, with almost this entire growth taking place in 2005 and later.
Global conditions, improvements in the banking sector and macroeconomic conditions in Turkey as well as the conditions in the home countries of foreign banks affected foreign banks' entry decisions. Global liquidity conditions helped foreign banks raise funds to penetrate into the Turkish market. Low returns in home countries made expansion an inevitable path to follow for international banks. The December 2004 decision of the EU to start accession negotiations with Turkey contributed positively to foreign bank entries and the *growth period*. The declining inflation and public sector borrowing requirement (PSBR) in Turkey brought the intermediation role of banks to the fore. It was not possible for foreign banks to benefit from the growing loan markets in Turkey through their small subsidiaries. Hence, they preferred to acquire existing banks to penetrate faster into the Turkish market. The regulations, supervision and the better fit to Basel-II guidelines also increased the confidence in the Turkish economy and provided more reliable means of assessment for foreign banks. So far, Turkey has benefited mainly from the capital inflows generated by these entries

1.3. 2.Political Background

Regarding the political instability, in March 1996, a Coalition was formed between the Motherland Party and the True Path Party, led by Motherland's Mesut Yilmaz and Tansu Çiller of True Path. The

plan was for Yilmaz and Ciller to alternate the Prime Ministry. However, there was much public distraction caused by Welfare Party leader Necmettin Erbakan's threats to investigate Ciller for corruption. Erbakan, who was excluded from the coalition, did everything he could to rally support for an Islamic NATO, and an Islamic version of the European Union. The Motherland Coalition would collapse in part because of Erbakan's widespread public support. Addition tensions wreaked havoc on the government. Yilmaz was forced to resign on June 6, 1996 with the government having lasted for only 90 days. Erbakan became Prime Minister on 29th of June as the head of a Welfare/True Path coalition. The success of the new Welfare-Path Coalition was viewed with hostility by the military. Erbakan's explicitly Islamist politics resulted in a post modern coup in which the military forced Erbakan to yield power to Demirel who yielded to Yilmaz on June 19, 1997. The political fighting between Yilmaz and Ciller on one side and Erbakan on the other would continue, making coalitions difficult to create. In addition, corruption was rampant at this time. People were highly disillusioned with their government. This lack of faith and efficacy would cause foreign nations to carefully examine any investment in Turkey.

The IMF team in 1996 warned of an impending financial crisis because of the deficit which soon came into being. Turkey's unstable politics led many foreign investors to divest from the country. $70 billion of capital had left the country in a matter of months. This left a vacuum of capital in the country that Turkish banks were unable to alleviate because the government was no longer able to pay off its bonds. With no capital to speak of, the Turkish economy slowed dramatically as foreign investors watched its politics and the Turkish government tried to eliminate the budget deficit.

The IMF provided Turkey with $11.4 billion in loans in November 2000 and Turkey sold many of its state owned industries in an effort to balance the budget. In the case of Turkish Airlines, advertisements were placed in newspapers to attract offers for a 51% stake in the company. By 2000 there was massive unemployment, lack of medicine, tight credit, slow production of fight inflation, and increased taxes. By the turn of the century, stabilization efforts had yet to produce any meaningful effects, and the IMF loan was widely seen as insufficient.

Turkey's financial and political instability necessitated a positive government stance to assuage fears of a total economic collapse. However, on February 19, 2001, Prime Minister Ecevit argued with President Sezer and left the meeting saying that "This is a serious crisis." This was a poor choice of words resulting from a heated debate and made the bad situation worse. Stocks plummeted and interest rates reached 3000%. Liras were sold for dollars and Euros causing the Turkish Central bank to lose $5 billion of its reserves. Ecevit's statement in such unstable, unpropitious times looked like an admission of defeat by the government to many.
The crash triggered even more economic turmoil. 14,875 workplaces closed in the first eight months of 2001, the dollar rose to 1,500,000 liras, and income inequality had risen from its already high level.
The crash symbolized the political and economic problems that had been wearing on Turkey for years. Confidence in government had eroded because of corruption and an inability to form coalitions and govern for any reasonable length of time. The stock market crash showed Turkey's economic situation to be extremely brittle and wholly dependent on foreign investment. Although not as significant as decreased foreign investment or the massive budget deficit, it highlights Turkey's recent political instability.

The fiscal consolidation in the aftermath of the 2001 crisis up to 2007 is impressive. The main fiscal adjustment took place in three areas. First, prospective deficits hidden in the balance sheets of state banks were cleared. [1] Second, losses of the social security system, state economic enterprises and municipalities were reduced, which led to a sharp decline in public sector borrowing requirement and general government balance. In addition to these measures, the restructuring and recapitalization of the financial sector - especially state banks, and successive high primary surpluses[2] increased confidence, reduced risk premium, and lowered Turkey’s default risk as measured by the EMBI spread, and lengthened domestic borrowing maturities.

[1] After 1992 growing government debt instruments outstanding and the increasing financing needs of the Treasury led the government to finance some activities through loans taken from state banks. Instead of repaying the principal and the interest accrued, the Treasury allowed these nonperforming loans to be treated as performing loans by state banks. As of the end of 2000, this so called ‘duty loss’ stock of state banks was almost 9.2 percent of GDP. See, Ozatay and Sak (2002) for details.

[2] The average primary surplus to GDP ratio of the 1992-2000 period was under 1 percent and that of 2000 was 4.3 percent, both well below the average of the 4.8 percent of the 2001-2006 average.

Note that there are no official structural balance figures. Özatay (2008) provides cyclically adjusted primary and operational balance and structural balance figures, which show that especially the 2003-2006 period witnessed considerable fiscal impulse. 2000 was another year of significant fiscal impulse, however as stated in the previous footnote, the 2000 program failed to address the prospective deficits problem hidden in state banks.

Hence, the third adjustment mainly stemmed from the considerable decline in real borrowing rates, which is reflected itself in the central government balance as a striking reduction in interest expenditures to GDP ratio. Starting from the end 2003, the increase in credit volume, partly a result of financial sector recapitalization and restructuring efforts had helped the fiscal consolidation process not to undermine the growth performance. This performance led to the motto of the period, namely 'fiscal discipline, credibility and confidence' which has had repercussions on the response of economic policymakers to the current global financial crisis.

The motto of the post-2001 crisis period: fiscal discipline, credibility, and confidence

The exchange rate based stabilization program collapsed in February 2001. The accompanying huge increase in overnight rates, drying up of liquidity in the interbank money market and the sharp depreciation of the lira brought the financial sector to the edge of near collapse and created immense problems in the corporate sector. The immediate recapitalization need of the financial sector almost doubled the public debt to GDP ratio to 74 percent at the end of 2001. As of the end of 2001, the central government deficit was 12 percent of GDP and interest expenditures of the budget amounted to 17 percent of GDP. The main challenge for policymakers of the time was to diminish debt sustainability concerns stemming from this rather poor fiscal position. Such concerns were selffulfilling: increasing real interest rates and putting a significant real depreciation pressure on the lira, which was further increasing public debt and further intensifying sustainability concerns. To curb such reinforcing concerns, the government opted for a rather ambitious fiscal consolidation program.
The underlying logic was the following: The evolution of the debt ratio is a function of the real growth rate, the real interest rate, the real exchange rate (due to foreign debt and foreign currency indexed domestic debt) and the ratio of primary budget surplus to GDP. To reverse the unsustainable time path of public debt, among these factors, policymakers can only control their budget and at most expect to affect the real interest rate and exchange rate through the confidence channel. A tight fiscal policy will increase confidence in sustainability of debt and hence decrease the country risk premium, provided that fiscal policy is regarded as credible by the public. Furthermore, the literature on expansionary fiscal consolidations, shows that fiscal consolidations can cause expansion mainly through credibility and expectations channels, as long as some initial conditions are met. [3]
Hence, what was expected from the fiscal austerity cum financial sector rehabilitation measures was to i) reduce default risk, ii) decrease real interest ratesk, iii) prevent further depreciation pressures on the exchange rate which at that time was obviously overshot, and then bring the exchange rate to more reasonable levels through market forces, iv) improve balance sheets of the corporate and banking sector whose liabilities denominated in foreign currency far exceeded its assets in foreign exchange, v) increase credit supply to the private sector by recapitalizing the banking sector, decreasing the risk perception of the banking sector, and reducing the amount tapped by the public sector from the sources of the banking sector and vi) boost private demand through the combined impact of these factors.

1.3.3. Turkish Economy and Banking Sector

Turkey has a long history of double-digit and persistent inflation rate accompanied with frequently and severely disrupted growth dynamics. High level of public involvement in the economy has been blamed by many as one of the major sources of these severe disruptions in the economy. Large size of the government, coupled with an ineffective tax system, led public debt to become one of the highest among the country's peers and government policies often aimed little more than maintaining the ability to roll over the debt in the short run. Banking sector, as a result, heavily relied on money market operations to finance public sector borrowing in their business model rather than focusing on retail banking activities.

[3]If the initial value of public debt is high and there are widespread concerns on the sustainability of debt, a credible fiscal consolidation now minimizes debt repudiation risk in the future. See, for example, Sutherland (1997).

This business model left banks severely exposed to direct interest rate and indirect exchange rate risks, and as policy actions responded to economic fluctuations, not surprisingly, macroeconomic shocks hit banks hard and lending to the private sector exhibited severe and frequent oscillations.

Turkey's financial system and banking sector are virtually synonymous with respect to many of the transactions and activities carried out in both money and capital markets: banks and assets of the banking sector constitute more than 85 percent of total financial system assets as of end of 2007. The 2000-01 crisis had several reasons, [4] but the major problems that underlined the turmoil in the banking sector were (i) the unsustainable business model relying on short-term financing of the large public sector debt, and (ii) inadequate risk management practices, poor corporate governance, and lax supervision. Following the crisis, the monetary and fiscal policies changed drastically. In 2001, the government set out an IMF-backed 3-year stabilization program and committed to strengthen its balance sheet position. [5] Concurrently, the central bank adopted a strong disinflation program and the double-digit inflation rate, which was around 70 percent at the time, was reduced to single digits by the end of 2004.

The banking sector also went through considerable change at the back of initiatives to increase resiliency and supervision quality. A series of banking laws, bringing regulations closer to the European Union and other international standards, has been enacted. In June 1999, the Banking Regulation and Supervision Agency (BRSA), with financial and administrative autonomy, were established to take over as the main regulatory and supervisory body, a role played by the Treasury and the Central Bank prior to the changes in the law.

With the establishment of the BRSA, the Savings Deposits Insurance Fund (SDIF), previously under the authority of the Central Bank, started to operate under the administration of the BRSA. Later on, in December 2003, the management of the SDIF was separated from the management of the BRSA. The voluntary out-of-court debt restructuring ("the Istanbul approach") introduced in January 2002 also helped restore banking sector solvency

In November 2005, the supervisory system was further strengthened by the passing of additional regulations concerning foreign exchange exposures, capital adequacy, internal control and risk management, lending limits, conditions on bank ownership and corporate governance, consolidated and cross-border supervision of banks, accounting standards for financial disclosure purposes, prudential reporting, and loan loss provisioning.

As of December 2007, there were 46 banks operating in Turkey, with deposit banks accounting for the bulk while development and investment banks showed small existence. Domestic private banks constitute slightly more than half of the banking sector in terms of market share. The banking sector assets amount to around 60 percent of GDP while the whole financial system assets are about 70 percent of GDP.

While both the relatively large number of banks and the Herfindahl-Hirschman index, at 0.09, suggest a high degree of competition, careful inspection reveals that the share of top 5 banks command almost two-thirds of the market. In addition to high concentration, the banking sector, despite the quick wave of acquisitions of previously domestically owned banks by foreigners following the crisis, remains mostly domestic, especially relative to other emerging markets (BIS 2006, IMF 2007). Public involvement also remains high comprising around a third of the sector assets.

The capital structures of the banks in the system were the core of the restructuring program. A three-phase audit revealed the real capital needs of private banks, and once identified, the capital structures of banks having capital shortages were strengthened. The average capital adequacy ratio of the whole sector as of December 2007 stood at 18.9 percent. The results of the financial and operational restructuring of banking system have been observed as an improvement in the profitability ratios of the whole sector.

[4] The crisis erupted in November 2000 when Demirbank, a medium-sized financial institution, liquidated a large amount of government securities as it failed in rolling over its overnight liabilities. The collapse in the value of government securities triggered capital outflows and a subsequent fall in international reserves. The crisis revealed the maturity mismatches and exposure of the banking sector to interest and exchange rate risks. After the initial response of extending guarantees on deposits and other bank liabilities in December, continued deterioration in economic conditions and weak policy implementation, including tensions in the political scene, ignited yet another capital outflow in February 2001. Overnight interest rates spiked and liquidity injections to contain those destabilized the crawling peg. Ultimately, the peg was abandoned and the fiscal cost of the crisis reached 32 percent of GDP while output loss is estimated to be 16 percent of GDP.

[5] Turkey had several programs with the IMF prior to 2001; the 1999 one also included a stabilization program and reform of the banking sector among its priorities.

2. Literary Review (a)

Brooks (2007) studies the monetary transmission during the May-June 2006 financial turbulence in Turkey. By applying a difference-in-difference approach to a bank-level dataset, she shows that bank liquidity affects loan supply significantly. The fact that these two latter studies find stronger evidence of a statistically significant monetary policy transmission mechanism in Turkey could be that both studies focus on exceptional periods of macroeconomic or financial turmoil.
While the literature on the bank lending channel of monetary transmission mechanism is vast, less attention has been paid to the implications of fiscal policy on bank credit supply to the private sector. High level of public debt has been blamed as a major source of disruption (see, for instance, statements by Selcuk Demiralp, former Undersecretary of the Treasury in Turkey, cited in McHale, 2001) yet formal studies of these assertions are somewhat scant.
Degirmen (2007) shows that, relying on descriptive statistics and impulse responses, public sector borrowing led to a decrease in lending by state-owned banks in Turkey during the 1990s.
Hauner (2008) studies the impact of credit to government on banking sector performance by using a panel data set for 142 countries. One of the measures of banking sector performance he uses is the growth rate of bank-credit-to- GDP ratio, on which credit-to-government has a negative impact in developing countries. However, supply- and demand-side effects are not separated in arriving at this result.

3. Macro Analysis

The optimum way to examine the Turkish economy before and after the departure of the International Monetary Fund is by examining the variation of five basic macroeconomic indicators, Total Unemployment, Gross Domestic Product, National CPI, Gross Debt and Net Exports of Goods and Services, in the period 1998-2004. The period will also expand to 2007, when IMF bailout took place, and then up to 2010.

The Turkish economy entered the global financial and economic crisis following a six-year growth surge that was fuelled by far-reaching policy reforms and greater political stability The reforms of the past decade, particularly fiscal discipline, introduction of inflation targeting, and overhaul of financial sector oversight, together with political stability and opening of EU accession negotiations, significantly improved confidence in the management of the economy. These factors contributed to a high fiscal primary surplus, rapidly falling public debt, and moderate inflation. The aforementioned policy reforms kept pre-crisis vulnerabilities more contained than elsewhere in the region, enabling Turkey to better weather the ensuing international economic and financial disruption. Good policies in the context of surplus global liquidity attracted strong capital inflows that relaxed the financing constraint and enabled a domestic-demand led expansion. The resulting boom in private investment and fall in private savings led to a widening of the current account deficit in a strong currency environment. Nonetheless, Turkey's domestic and external imbalances remained more contained than in the rest of Emerging Europe, reflecting a smaller foreign-financed credit boom, macro policies that were better focused on resisting the cyclical upswing, and more restrictive prudential regulations.

Growth has resumed, but risks being overly reliant on consumption, which would feed external vulnerabilities—especially in the current global environment. Vigilance and timely policy responses are required to avoid rising inflation and an unsustainable widening of the current account deficit in a strong capital–inflows environment, particularly if these flows are mostly short term.

3.1 Total Unemployment

First, it’s wise to set off this macro analysis by drawing the following diagram:

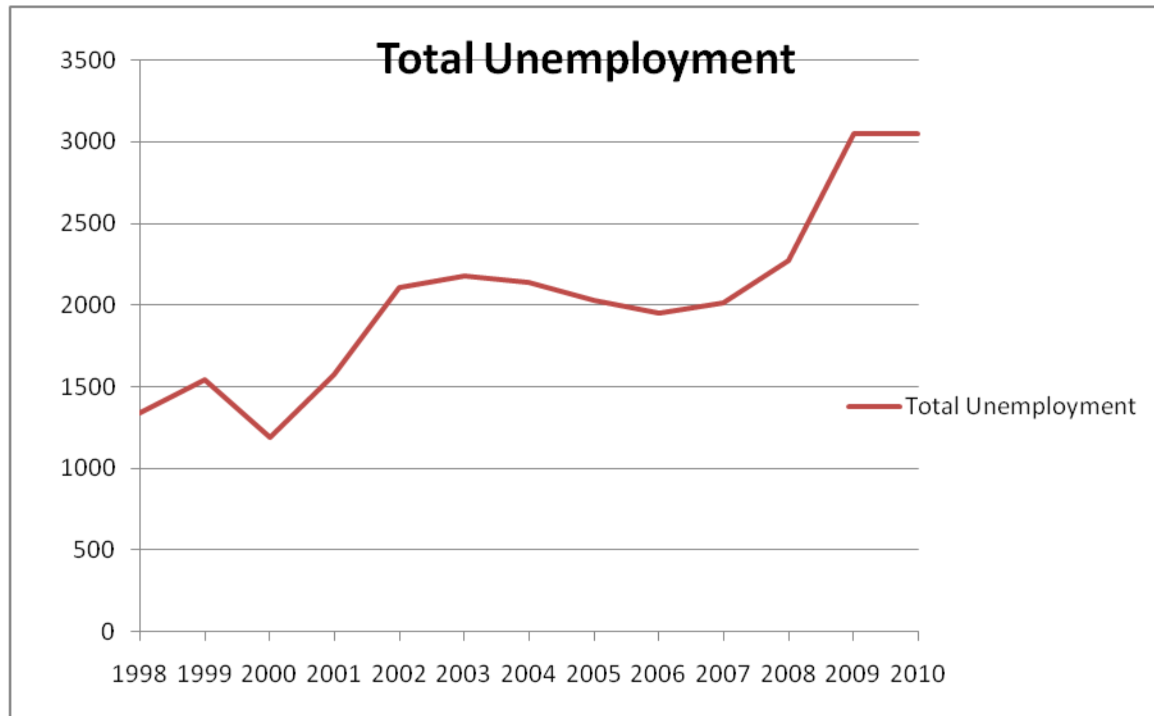

Diagram 1- Total Unemployment in Turkey

In general terms, someone can easily notice that there is a rising tension referring to the total unemployment indicator. It’s not clear though, if unemployment indicator is directly linked to the economic crisis, therefore the following tool should be used for a clearer view. The total unemployment rate in the period 2002-2010, actually shows the percentage of the labor force which is unemployed. Employment generation was strong during the period of 2006-07. The labor force is defined as the number of people employed plus the number unemployed but seeking work. The non-labor force includes those who are not looking for work, those who are institutionalized and those serving in the military. Its dynamics has been reflected in the transformation of Turkey’s economy from agriculture to largely services and industry. Throughout 2010 employment is also continuing to recover, although higher labor force participation—itself a sign of rapid recovery—is slowing the fall in the unemployment rate.

Unemployment, which initially jumped up sharply (2000-2002), has moderated somewhat, but remains elevated. Nonetheless, the unemployment rate remained stuck around 10 percent during the period 2002–07, with a high share of unofficial or semi-official employment. This may reflect significant inefficiencies in the formal sector labor market, including a minimum wage that was increased substantially (tripling in U.S. dollar terms since 2002), is now higher than in almost all new EU member countries, and is binding in lower-income regions of Turkey. Also, Turkey’s severance pay scheme is among the most generous in the OECD (one month per year of tenure), while its regulations on short- term contracts are the most restrictive. As a result, jobs have been squeezed from the formal to the informal sector (wages reported to the Social Security Institution are less than 20 percent of GDP and more than 40 percent of private-sector wage earners report only the minimum wage—also representing a significant tax leakage), or job creation has been discouraged altogether.

The unemployment rate in Turkey was last reported at 11 percent in November of 2010. From 2005 until 2010, Turkey's Unemployment Rate averaged 11.14 percent reaching an historical high of 16.10 percent in February of 2009 and a record low of 8.80 percent in May of 2006.

Employment generation remained moderate during 2006. The annual unemployment rate has been nearing average 10 percent since 2002 and sustained at 9.2 percent by end 2007. During 2005 it decreased essentially by 0.4 percentage points, providing employment to 284 thousand people compared to 2004. During this period, employment generation in the industrial and services sectors increased by 2.9 and 5.0 percent.

3.2. Gross Domestic Product (GDP)

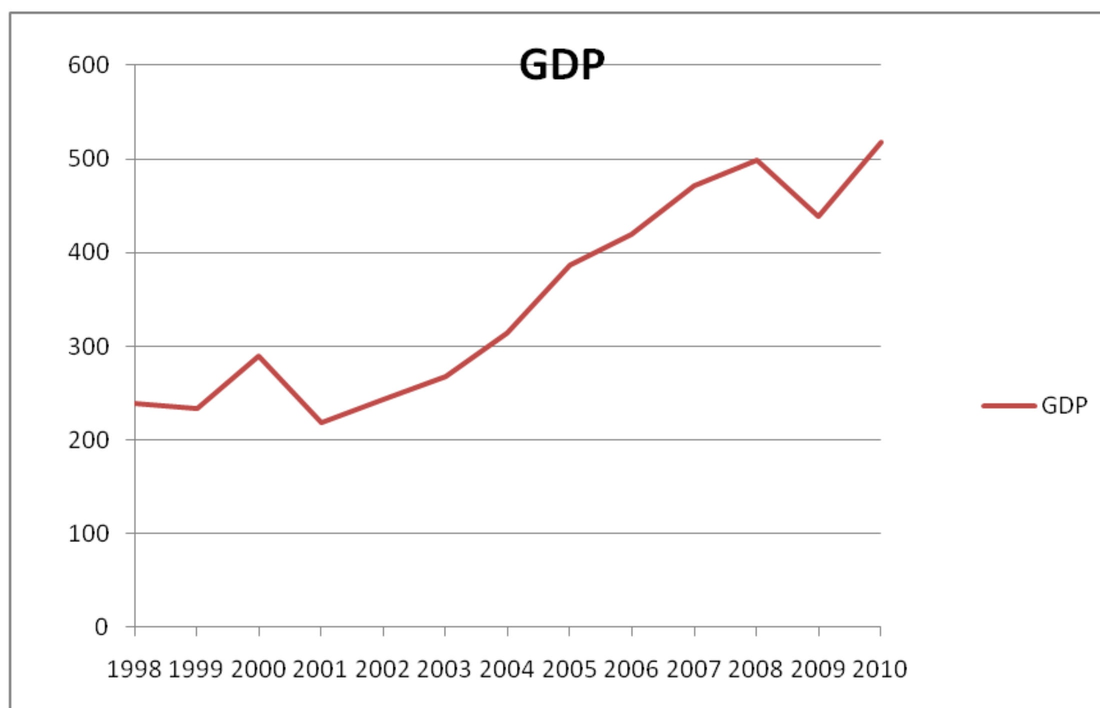

Diagram 2- Gross Domestic Product (Turkey)

Turkey Gross Domestic Product is worth 617 billion dollars or 1.00% of the world economy, according to the World Bank. Gross Domestic Product reached a historical high of 517.5 Mrd ECU/EUR in 2010 and a low point of 217.9 Mrd ECU/EUR in 2001. The general image that we can derive from the above diagram is that the Gross Domestic Product has been rising from 2001 to 2008, headed down as of 2009 and stood at a record high in 2010, respectively in April 2010.

Turkish GDP was hit hard by the onset of the global financial crisis, but quickly retraced its losses. The rise of Turkey's GDP, over the period of 2001-2008 was due to the agricultural value added, the industrial value added and the value added in the services sector. It was due to the expansion in the trade sector and import taxes. In 2006 the construction sector leading in the real GDP growth and showed 21.5 percent growth during 2005. Gross GNP grew by 6 percent by end of 2006.

The economic growth has slowed down during 2008 due to the appreciation of the New Turkish Lira-YTL, the delayed effects of monetary tightening and the expected drop in agricultural output due to draughts.

In 2009, the Gross Domestic Product (GDP) shrank by 12.04 percent due to global financial turmoil. The economic contraction observed as of the last quarter of 2008 was reversed as of the last quarter of 2009. Globally-synchronized capital outflows and a sharp decline in confidence led GDP to fall during 2008-2009. A high growth rate was achieved in the first quarter of 2010, thanks to continued growth and the low base effect.

A comparison of Turkey's GDP collapse during the 2009 global crisis and Turkey's 2001 financial crisis indicates that, while the overall GDP decline was of a similar magnitude, the underlying expenditure composition was quite different. The global nature of the current crisis made exports much less supportive in 2009 than in 2001, when export growth was even positive. Inventory drawdown was also much deeper in 2009 than in 2001, as the widespread nature and expected long duration of the

current crisis at its onset caused firms to run down inventories. Consequently, with the global recovery occurring sooner and stronger than initially anticipated, inventory restocking has been an important driver of growth since Q2 2009.
However, the pace of recovery is still unknown as developments in global markets will affect external demand directly and domestic demand indirectly in the upcoming period. Turkey, however, is a rapidly developing country and the largest national economy in Central and Eastern Europe. In 2009, Turkey's economy share of world total GDP, adjusted by Purchasing Power Parity, was 1.25 percent. In 2015, Turkey's share of world total GDP is forecasted to be 1.20 percent. As Turkey's gross domestic output (GDP) is set to grow by 6% per year on average, its contribution would rise from less than 5bn Euros in 2014 to almost 9bn Euros by 2020.
Turkey's dynamic economy is a complex mix of modern industry and commerce along with a traditional agriculture sector that still accounts for about 30% of employment. It has a strong and rapidly growing private sector, yet the state remains a major participant in basic industry, banking, transport, and communication.

3.3. National CPI

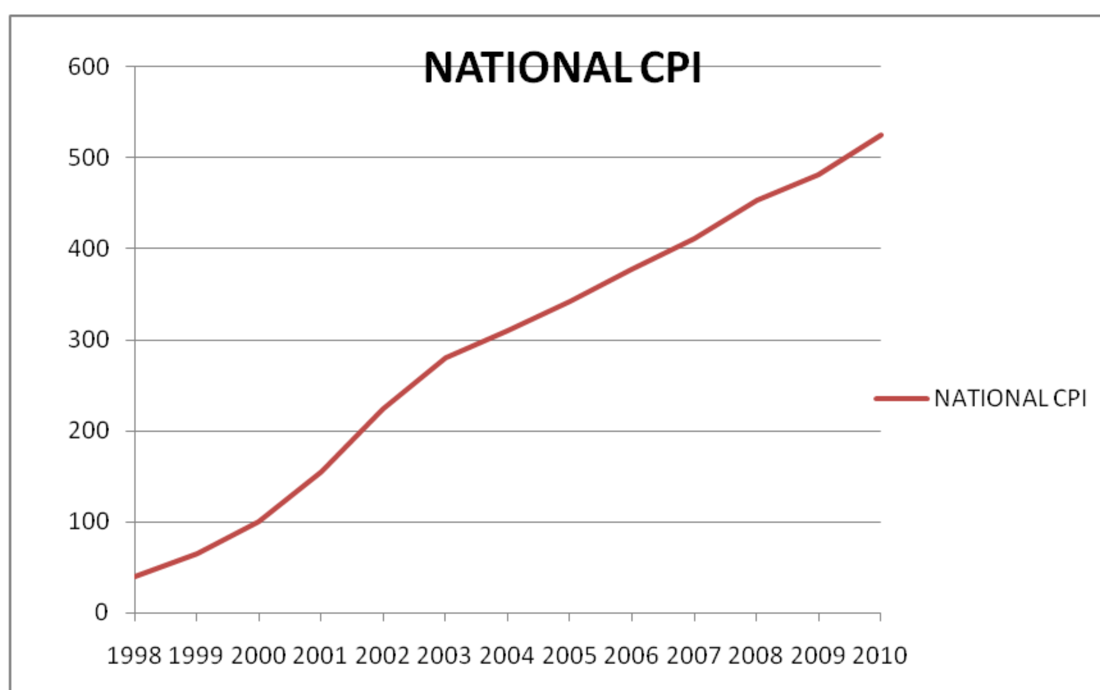

Diagram 3- National CPI (Turkey)

Inflation is the most serious problem facing Turkey. The above diagram of National Consumer Prices Index (CPI) shows that for more than 10 years inflation has gradually increased and never fallen below two digits.
National Consumer Prices Index (CPI) inflation increased by 9% from 2009 to 2010 The rise in question was mainly driven by price increments stemming from tax adjustments, introduced in January 2010 covering fuel-oil products, alcoholic beverages and tobacco products, the surge in unprocessed food prices and the low base stemming from last year's tax cuts. Inflation, which followed an upward trend in the first quarter of 2010 due to the cost-push pressures and the low base effect due to tax cuts, is expected to gradually head downwards as the mentioned effects fade away. Therefore, the projection that the recovery in economic activity will be gradual, is retained, and total demand conditions are expected to underpin disinflation for quite some time.
According to IMF Staff-Report-September-2010, the inflation targets for 2009 and 2010 were revised up in mid-2008 from 4 percent to 7.5 and 6.5 percent, respectively, on the expectation of persistent high global food and energy price inflation. The inflation target for 2011 is set to 5.5%.
The period following the 2000-01 crises was marked by a successful disinflation program sustained through inflation targeting and fiscal discipline in Turkey.

During the period between 2002 and 2004, banks in Turkey reported their balance sheet statements with respect to the inflation adjustment communiqué of the BRSA.
By 2004, the chronically high inflation rate was reduced to single digits in Turkey, and hence, BRSA announced in its 2005/5 circular that inflation adjustment will be ceased from balance sheet reporting standards starting with the statements scheduled for release on 1st January 2005.
A cumulative 40 percent appreciation of the CPI was based on real exchange rate from 2002 to 2007. During 2006, the CPI rose to 377.5, reflecting the 10.5 percent increase compared to 2005. Several factors, such as high commodity, food and energy prices have added to the increase in the CPI. Also, huge capital inflows of $19.9 billion in 2006 of Foreign Direct Investment and domestically generated proceeds from privatization have largely contributed to rising inflation. The annual inflation rate declined to 6.5 percent by 2007.
The Consumer Prices Index average in Turkey was reported at 481.7 in 2009, according to the International Monetary Fund (IMF). In 2015, Turkey's Consumer Prices Index average is expected to be about 610. Data for inflation are averages for the year; not end-of-period data. The index is based on year 2000=100.

3.4. Gross Debt

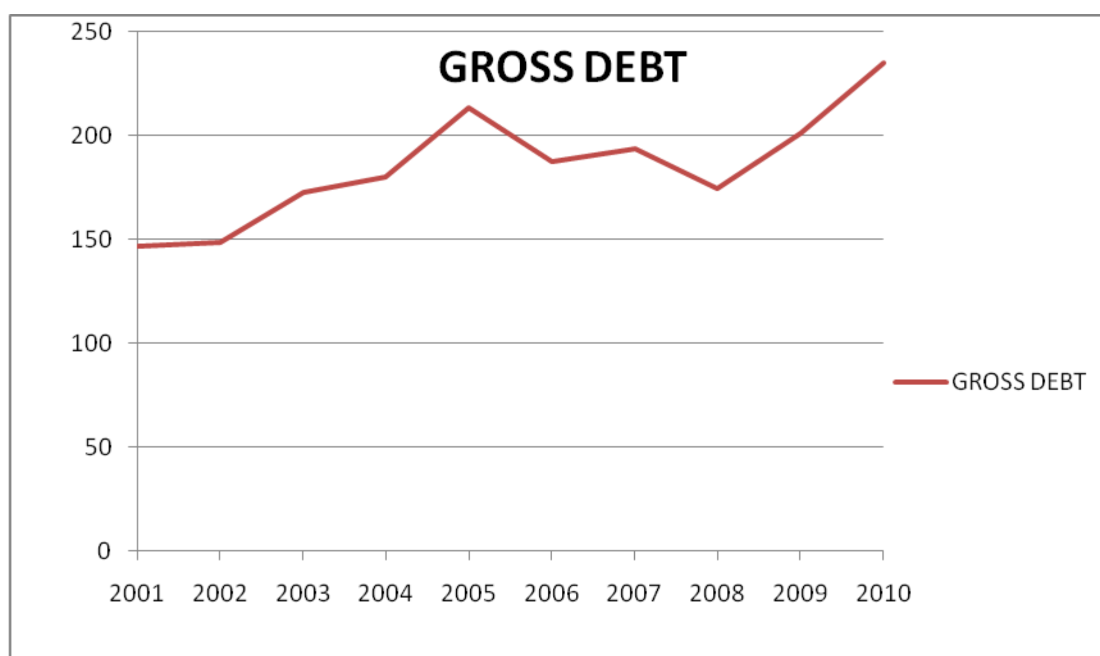

Diagram 4 - Turkish Gross Debt

Gross debt comprises the stock (at year-end) of all government gross liabilities (both to residents and nonresidents). To avoid double counting, the data is based on a consolidated account (eliminating liabilities and assets between components of the government, such as budgetary units and social security funds). The year 2001 is used as basis of recording, Cash General Government includes: Central Government; State Government; Local Government; Social Security Funds.

Data for Total Government Gross Debt (% of GDP) for the years 1998 and 1999 is not available. In year 2001 Gross Debt is 77.557 %, which makes Turkey No. 54 in world rankings according to Total Government Gross Debt (% of GDP).

The country's massive debt in 2004 - which includes $23bn owed to the IMF and billions borrowed via the international bond markets - also remains a major obstacle to its ambition of joining the EU.

Turkey's debts have largely arisen from its efforts to push through banking reform after a run on the banks in 2001 caused the country's devastating recession. "There is no question that although Turkey is doing much better than in the past, it remains quite vulnerable," says Michael Deppler, director of the IMF's European Department. "Its debt is far too high for an emerging economy."

Gross Debt (% of GDP) in year 2005 is 52.306 % which makes Turkey No. 80 in world rankings according to Total Government Gross Debt (% of GDP).
The ratio of gross debt started to decline in 2005 after five consecutive years of rising. Among the factors that contributed to the reduction of a gross debt ratio were: higher foreign direct investment inflows, which accounted for 4.8 percent of the GNP by end 2006 compared to 2.4 percent by end 2005. Also, a considerable decline of the net domestic public debt from 46.7 percent to 50.5 percent of GNP helped reduce the country's gross external debt. Turkey has shown a remarkable economic performance during 2006-07. The government has succeeded in maintaining prudent fiscal discipline, which resulted in a stable macroeconomic environment. Reduction in government debt facilitated sustained economic growth and increased FDI inflows.
Total Government Gross Debt (National Currency) for Turkey in 2010 is 481.29 Billion.
In the forecasted year, 2011, Total Government Gross Debt (National Currency) for Turkey will be 516.80 Billion, which is 7.38% more than the 2010 figure.

3.5. The balance of trade of Goods and Services

Diagram 5- Balance trade of Goods & Services (Turkey)

<u>Balance of Trade Definition</u>

The balance of trade (or net exports, sometimes symbolized as NX) is the difference between the monetary value of exports and imports of output in an economy over a certain period. It is the relationship between a nation's imports and exports. A positive balance is known as a trade surplus if it consists of exporting more than is imported; a negative balance is referred to as a trade deficit or, informally, a trade gap. The balance of trade is sometimes divided into a goods and a services balance.

The balance of trade forms part of the current account, which includes other transactions such as income from the international investment position as well as international aid. If the current account is in surplus, the country's net international asset position increases correspondingly. Equally, a deficit decreases the net international asset position.

Analysis

Turkey reported a trade deficit equivalent to 15.3 Mrd ECU/EUR in 2010. Turkey major exports are: textiles and clothing, automotive, iron and steel, white goods and chemicals, pharmaceuticals and ships. Turkey imports mainly machinery, chemicals, semi-finished goods, fuels and transport equipment. Its main trading partners are: European Union (57% exports, 40% imports), Russia and The United States. As traditional Turkish exports lose their competitiveness, new export lines emerge. Yet, these are mostly import-dependent, assembly-line industries, such as automotive parts and consumer durables. They use the advantage of cheap import materials, get assembled in Turkey at low value added and then are re-directed for export. Thus, being mostly import-dependent, they have a low capacity to generate value added and employment. As traditional exports dwindle, the newly emerging export industries are not vigorous enough to close the trade gap.
When the data for export and import are classified, a downward trend in the balance of trade occurred started from 2001 to 2007. This decrease drives to a trade deficit starting from the third quarter of 2002 and continuing until 2010. Consequently, starting in the end of 2002 Turkey has witnessed expanding current account deficits, with the figure in 2004 reaching a record-breaking magnitude of $23.1 billion. Regarding to this notification, it is seen that the effect of global financial crisis occurred in this period. The sharp increase in energy prices significantly contributed to the deterioration in the current account deficit. However, even filtering this effect out, the deficit registered in the aforementioned period was still high. Thus, the strong pressures towards deterioration of the current account balance continued to persist over 2006 onwards. Turkey's current account deficit accounted for 7.9 percent of Turkey's GDP in 2006. The main sources of surplus were (i) increases of energy and commodity prices, and (ii) high growth of imports due to the rise in production and domestic demand. Appreciation of the Turkey's national currency unit, New Turkish Lira (YTL,) has added to widening of the current account balance. The resulting gap was financed by FDI (Foreign Direct Investment) mainly, that covered nearly 50 percent of the deficit. High imports were due to consumer expectations of the global increase in prices for energy and food. In addition, booming housing construction in traditional trading partner economies, notably, of the Middle East, Central Asia and the Commonwealth of Independent States (CIS) drove import prices in construction materials and equipment high. On the other hand, the effect of this crisis has begun to decrease from the beginning of 2007 and export and import have partly begun to show an increase. During the period 2008 -2009, it revealed that the values of import proportionally decreased more quickly than the values of export. This fact means that in the years the country grew, the important values increase more quickly; in this case the foreign trade deficit grows and current account deficit increases. In addition, another result this situation has revealed, is that the source of export and thus of growth is import.
As imports contracted faster than exports throughout 2009, net exports made a positive contribution to growth. Nevertheless, parallel to the economic recovery in the last quarter of 2009, imports grew faster than exports. Under the assumption that the recovery in demand in Turkey's largest trade partner, Europe, will take a long time, the rise in exports is expected to be gradual. In 2010, imports once again started to climb rapidly. Meanwhile, the recovery in exports, which displayed a relatively limited decline during the crisis, lags behind due to the weak course of external demand conditions and this pushes the foreign trade deficit up. More analytically, abundant low–cost external savings relaxed residents' borrowing constraints and, combined with the inadequate competitiveness due to structural factors, pushed up imports and suppressed exports. As a result, the current account deficit is more than double in 2010, nearly 6 percent of GDP. Inadequate competitiveness is also drawing capital away from tradable sectors and into real estate, energy, and retail trade. Within this framework, the current trend is expected to continue throughout 2011 and net exports are expected to have a negative effect on growth.

Expectations for 2011

Low interest rates in advanced countries, favorable near-term growth prospects and healthy balance sheets of the Turkish government and banks, as well as less-leveraged households than in most of Europe, will continue to underpin inflows. Inadequate competitiveness, the rising current account deficit and potentially-volatile short-term inflows highlight Turkey's continued exposure to market sentiment, including contagion concerns from problems in Europe. Most inflows next year will continue to be intermediated through banks, driving credit, domestic demand, and imports. In all, for 2011, growth is expected to reach 4½ percent, the current account deficit to widen to around 6½ percent of GDP, and year-end inflation to reach 6½ percent.

	BEFORE IMF																								
	1998	1999	Variance% 1998-1999	2000	Variance % 1999-2000	2001	Variance % 2000-2001	2002	Variance % 2001-2002	2003	Variance % 2002-2003	2004	Variance % 2003-2004	2005	Variance % 2004-2005	2006	Variance % 2005-2006	2007	Variance % 2006-2007	2008	Variance % 2007-2008	2009	Variance % 2008-2009	2010	Variance % 2009-2010	
TOTAL UNEMPLOYMENT	1337,8	1542,5	15,30%	1191,3	-22,77%	1574,5	32,17%	2105,8	33,74%	2177	3,38%	2139	-1,75%	2030	-5,10%	1952,8	-3,80%	2013,3	3,10%	2274,5	12,97%	3047,1	33,97%	3049	0,06%	UNIT=1000
GROSS DOMESTIC PRODUCT (AT CURRENT MARKET PRICES)	239	233,9	-2,13%	289,9	23,94%	217,9	-24,84%	243,4	11,70%	268,3	10,23%	314,6	17,26%	386,9	22,98%	419,2	8,35%	472	12,60%	498,4	5,59%	438,4	-12,04%	517,5	18,04%	UNIT=Mrd ECU/EUR
NATIONAL CPI	39,2	64,6	64,80%	100	54,80%	154,4		223,8	44,95%	280,4	25,29%	310,1	10,59%	341,6	10,16%	377,5	10,51%	410,5	8,74%	453,4	10,45%	481,7	6,24%	525,1	9,01%	NIT=(2000=100)
General government consolidated gross debt: Excessive deficit procedure (based on ESA 1995) former definition (linked series)	N/A	N/A		N/A		146,8		148,6	1,23%	172,8	16,29%	180,4	4,40%	213,2	18,18%	187,5	-12,05%	193,6	3,25%	174,4	-9,92%	201,4	15,48%	234,9	16,63%	IT=Mrd ECU/EUR
Net exports of goods and services at current prices (National accounts)	2,8	0,4	-85,71%	-8,7	-2275%	9	-203,45%	4	-55,56%	-2,8	-170,00%	-8,3	196,43%	-13,5	62,65%	-20,6	52,59%	-24,4	18,45%	-22,1	-9,43%	-9,7	-56,11%	-15,3	57,73%	IT=Mrd ECU/EUR

Articles:

1. Turkey—2010 Article IV Consultation and Post-Program Monitoring: Preliminary Conclusions.

2. Financial Stability Report May 2010, VOLUME: 10.

3. Turkey—Second Post-Program Monitoring Discussions, Preliminary Conclusions December 17, 2010

4. Anatomy of banking crises in developing and emerging market countries by Rupa Duttagupta, Paul Cashin.

5. Transformation of the Turkish Financial Sector in the Aftermath of the 2001 Crisis

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4. Overview of the Turkish banking system

The following factors have contributed to the decline in the financial intermediation function of the banking sector.

- Macroeconomic Instability: The high and volatile inflation rates of 1990s, the boom-bust cycles of economic growth and the fragility of external capital inflows.
- High Public Sector Deficit: The increase in public sector deficit and its financing with high real interest rates from the domestic financial markets led to a sharp decline in the allocation of resources to the real sector.
- Systemic Distortions Created by the State Banks: The financial health of the state banks deteriorated rapidly as a result of the accumulation of duty losses and inefficient management.
- Inadequate Risk Assessment and Management Systems: The banks' risk assessment and management systems were not developed adequately. The lack of independent and effective supervision and regulation and the existence of deposit insurance, which created a serious moral hazard problem, contributed to the weaknesses in risk management.

As a result of all these developments, the Turkish banking system as a whole has been subject to the following structural weaknesses in 2001: (a) Inadequate capital base. (b) Small and fragmented banking structure. (c) Dominance of state banks in total banking sector. (d) Weak asset quality. (Concentrated credits, mismatch between loans and provisions) (e) Extreme exposure towards market risk. (Maturity mismatch, FX open position) (f) Inadequate internal control systems, risk management and corporate governance. (g) Lack of transparency.
The Banking Law (No. 4398) is a corner stone in the banking sector legislation and regulations issue, which was effective as of June 1999, since it delegates Banking Regulation and Supervision Agency (BRSA) that started to operate in August 2000 as the independent authority to regulate and supervise the banking sector in Turkey.

4.1. 1999 - Economic Program

The Turkish economy has encountered frequently economic crises during the 1990s. Turkey's previous economic program (1999) highlights three main reasons behind these crises: The increasingly unsustainable nature of debt burden; a high and inertial inflation, and structural flaws in the financial

sector stemming from the mismanagement of state banks and the weakness of the banking system as a whole.
When we look at the Turkish Economy as a whole, the problems indicated below compelled a comprehensive economic program to struggle with:
1. Inflation is the most serious problem facing Turkey. The history of Turkish inflation shows that for more than 20 years inflation has been gradually increased, never fallen below two digits.
2. The fiscal imbalances have also caused difficulties in financing the deficit. While the amount of external financing available for the budget deficit has declined, the ratio of cash domestic debt to GNP also grew rapidly during the 1990s and finally reached 24 percent of GNP in 1999. This huge amount of debts pushed the real interest rates up and they reached 32% on average, while annual growth rates averaged less than 4% between 1995-2000.
3. In addition to the Turkish government's failure to complete the liberalization efforts that initiated in the early 1980s, political instability and short-lived coalition governments prevailed during 1990s, thereby exacerbating Turkey's economic problems.
4. The coalition government took office at a time when Turkey was still under prolonged affects of deep economic recession triggered by the world financial crisis, such as the Asian and Russian crises.
5. Both world crisis and the devastating effects of two major earthquakes of August and November 1999, dragged Turkey into recession and in 1999 the economy shrank by 6.1% percent.
6. EU candidacy further stimulated domestic pressure on the government to undertake structural reforms in Turkey.
7. Weak financial system, especially banks already began to create problems like bankruptcies.
Because of above-mentioned problems, a radical program was urgently needed and government prepared a comprehensive "disinflation program" backed up by the IMF and the World Bank.

The main pillars of the Program could be summarized as:

1. A tight fiscal policy focusing on improving the primary surplus

2. Speeding the structural reforms and privatization efforts

3. An income policy geared to targeted inflation.

4. A pre-announced exchange rate basket.

The essential goals of the disinflation program were:

1.To bring down the CPI inflation to 25 % by the end of 2000, 12 % by the end of 2001, and 7 % by the end of 2002, via coordinated actions of consistent, powerful, credible, and persistent fiscal, income, monetary, and exchange rate policies, all supported by relevant structural reforms.

2. To reduce real interest rates to reasonable levels.

3. To increase the growth potential of the economy.

4. To provide a more effective and fair allocation of the resources in the economy.

Within this context and content the program supported by the IMF with a stand-by agreement for three years, and the Central bank of Turkey announced the monetary and the exchange rate policy principles for the following three years at the end of 1999.
"According to the program the exchange rate basket which was composed of 1 US dollar+0.77 EURO would be announced on a daily basis covering an one-year period. A pro-active role was assigned to monetary policy based on reduced rate of exchange rate depreciation in line with the targeted inflation, providing a nominal anchor for inflationary expectations. The exchange rate commitment was supported by strong fiscal adjustment and consistent income policies in the government sector." This meant that a strong government support would be compulsory for convincing the market sentiments to break inflationary inertia and the pre-announced quarterly targets would create market confidence to adopt the official inflation target, which in turn would help to lower the inflation rate.
To impede being locked in the rigid monetary snake beyond the disinflation stage, a pre-announced exit strategy had been included in the program. This exit strategy would allow increasing exchange rate flexibility over the time within a predetermined path and a specific time horizon. The gradual shift towards a more flexible exchange rate regime (with widening symmetric bands around the pre-announced exchange rate path) was introduced in July 2001 completed at the end of 2002.

4.2. Initial Performance: A Period Of Success (June 1999-September 2000)

1. At the end of 2000, the inflation targets which were envisaged in the program, could not be reached, an undeniable progress was made in the fight against inflation. The rate reached its lowest level (WPI-Wholesale Price Index fell to the %30s level) ever in the last 14 years.

2. The government initially made a good effort to tackle with the structural problems piled up throughout 1990s. Between June and September 1999, the government successfully enacted legislation that included reform of the country's banking sector and social security system, and codified procedures for the submission of foreign investment contracts to international arbitration.

3. The privatization program has started with a great enthusiasm. In the first ten months of 2000, a total of 5.2 billion US dollars (2/3 of the targeted value of 7.6 billion US dollars for 2000) was realized from sale of the POAS (Petroleum retailer), TUPRAS (Oil refinery), and GSM license (Mobile telephone). This amount was higher than the total privatization revenues of last 15 years.

4. There had been an impressive progress on the fiscal side. During the first ten months of the year, revenues increased beyond projections while discipline on spending was maintained. A significant amount of primary surplus was achieved which would help to reduce the interest burden on the budget in the long term and stabilize the debt to GNP ratio. The most welcomed outcome of the Stabilization Program had been the dramatic decline in interest rates due to increasing confidence for program and decreased exchange rate risk. The average interest rates during the first ten months of the year fell to 35% percent, down from 100% percent of the previous year.

5. The target for external borrowing in 2000 had also been achieved thanks to increased investor confidence as a result of EU candidacy, and a credible program backed by the IMF Stand-by Arrangement.

6. The program was successful in growth side, too. While the economy shrank by 6.4% in 1999 because of above-mentioned problems, by the end of year 2000, the economy expanded by 6.1%, particularly as a result of the increase in domestic demand.

4.3. Reasons and Evolution of Crises

We can summarize the reasons of November 2000 and February 2001 crisis as shown below:

- Disputes and friction among the coalition parties about timing and modeling of some structural reforms and privatization delayed the reforms. This affected the confidence for government both in country and abroad.
- The combined effects of some internal and external factors created a huge current account deficit. The sharp rise in oil prices, the deterioration of Euro against dollar, and much less international capital inflows than expected were deteriorating external factors. On the other side, there was a boost in demand for both domestic and imported goods because of bank credits, delayed imports from last year, and economic growth. Banks had excess credit sources, that they mostly borrowed from European banks as syndication credits to lend the government with a high interest expectation. Since interest rates on government papers fell sharply they channeled these excess sources to privates and firms. The rising demand and inertia caused the inflation remain higher than projected. These developments resulted in appreciation of Lira and thereby depreciation of Turkish exports sectors and then current account deficit reached to the dangerous levels, 4.2% of GNP. As a result, all these factors arose the concerns on durability of crawling peg that inherently target for speculative attacks.
- Additionally, IMF's refusal to give the third and fourth trenches because of delayed structural reforms culminated the concerns on the program at its zenith.

4.4. Ongoing aftershocks and reform efforts on banking system in 2002

Identified as the key trigger to the latest financial crisis, but also part of a much wider problem, the banking sector has been placed at the forefront of the structural reform. The "Banking Sector Restructuring and Rehabilitation Program" implemented by BRSA, can be summarized as follows:
The main goal of the Program is to eliminate the distortions in the financial sector and to adopt regulations to promote an efficient, competitive and sound banking sector. The strategy under this program rests on four main pillars: the financial and operational restructuring of state banks, the resolution of the banks under management of the Savings Deposit Insurance Fund (SDIF) banks, the strengthening of private banking and the strengthening of the legal and regulatory environment.

a) The financial and operational restructuring of state banks

As stated before, the financial health of the state banks deteriorated rapidly as a result of the accumulation of duty losses and inefficient management and this situation is stemming especially from the political structure of the country. The state banks are always seemed as the most important mechanism for public sources to share between and to canalize to the supporters of a political party. It was stated with the program that the state banks would no longer be forced to run duty losses. In the future, any support provided via the state banks will be budgeted and will not lead to a loss by the state banks. The management of the two largest state banks, *Ziraat* and *Halk*, is strengthened through the establishment of a common and politically independent governing board. The new management began to apply commercial criteria to operations and pricing policies that ensure profitability. The board was also formulating plans for the privatization of these banks; the banks were to be privatized within three years. The banking license of *Emlak Bank* was withdrawn and its liabilities and remaining assets were transferred to *Ziraat Bank* at the end of May 2001. The privatization process of *VakifBank* was following as soon as market conditions allowed. Once financial restructuring was completed, the state banks would be required to fully comply with all BRSA regulations applicable to commercial banks.

b) The resolution of Savings Deposit Insurance Fund (SDIF) banks

The number of banks under SDIF increased from 2 at end-1998 to 8 in 1999 and to 11 by end-2000. But, with an effective strategy including merging, selling and license withdrawing, the number of banks under SDIF is just 2 as of the date given. But it must be stressed that, these banks had heavy costs for Turkish economy and as of May 14, 2001 the Turkish Treasury issued USD 8,007mn FX denominated securities and TL 8,529 trillion in domestic currency to the SDIF. The Treasury has supplied in total TL 16,3 quadrillion of securities to SDIF.

b.1) Banks taken over by the SDIF 1998-2003

Bank	*Takeover date*	*Status*	*Resolution date*
Bank Expres	Dec 12, 1998	Sold to Tekfenbank	Jun 30, 2001
Interbank	Jan 7, 1999	Merged with Etibank	Jun 15, 2001
Esbank	Dec 21, 1999	Merged with Etibank	Jun 15, 2001
Egebank	Dec 21, 1999	Merged with Sümerban	Jan 26, 2001
Yurtbank	Dec 21, 1999	Merged with Sümerban	Jan 26, 2001
Yaşarbank	Dec 21, 1999	Merged with Sümerban	Jan 26, 2001
Sümerbank	Dec 21, 1999	Transferred to Oyakban	Jan 11, 2002
Etibank	Oct 27, 2000	Merged with Bayındırbank	Apr 4, 2002
Bank Kapital	Oct 27, 2000	Merged with Sümerbank	Jan 26, 2001
Demirbank	Dec 6, 2000	Shares transferred to HSBC	Oct 30, 2001
Ulusalbank	Feb 28, 2001	Merged with Sümerbank	Apr 17, 2001
Iktisat Bankasi	Mar 15, 2001	Merged with Bayındırbank	Apr 4, 2002
Sitebank	Jul 9, 2001	Shares transferred to Novabank	Jan 25, 2002
Bayindirbank	Jul 9, 2001	Restructured as "Birleşik Fon Bankası" Under SDIF	Dec 7, 2005
Kentbank	Jul 9, 2001	Merged with Bayındırbank	Apr 4, 2002
EGS Bank	Jul 9, 2001	Merged with Bayındırbank	Jan 18, 2002
Tarişbank	Jul 9, 2001	Shares transferred to Denizbank	Dec 27, 2002
Toprakbank	Nov 30, 2001	Merged with Bayındırbank	Sep 30, 2002
Pamukbank	Jun 19, 2002	Transferred to Halkbank	Nov 12, 2004
Imarbank	Jul 3, 2003	Decision to liquidate taken	

Source: SDIF

c) The Strengthening of Private Banking

The private banks also had significant losses in the aftermath of the crises that led to a general loss of confidence in the financial sector. The confidence in markets was expected to be restored with the strict implementation of the "Banking Sector Restructuring and Rehabilitation Program". The rehabilitation of the state and SDIF banks is now significantly reducing the pressure on interest rates and provides a level playing field for the banking sector.

On the other hand, some specific measures have been taken to promote the soundness of the private banks and the most important ones are: The BRSA has introduced an enhanced monitoring system for the liquidity position and interest rates in all banks to prevent their engaging in unsound practices. Also another important step was that BRSA has received, on an individual bank basis, comprehensive Letters of Commitment regarding the bank's business plan, projections and if necessary the restructuring/rehabilitation strategy.

d) Strengthening of the legal and regulatory environment

The legislative amendments and institutional changes aim to promote efficiency and competition, facilitate sound banking practices and thus establish confidence in the sector. Some of the legislative changes have been incorporated to the amendments to Banking Law. In this context:

- The legal amendment defining "consolidated own funds" was introduced to allow consolidation of related parties lending and make the regulation fully consistent with European Union standards.
- Banks' non-financial subsidiaries were limited to 15% of total net worth and the total sum of all such subsidiaries were limited to 60% of total net worth with a transition period until 2009.
- Forward contracts, option contracts and other similar derivative type operations would be included under the definition of "credit" to limit the overall exposure to individual and related counter parties.
- Corporate tax deductibility of specific provisions was clarified.

The BRSA introduced the following regulations and take prompt actions to strengthen supervisory infrastructure:

- In order to prevent loan concentration, direct and connected lending would be amalgamated in the calculation of lending limit to a group.
- The establishment of Banks' Internal Control and Risk Management System, which was effective as of January 1, 2002, was closely monitored.
- Banks were obliged to take into account market risks in the calculation of capital charges on an individual basis by January 1, 2002 and on a consolidated basis by July 1, 2002.
- Banks were encouraged to utilize independent external audit in assessing their internal control and risk management systems as well as loan and trading portfolios.
- Offshore banks owned by Turkish entities were supervised in cooperation with the host country supervisory agency.
- Turkish banks' foreign branches were subject to on site supervision.

4.5. The period following the 2000-01 crises

The period following the crises was marked by a successful disinflation program sustained through inflation targeting and fiscal discipline in Turkey. The paper **"Bank Lending in Turkey: Effects of Monetary and Fiscal Policies"** studies the impact of monetary and fiscal policies on credit growth during this period. Using quarterly bank-level data covering 2002-08, **Burcu Aydin and Deniz Igan1** find evidence that liquidity-constrained banks have sharper decline in lending during contractionary monetary policies and that crowding-out effect disappears more for banks with a retail-banking focus when fiscal policies are prudent. The results are statistically weak; suggesting that bank lending channel is not strong in Turkey and government finances have limited direct impact on credit.

To sum up, **Burcu Aydin and Deniz Igan1** study the impact of monetary and fiscal policies on the growth of credit to the private sector in Turkey. By gathering detailed bank-level data from the last quarter of 2002 to the first of 2008, they are able to use the cross-sectional variation in banks liquidity positions and business models to disentangle the supply- and demand-side effects. They show that the liquidity-constrained banks have sharper decline in lending during contractionary monetary policies and that crowding-out effect disappears more for banks with a retail-banking focus already in place when the government adopts fiscal discipline. The empirical findings suggest that bank lending channel of monetary policy and fiscal policy transmission is particularly important for credit denominated in domestic currency. Furthermore, a contraction in any of these policies leads banks to extend more of short-term credit as the importance of liquidity constraints and retail-banking focus diminishes for loans at short-term maturity. Lastly, the impacts of monetary and fiscal policies are limited for loans extended in foreign currencies and for foreign banks.

4.6 Composition of Banking Sector as of today

The Turkish banking sector consists of deposit banks, development and investment banks, and participation banks that operate according to profit/loss sharing principles. The number of banks operating in the Turkish financial sector, which was 49 by end-2009, remained unchanged in March 2010. The number of branches, which was 9,308 at end-2008, increased by 271% to 9,579 in 2009 and later rose by another 20% to reach 9,599 by March 2010. In 2009, the number of banking sector staff increased by 1,535% compared to end-2008 to become 184,205, whereas this number increased by 2,414% in the first three months of 2010 and reached 186,619 by March 2010.
According to the Financial Stability Report on May 2010, by the end-2009, the total asset size of the banking sector grew by 6.9 percent in real terms compared to the end of previous year and reached TL 834 billion, while it climbed by 16.5 percent to 561 billion in USD terms. While the said figure increased by 3.2 percent in nominal terms compared to end-2009, it decreased by 0.7 percent in real terms to TL 861 billion by March 2010 and became 568 billion in USD terms with an increase of 1.3 percent.

The ratio of the Turkish banking sector's asset size to GDP increased from 77.1 percent at end-2008 to 87.4 percent at end- 2009. The share of the Turkish banking sector within the GDP is higher than that of Poland and Romania, but lower than that of EU countries. By March 2010, of the 49 banks in the Turkish banking sector, 32 are deposit banks, 13 are development and investment banks and 4 are participation banks, thus pointing to the prevalence of deposit banking in the Turkish banking sector. The following table compares the bank's performance in the year of crisis 2001 and 2010.

Bank's performance in 2001 and 2010			
	2001	2010	
Loans (TL billion)	38	526	
Deposits (TL billion)	110,4	617	
Number of empoyees (thousands)	140,88	191,18	
Number of branches (thousands)	6,98	10,067	
Total assets (TL billion)	173,4	1,01	
Profit (TL billion)	-10,5	21,9	
Number of banks	67	49	

4.7 CAMELS rating system

The CAMELS ratings is a US supervisory rating of the bank's overall condition used to classify the nation's fewer than 8,000 banks. This rating is based on financial statements of the bank and on-site examination by regulators like the Fed, the OCC and FDIC. The scale is from 1 to 5 with 1 being strongest and 5 being weakest. These ratings are not released to the public but only to the top management of the banking company to prevent a bank run on a bank which holds a low CAMELS rating.

It is being used by the United States government in response to the global financial crisis of 2008 to help it decide which banks to provide special help for and which to not as part of its capitalization program authorized by the Emergency Economic Stabilization Act of 2008.

Credit unions in the United States use the similar CAMEL rating system.

The components of a bank's condition that are assessed:

- (C) Capital adequacy,
- (A) Asset quality,
- (M) Management,
- (E) Earnings,
- (L) Liquidity and
- (S) Sensitivity to market risk

Based on these features Credit rating agencies, rate instruments proposed to issue by the respective company.

The paper **CAMELS Rating System in the Context of Islamic Banking: A Proposed 'S' for Shariah Framework** by A. Sarker reviews the CAMELS standards for off-site supervision of banking institutions, and their compatibility with Turkey's setup. It puts forward a Shariah Matrix to elicit comments and suggestions from Shariah experts.

Turkey's banking has existed in Bangladesh for more than two decades, and is growing rapidly. Yet, Islamic banks in the country continue to be supervised according to the secular supervisory and regulatory systems that are used for traditional banks and financial institutions.

•Lack of enforcement and supervision in line with Turkey may lead Turkey's banks into systemic Shariah distress;

•Existing rules, regulations and guidelines with respect to Islamic banks are inadequate;

•Similar supervision for conventional and Turkey's banks does not take into consideration the peculiar characteristics of Islamic banks

Banking supervisory agencies around the world have been utilizing CAMELS rating system (or variants) for many years. In the study "CAMELS Rating System and Forecasting the Financial Failure in the Turkish Commercial Banking Sector"by Murat Hinko, financial ratios were used to calculate representative CAMELS ratings and components for the period 1996 - 2000. The financial ratios, which were used to calculate the CAMELS components, were utilized to predict the transfer of commercial banks in 2001 to the SDIF by the use of discriminant analysis, logistic regression and neural network models. Findings of the study presented that it was not possible to predict the transfer of a bank to SDIF by the use of CAMELS ratios.

5. Literary Review (b)

The phenomenal financial expansion of the last decades has been characterized by an exacerbation of systemic instability and an increase in the frequency of financial crises. The literature on financial crises has developed concomitantly, but despite a large number of papers written on this subject economists are still struggling to understand the underlying determinants of these phenomena.
For this literary review, I tried to collect a sample from the literature on the Turkish bank crisis in order to give an overview of the prevailing views.

John Maynard Keynes identified "the three evils of the economy" as poor income distribution, volatility of expectations and high unemployment. When all three factors come together, the economy will end up in a state of disappointment, and stability will vanish. In 2001, the Turkish economy can be characterized as one where uncertainty is at a maximum, income is poorly distributed, and the unemployment rate is kept mild. From that view of angle, it can be said that Turkey entered the devil's triangle beginning from late 90s and stayed in this triangle until 2003.

Fatih Özatay and **Güven Sak** by analyzing the performance of the economy in the aftermath of the crisis, they argue that the Turkish crisis is hardly a second-generation type. In their article "THE 2000-2001 FINANCIAL CRISIS IN TURKEY" they provide strong evidence that point to the weakness of the banking sector. Furthermore, they point to two types of dichotomy in the banking sector: between private and state banks and within the private banks.
In addition, they point out the major differences between 1999 and 2000. First, as opposed to the managed floating exchange rate system of 1999, there was a pre-announced crawling peg system in 2000. Second, current account registered a record high level of deficit in 2000. Third, given a weak banking system and promises to strengthen the system, delays in reforming the banking sector increased tensions in the markets in the second half of 2000. Fourth, taking over of some of the private banks starting from September and simultaneous sensational criminal investigations for some of the bankers, made it crystal clear that the banking system was not homogenous rather dichotomized as 'good' and 'bad' banks. This intensified rumors about which banker and which bank was in the line. As a result, in the second half of November 2000, 'good' banks closed their credit lines to 'bad' banks. In the paper, it is argued that the first two differences were not sufficient to trigger a crisis. Main igniting factors were the delays in reforming the banking sector and the actions that caused the dichotomy in the banking sector to come to the surface.
Finally, they note that the root cause of the fragility of the banking system was high public sector borrowing requirement and the way it was financed. Note that especially starting from early the 1990s, there was no close link between rising deficits and inflation. The main reason was that budget deficits were mainly financed through government securities. However, the sustainability of this financing mechanism was conditional on the continuation of demand for government securities. In the absence of a program that reduces borrowing requirement, a halt in demand would force authorities to monetize and hence cause a jump both in the exchange rate and inflation rate. This led economic policy makers to do their best to prevent a decline in demand for government securities. Both the upward trend in

government debt instruments portfolios of the banks and such policies increased the vulnerability of the banking system.

NAZIM KADR EK NC & **KORKUT ALP ERTÜRK** in their article “Turkish Currency Crisis of 2000–2001” note that Turkey’s exchange rate based stabilization program had collapsed within just 11 months of its implementation in the midst of a liquidity crunch in November 2000 caused by a reversal in the capital inflow. The onset of the stabilization program created ample opportunities for speculative investors to make relatively safe one-sided bets, and the initial success of the program in bringing down interest rates implied substantial capital gains over securities obtained in 1999 and early stages of the program. It was only natural that speculative investors would take the opportunity to realize these gains while the firm exchange rate commitment was still in place. The program failed to deal with this contingency effectively, assuming that as long as it was implemented faithfully, long-term investors would be forthcoming to takeover positions speculators would want to unload. That assumption proved disastrously wrong.

Irfan Civcir and **Anıl Akc** in their article “Inflation targeting and the exchange rate: Does it matter in Turkey?” attempt to shed light on question to what extent exchange rate developments still continue to influence monetary policy, even under inflation targeting. Using the VAR model, their study shows that there has been strong pass-through during the period 2002-2005. Moreover, in the post-crisis period, exchange rate has been the main reaction variable for the CBRT.

Burnside, **Eichenbaum** and **Rebelo** (2001) argue that a principal cause of the 1997 Asian crisis was large prospective deficits associated with implicit bailout guarantees to failing banking systems. Economic agents expect that these future deficits are going to be financed by money creation, which leads to a collapse of the fixed exchange rate regimes. The Turkish case has also some similarities with prospective deficits models. Given the fragility in the banking sector in the period immediately preceding the crisis, it is no surprise that the crisis triggering factors were closely related to the banking sector and its mode of carrying government debt instruments portfolios.

Prof. Dr. **Ahmet KÖSE** in his study entitled “FOREIGN BANK PRESENCE AND DOMESTIC BANK PERFORMANCE IN TURKISH BANKING SYSTEM” investigates the effect of the foreign bank presence on the performance of domestic banks in the Turkish Banking System. The findings of the study that has been conducted in the period 2004-2007, using the data of 13 deposit banks, have shown that interest spreads; non-interest incomes and overhead costs of domestic banks vary depending on the foreign bank presence; however no significant differences have been observed in terms of profitability and loan loss provisions. When evaluated together, even though the study has displayed some evidence on the effects of the foreign bank presence on the competition in Turkish Banking System, its effects on domestic banks can be considered negligible in terms of profitability and risk taking.

E. NUR OZKAN-GUNAY and **ARZU TEKTAS** in their study “EFFICIENCY ANALYSIS OF THE TURKISH BANKING SECTOR IN PRECRISIS AND CRISIS PERIOD: A DEA APPROACH” assesses the technical efficiency of nonpublic commercial banks between 1990 and 2001 following the DEA model (Data Envelopment Analysis). The study reports a declining trend in the number of efficient banks and the mean efficiency of bank subgroups. It analyzes sensitivity to the output variables and depicts consistency between the model proposals and supervisory agent decisions. Thus the DEA model can be a tool to detect and improve the sources of inefficiency by bank management and supervisory agents. Structural weaknesses accumulated throughout the years and the three crises that Turkey experienced in the past decade increased the fragility of the Turkish banking system. Consequently, 25% of the domestic commercial banks were taken over by SDIF between 1997 and 2001. These developments make it worthwhile to make an efficiency analysis and assessment for the Turkish banking sector for the precrisis and crisis periods. The study reports that the number of efficient banks and the mean efficiency of both models in the sample have a declining trend throughout the analysis period. The study of banks in the pre-crisis and crisis of the 2000 and 2001 period has shown that most of the banks that were taken over by SDIF were relatively inefficient compared to non-failure domestic commercial banks in the sample set. The results indicate the consistency between the model proposals and supervisory agent decisions. Thus, the DEA model can be used as a tool to

detect and improve the sources of inefficiency by both bank management and supervisory agents. This study covers the precrisis period immediately preceding the November 2000 and February 2001 crises.

Teoman Pamukcu and **Erinc Yeldan Bilkent** in their article "Country Profile: Turkey Macroeconomic Policy and Recent Economic Performance" note that Turkish growth pattern over the post-2001 crisis period displays two key characteristics: first, it is speculative-led in nature; second, it has limited job creating capacity.

Yet, beyond this observation, the tacit dilemma faced by the Turkish authorities is simple, yet bitter: in order for the output growth to be continued, the economy had been addicted to short term foreign finance which in turn necessitates relatively high real interest rates to be offered as a "new emerging market" in the global financial markets. Yet, high real rates of interest run counter to the objective of debt sustainability via successful primary surplus operandi. Availability of cheap foreign exchange lured by attractive real returns thus far has become instrumental in reducing costs of imported intermediates and lowering inflationary expectations. It has also been the sole source of output growth in an otherwise contractionary macroeconomic environment.

However, the fact that such sources of growth virtually depend on the speculative caprices of the financial arbiters, and that the increased fragility of the Turkish macroeconomic environment signals an unsustainable output performance for the days to come. Such "speculative-led" characteristics of the Turkish growth cycle resemble the 1990-93 and the 2000.I-2001.I cycles of (unsustainable) growth—crisis—post crisis adjustment, with bitter lessons that hopefully should have been well-understood by now. Yet, the pleasures of cheap foreign exchange bonanza together with high real rates of interest are too dear for the myopic speculators, domestic and foreign alike and the dangers of such speculation-led accumulation seem, unfortunately, not to be appreciated yet by the so-called market participants.

Recurring financial crises in the semi-periphery have raised serious question marks concerning the role of the IMF in the era of financial globalization, particularly in the aftermath of the Asian Crisis of 1997.

The paper" EMERGING MARKET CRISES AND THE IMF:RETHINKING THE ROLE OF THE IMF IN THE LIGHT OF TURKEY'S 2000-2001 FINANCIAL CRISES" by **Emre Alper** and **Ziya Onis** attempts to provide a critical and at the same time a balanced perspective on the Fund's involvement in crisis-ridden emerging markets with special reference to the recent Turkish experience. The analysis points towards both the limitations underlying the Fund's approach itself as well as some of the dilemmas faced by the organization in trying to reform the economies of debtor countries given the nature of the domestic political environment in the countries themselves. It is also argued that the kinds of reforms promoted by the Fund are necessarily incomplete in so far as they focus only on the regulatory role of the state, neglecting issues relating to income distribution and longer-term development in the process.

Emre Alper and Ziya Onis concluding that crisis-ridden countries need to develop a domestic political base to "internalize" the kind of reforms sponsored by the IMF, which are important in terms of their ability to benefit from the process of globalization. Secondly, the countries concerned need to extend their horizons and develop their domestic capacities in areas such as income distribution and longer-term competitiveness, areas that not traditionally emphasized by the Fund.

Erinc Yeldan in his article "THE IMF-DIRECTED DISINFLATION PROGRAM IN TURKEY: A Program for Stabilization and Austerity or A Recipe For Impoverishment and Financial Chaos?" notes that the program itself has achieved modest gains in disinflation, and as such it should be seen as a program for maintaining price stability at the expense of de-stabilization of the Turkish economy along with worsening of its financial and external balances. The Central bank was deprived of all its traditional tools of austerity and crisis management and was left defenseless against both the "speculative attacks" and the "sudden stops". Under these conditions it has to be no surprise that the viability of the program would finally suffer at one point when the "uneasy speculators" shift focus, and decide to reverse their flows, leaving the incipient country illiquid and dried out.

Ahmet Ertugrul and **Erinc Yeldan** "ON THE STRUCTURAL WEAKNESSES OF THE POST-1999 TURKISH DIS-INFLATION PROGRAM" highlight the structural weakness of the exchange rate backed disinflation program as manifested in its liquidity creation mechanism in a small and fragile financial system such as Turkey. They document the fragility indicators of the Turkish banking system, and show that the disinflation program led to an increase of the vulnerability of the banking system throughout 2000/2001. Given the structural characteristics of the Turkish banking system, they argue

that the orthodox policy of fully connecting the monetary expansion and liquidity requirements of the domestic economy exclusively to the speculative short term capital flows was clearly a design flaw, overseen by the IMF's technical expertise.

The collapse of many banks during the 2001 crisis cost the state $39.3 billion. This amount was equal to 26.6 percent of the total gross domestic product (GDP) in 2001 and to 20 percent of the total debt stocks at the time, showing the scale of the cost of the 2001 crisis to the Turkish economy.
The banking sector went through a serious restructuring following the 2001 crisis, and a large number of bank employees who lost their jobs failed to get their jobs back when the crisis ended. Turkey had 170,401 bank employees in 2000. This figure fell to 137,495 in 2001. Another 14,000 bank employees lost their jobs in 2001, bringing the total down to 123,271 in 2002.
The Turkish banking sector was only able to return to pre 2001 crisis levels in terms of employees in 2010. Following a series of mergers and acquisitions, the number of banks in Turkey also fell when compared to the period before 2001. This meant a decrease in the number of people hired in the banking sector, also bringing about a decline in salaries. İstanbul Sunday's Zaman

Mathieu Dufour outlines an alternative framework, drawing from Post-Keynesian and Behavioral insights, in which international financial crises are seen as being a direct consequence of the way agents take investment decisions as they struggle to forecast a fundamentally uncertain future. He then applies this framework to the study of the 2000-2001 financial crises in Turkey, which is notorious for not lending itself easily to explanations based on the existing theoretical literature on international financial crises. In his view, two moments can be identified prior to the crisis: A phase of increasing financial fragility, lasting from a previous crisis in 1994 to 1999, and a financial bubble in 2000 during the implementation of an IMF stabilization program, partly predicated on the previous increase in financial fragility. His framework can account for both periods; it fits particularly well the first one and enhances the explanatory content of existing stories about the events that took place in 2000.
First, he tries to see from his survey whether managers are projecting more, less, or the same amount of investment over 2007. There seems to be an increasing number of firms willing to make more investment rather than until the end of 1995, a proportion which decreases until 1999 and rises again in 2000. He is not sure how to interpret this; the original increase in the proportion of people willing to invest seems to be consistent with my story, but the trend would appear to reverse a little too early. Second, he looks at the level of business confidence over the inter-crisis period. He cannot really discern any trend, but the values for 1999 and 2000 are unmistakably in the right direction: A downturn in confidence in 1999, followed by a major upturn in 2000 that lasts until the fall of that year. It is hard to miss the buoyant optimism of the first few months. A similar pattern can be observed in the general confidence index.

A number of confidential documents Sunday's Zaman has acquired uncover important details concerning some IMF officials' approach to the Turkish government during talks for a loan agreement following the 2001 crisis. The fund appointed an advisory team to provide technical support to the Banking Regulation and Supervision Agency (BDDK). Records show that the BDDK paid the IMF team $249,600 in return for its services.

Another document reveals a letter sent by the IMF's **Carl-Johan Lindgren** to the BDDK, uncovering details concerning the fund officials' approach towards his Turkish counterpart. Sent to Engin Akçakoca, who served as president of the BDDK at the time, a letter, dated July 8, 2001, reads that the IMF insisted Kent, EGS and Bayındırbank be transferred to the Savings Deposit Insurance Fund (TMSF) before the IMF would extend any loans to Turkey. A senior state official who asked to remain anonymous says the letter's "patronizing and menacing tone" was unacceptable.

High inflation rates were a major concern in this period; liberal foreign trade policies and a controlled exchange rate regime were the fashionable remedies proposed by international institutions. High public sector borrowing requirement (PSBR) and the resulting high interest rates, together with the government's commitment to the controlled exchange rate regime, led to immense amounts of short-term capital inflows, mostly through international interbank lending (**Uluceviz** and **Yildiran** 2008). The syndicated loans borrowed by private banks were used, to a significant extent, to acquire government securities. The excessive level of exchange rate risk assumed by some of these banks was disregarded by the Treasury.
When the government attempted to suppress interest rates while adhering to the controlled exchange rate regime (impossible trinity), capital outflow broke out in 1994. Devaluation ensued; several banks

with high open positions fell insolvent and were taken over by SDIF. A full-blown panic was prevented by launching the 100 per cent deposit insurance scheme, albeit credit crunch and economic contraction could not be avoided.
Following the crisis, with the stabilization program of the IMF, state economic enterprises and extra-budgetary-funds were reined in to enhance fiscal discipline and reduce budget deficits. However, these measures were not effective; governments had recourse to public banks to implement their rent-distributing policies. They employed Ziraat Bankası and Halkbank to extend subsidized credits to agricultural producers and small and medium sized enterprises (SMEs). The significant amount of duty losses of the public banks (close to USD 20 billion) stemming from these directed lending practices could not be backed immediately by the Treasury due to budgetary concerns.
The public banks were then obliged to raise funds from the markets, resulting in, to the detriment of the whole banking sector, very high interest rates on deposits and interbank borrowing (**Alper** and **Öniş** 2004). The number of private banks increased during this period. Not only was deficit financing a profitable business but also the private sector's access to funds was impaired due to the high PSBR. These provided motive to large industrial conglomerates for founding their own banks (**Akçay** 2001). Connected lending became prevalent. There was not sufficient regulation to put a check on this process, and political interference was abundant. As a result, the share of nonperforming loans increased sharply after 1997 (**Özatay** and **Sak** 2002). In 1999, upon rising concerns over severe deteriorations in the fiscal balance and banking sector soundness, the IMF was invoked to standby to avert an imminent crisis.
Meanwhile, twin (currency-banking) crises prevailed all around the globe especially in the second half of 1990s. Neoliberal policies were deemed to be the underlying cause. It was envisioned that, with capital account and financial liberalizations, capital would be channeled toward investment opportunities in emerging countries. However the liberalizations led to severe banking sector weaknesses in these countries where institutional quality was not high. Serious doubts were cast on the adequacy of Basel-I in controlling banks' risk taking. The Accord was severely criticized for being too crude,2 not incentive compatible, unable to respond to developments in the markets and for leading to excessive short-term capital flows to developing countries. To respond to these criticisms, some amendments were proposed in the New Accord (Basel II) in 1999. Risk groups were refined to make the Accord more risk-sensitive and a menu of regulatory approaches (standardized, internal rating based, etc.) was offered to banks to achieve incentive compatibility. Moreover, to prevent excessive short-term capital flows to emerging countries, the risk weights of the loans to these countries were based on external rating agencies' grades, and to enhance transparency and market discipline, disclosure requirements were imposed on banks.
Concurrently, the IMF was also exposed to severe criticisms, in general for offering the same set of policies to all countries, and in particular for not being able to diagnose the symptoms leading to the Asian Crisis of 1997, in which banking sector problems had played a major role (**Öniş** and **Aysan** 2000). The IMF, having identified financial sector vulnerabilities as a key component of the Asian Crisis of 1997, started laying a strong emphasis on structural reforms in the financial sector in its programs after this catastrophe. In May 1999, the IMF and the World Bank jointly launched the Financial Sector Assessment Program to remedy the prevalent banking sector deficiencies observed in member countries. These institutions' recognition of the importance of financial sector regulations were hence reflected in the IMF-supported programs carried out in Turkey. The commitment to the regulation of financial markets and the strengthening of banks is visible in the Letters of Intent to the IMF in the period after the Asian Crisis4. Also apparent in these letters is the consequence given to the independence of the Central Bank. The 2000-2001 financial crises in Turkey, however, supplied the more suitable environment to implement reforms in these directions.

Under these global circumstances, an IMF-supported program was introduced at the end of 1999 in order to curb inflation via an exchange rate anchor in Turkey. With the IMF program a new banking law was enacted (Banks Act No. 4389). To remove the fundamental shortcomings of the previous law, an independent institution, the BRSA, was established in 1999 under the strict guidelines of the Financial Sector Assessment Program of the IMF and the World Bank (**Al** and **Aysan** 2006). Rendering the BRSA immune from the direct influences of politicians and banking lobbies, and assigning to it the single straightforward objective of ensuring the soundness of the banking sector were the major improvements. Within this framework, the BRSA was also given the exclusive right to grant banking licenses and to run the SDIF, the institution authorized to take over and restructure insolvent banks. Furthermore, the former distinction between public and private banks was abolished, and they were subjected to the same set of rules and regulations.

The BRSA could only be fully operational towards the end of 2000, and the Treasury was the reigning regulatory institution in the meantime. In this period, the banking sector was afflicted with extremely perverse structural problems, including the dominance of public banks and their huge duty losses, a small and fragmented banking sector, low asset quality, connected lending practices, an inadequate capital base, extreme exposure to market risk, inadequate internal control and risk management systems, poor corporate governance and lack of transparency (BRSA 2001).5 All these deficiencies together with severe fiscal weaknesses were the factors that paved the way to the 2000-2001 crises. Besides, the insistence of the IMF on the controlled exchange rate regime in the presence of significant macroeconomic imbalances needs be added to the above list of factors (**Özatay** and **Sak** 2002).
The crisis story was similar to its antecedent in 1994, except for the close surveillance of the IMF throughout the process. High PSBR and the commitment to the exchange rate regime led to short-term capital inflows. Private banks acquired large portfolios of government securities, financed by either foreign currency denominated loans or overnight repo transactions. The resulting extreme vulnerability of private banks to market risks was overlooked by the Treasury. The crisis started with the failure of Demirbank, which had aggressively invested in government securities and financed them in the overnight repo market. With the rising interest rates, the bank ran into liquidity problems. As the required liquidity could be obtained from neither the Central Bank nor the interbank market, Demirbank fell insolvent and was taken over by SDIF in December 2000. The duty losses of public banks augmented the concerns over the economy, and a full-scale currency attack started in early 2001, leading to the collapse of the exchange rate program. An abysmal depreciation of the currency ensued, resulting in the most severe financial crisis Turkey had ever experienced. This calamity, however, yielded two important positive results. Firstly, the banking sector has become much sounder and leaner thanks to the lessons taken from the crisis .
Secondly, regulators emerged quite powerful from the crisis, enabling them to implement regulatory reforms while domestic coalitions against reforms in the banking sector were dissolved. The regulatory framework could be almost fully aligned with international standards starting with the May 2001 Banking Sector Restructuring Program executed by the BRSA in consultation with the IMF and the World Bank (**Steinherr** et al. 2004). A floating exchange rate regime, fiscal discipline and an independent central bank that will endeavor for price stability were the other covenants placed by these institutions in the wake of the crisis.
The most important factor that brought the Turkish banking sector from its miserable state after the 2001 crisis to its current well-capitalized, highly-liquid state with high asset quality and low exposure to market risks is the regulatory reforms that have been carried out since 1999. However, at least two other important factors should be mentioned as well. One is the macroeconomic stability and the unprecedented fiscal performance achieved in the post-crisis period. The other is the unusually favorable global liquidity condiions that were conducive to 26 consecutive quarters of uninterrupted growth.

Another interesting detail to show the commanding tone of the letter was that it questioned the power of such major financial institutions as the BDDK. Citing the transfer of Türkbank to the BDDK at the time, the letter criticizes the BDDK for failing to be credited with being an independent institution. The current situation raises questions regarding the future of the BDDK as an independent institution, the letter reads. Some observers note this approach resembles that taken with the Ottoman Empire's Public Debt Management Institution (Düyun-u Umumiye), founded in1881, in which most government revenue was administered by creditor countries, an imposition put on the weakening empire.

According to "Transformation of the Turkish Financial Sector in the Aftermath of the 2001 Crisis." by **G. Gulsun Akin**, **Ahmet Faruk Aysan** & **Levent Yildiran** "The regulations mainly aimed at restructuring state banks, resolving the situation of the unhealthy banks under the SDIF, strengthening private banks and providing a better framework to regulate banks. To this end, many measures to limit various types of risks were institutionalized in the later years of the post-crisis period. Due to the lessons derived from crises, the regulators took a more proactive stance. Basel-II provided an important benchmark for them to follow. Furthermore, certain proactive measures in recent years made the banking sector more prepared for the global shocks."
This paper has classified the post-crises era into two sub-periods. The first period comes up to 2004 and is named as the recovery and stabilization period of the banking sector in Turkey. The major characteristics of this period were the restructuring of the banking sector through regulations, the consolidation of the asset structure and reductions in the numbers of banks, employees, and branches. The sector started growing in 2004, marking the growth period. The numbers of bank branches and

employees started to increase along with a rapid increase in the assets of the banking sector. The growth period has also coincided with the favorable global liquidity conditions in international financial markets and improved macroeconomic conditions at home. Declining inflation rates and fiscal prudence helped banks assume their intermediation role, transferring the weights in their portfolios from government securities to loans. The December 2004 decision of the EU to start accession negotiations with Turkey was another important milestone in the growth period as a result of which the confidence in the Turkish economy and especially in the banking sector has been strengthened.
Another important feature of the growth period was the significant foreign bank entry.
Just in a couple of years, the asset shares of foreign banks increased substantially. The reasons for these foreign bank entries are classified into three groups as related to global, domestic and home country conditions. After covering these reasons, the paper has gone on to examine the costs and benefits of these entries. So far, Turkey has mainly benefited from the immediate capital inflows generated by foreign bank entries.
Akyüz and **Boratav** point out that the Turkish crisis has a number of features common to crises in emerging markets that implemented exchange-rate-based stabilization programs - that typically use the exchange rate as a credible anchor for inflationary expectations, often leading to currency appreciation and relying on capital inflows attracted by arbitrage opportunities to finance growing external deficits. The IMF, post facto, has been blaming widespread corruption and bad implementation by the Turkish government for the failure. However, Akyüz and Boratav believe that the shortcomings in the design of the programme, rather than a failure to implement it, are the main reason why the boom in capital inflows was much shorter in Turkey than in most other experiments with exchange-rate-based stabilization, and why the crisis broke out before inflation was brought under control."The recent bouts of liquidity crises in emerging markets have significantly eroded the confidence of international investors in the sustainability of such soft pegs, so that rapid exits tend to be triggered at the first signs of trouble. The Turkish experience also suggests that the chances of successful disinflation by means of an exchange-rate anchor may now be significantly lower." Also, the behaviour of private capital flows to emerging markets in the current downturn in the world economy shows that, unlike in the first half of the 1990s, international investors have become much more nervous in raising their exposure to emerging markets despite falling investment opportunities in the major industrial countries.
"However," say Akyüz and Boratav, "in many respects the Turkish economy today is in a worse shape than it was on the eve of the December 1999 stabilization programme." The programme has failed and the crisis has deepened in large part because of serious shortcomings in its design and implementation as well as in crisis management.
Analyzing the policy response in Turkey to the speculative attacks on the currency, and comparing it with the responses to the East Asia crisis, Akyüz and Boratav point out that "much of the IMF funding (to Turkey) has been used to pay foreign private liabilities, notably of banks, and to cover the withdrawals of foreign portfolio investors." In effect, this has allowed the Turkish government to translate part of its domestic debt into external liabilities to the IMF.

IMF Deputy Managing Director **Anne Krueger** has voiced the IMF's new approach to managing crises, though the proposals are different from that of United Nations Conference on Trade and Development (UNCTAD) in that a standstill could be activated only by the Fund. However, the proposals amount to a recognition that the approach so far adopted in official intervention in emerging-market crises, built on the principle of maintenance of open capital accounts and convertibility and guaranteed repayment to creditors, may not always be successful in stabilizing the markets and avoiding costly crises.This has certainly been the case in Turkey. But, even if orderly debt workouts become part of the international financial architecture, present difficulties in Turkey have to be resolved under existing rules. Turkey may not be allowed to sink for US geopolitical reasons.

According to the **Article IV of the IMF's Articles of Agreement**, important steps have been taken to maintain the strength of the Turkish financial sector, although some additional measures are needed. The signing of the Memorandum of Understanding and related protocol on systemic risk management by the Treasury, CBT, Banking Regulation and Supervision Agency (BRSA), and Savings Deposit Insurance Fund (SDIF) is a welcome development. Further enhancing stress testing methodologies, including to assess the implications of more complex scenarios (such as possible direct and indirect impacts from unsettled international financial markets) should be considered. While the regulation to allow onshore foreign currency lending to unhedged corporate borrowers will improve transparency, risks should be carefully supervised and adequately priced, with prudential norms tightened further if warranted. To further identify potential stress emanating from the corporate sector, data collection and monitoring for unlisted corporates should be enhanced.

One of the lessons from the East Asian crisis was that the worst time to "reform" a financial system is in the middle of a crisis. Overhauling the banking system before launching the stabilization program would have helped greatly to avoid many of these difficulties. However, these lessons appear to have been overlooked both in the design of the stabilization program and in crisis intervention. Furthermore, a careful examination of recent experiences with soft pegs and exchange-rate-based stabilization programs shows that many of the weaknesses in economic fundamentals, including currency appreciation, deterioration of the current account, and increased exposure to exchange-rate risk, often result from the effects of capital inflows themselves rather than from policy slippages. Such episodes are often characterized by an upturn in economic activity and a surge in imports, financed by inflows of arbitrage capital. In Turkey both the Fund and the government were quite happy to see that the economy was making a strong upturn in 2000 after a deep recession in 1999, and they were not willing to discourage capital inflows underlying the process.

Cizre-Sakallioglu and **Yeldan**, 2000; **Grabel**, 1996 point out that investors become the ultimate arbiters of national macroeconomic policy. Public policy became synonymous to populism and waste. Democratic institutions are put under siege through endless lists of conditionalities set forth by the IMF and the World Bank, and in the meantime, the transnational companies and the international finance institutions (IFIs) have become the real governors with an implicit veto power over any economic and/or political decision that is likely to act against the interests of global capital. The IFIs report rating scores in aligning the indigenous economies under the strategic realm of finance capital. Even direct political decisions are under scrutiny. Consider for example the rejected war motion by the Turkish parliament, disapproving the US troops to utilize the Turkish soil in the early days of the Iraq's invasion. In exchange for a total aid of 25 billion dollars, USA had asked permission from Turkey to use its borders with Iraq. The motion was rejected and a chaos ensued driven by the IFIs and their rating agencies. The following excerpt from Morgan Stanley Economic Forum on Turkey, is a critical example: (March 4, 2003). "the latest parliamentary decision to reject the much-debated 'war motion' is such a risk that will no doubt disturb the fragile equilibrium...(Turkey) is unlikely to get the promised $24 billion that would ease pressure on the domestic debt market..." The report concludes with the stunning question: "what happens if the parliament does not altogether vote for the economic reforms, arguing that 80% of the Turkish population is against the IMF program?"
The report is not only concerned with the loss of 25 billion dollars liquidity for the Turkish financial centers, but is also worried that the people may further exercise their rights over the future of the IMF-led austerity program in Turkey. In the classic words of **Diaz-Alejandro** (1985), a twist can also be mentioned: "Good-bye Budget deficits, hello democracy deficit..."

Speaking in broad terms, these are related to the transfer of decisions relating to the public sphere from constitutional institutions of respective countries to "independent" supreme bodies of regulation working under global rules and further commercialisation of public sphere (ISSA, 2006: 4). This process, whose legitimisation is presented as "dissecting politics from economics" enhances the hegemony of global capital and its domestic extensions on society by keeping large sections of people and working masses afar from political processes.
Reports containing mentioned policy suggestions not only define necessary measures and arrangements to be adopted, but also go as far as advising ways of securing public support in this field. The example below is from an **OECD Report** (2002) titled Regulatory Reforms in Turkey: Important Support to Economic Improvement: Governance: "...It is vital to have open communication channels in order to have continued public support for the reforms. There is a need for dissemination of the targets and the advantages of the regulatory reforms. Another benefit of this approach is to eliminate the widespread public view that the reforms are imposed from abroad. For this reason, the public perception should be treated as an important issue within the communication strategy of the government."

It is a commonly held view that the reason Turkish banks weathered the storm during the 2009 global financial crisis was basically due to strict fiscal reform implemented following the 2001 financial crisis.The Turkish banking sector managed the 2009 global financial crisis well. The sector left the crisis behind with the least damage among other sectors in Turkey, while banks secured high profits during the crisis. The major factor behind this, observers argue, was a series of new reforms made in the sector right after the 2001 crisis. **Tevfik Bilgin**, the current president of the BDDK, is of this view as he underlines the 2009 crisis only caused very limited damage to Turkey's banking industry. According to Bilgin, the 2001 crisis was a turning point defining the future of the Turkish banking sector. He says it is hard to tell if Turkish banks would be in a better position today had it not been for

the 2001 crisis.Bilgin argues the crisis forced the banking sector to make the necessary reforms which had been delayed and thus made the sector more resilient to external shocks. “The lessons learned from the crisis motivated the sector to face and solve its problems … and the elimination of a number of weak banks which threatened a healthy banking system was also important,” he said. While the 2001 crisis triggered major reforms in the Turkish banking sector, it also negatively affected the sector’s development at the time. Thousands of bank employees lost their jobs during that period. While the 2001 crisis hit the Turkish economy in every field, destruction inside the country’s banking industry was far worse than in any other sector. Many banks were transferred to state funds, while managers of a number of banks were even arrested over allegations of misuse of authority and corruption.

According to the “**Turkey—2010 Article IV Consultation and Post-Program Monitoring: Preliminary Conclusions**” on May 26, 2010 the authorities have begun to gradually implement comprehensive exit strategies from fiscal and monetary stimulus. The medium-term program (MTP) for 2010-12, adopted in September 2009, foresees a gradual improvement in the fiscal balance, supported by a deficit-based fiscal rule from the 2011 budget cycle. Predicated on a mild growth recovery of 3½ percent, the 2010 budget targets a primary deficit for the nonfinancial public sector of 0.3 percent of GDP, which has been supported by further increases in excises on fuel and tobacco at the beginning of this year and savings in healthcare costs. In view of increased uncertainty on the revenue outlook and a desire for prudent budgeting, the authorities intend to adhere closely to the original 2010 target. On monetary policy, the Central Bank of Turkey (CBT) plans to gradually reverse foreign currency and lira liquidity measures, with increases in the policy rate beginning in Q4 2010 under its baseline scenario. However, a temporary exemption from the general provisioning for new loans was recently introduced and the aforementioned loan restructuring regulations were extended in order to continue to support credit growth.

Also, the Article IV of the IMF's Articles of Agreement notes tha Fiscal policy in 2010 should preserve the cyclical adjustment envisaged in the 2010-12 MTP in the context of now faster growth, thus also establishing an appropriate starting point for the fiscal rule. While suitable when conceived in the midst of the crisis, the ambition of the 2010 primary balance target has been overtaken by the stronger 2009 outturn and upward revisions to 2010 growth and inflation forecasts. Adhering to the original target would now imply no structural improvement this year, while macroeconomic conditions and external developments argue for a structural tightening. Therefore, spending should adhere closely to the plans legislated in the 2010 budget (allowing for mandatory adjustments for inflation indexation-related increases in wages and pensions, and revenue sharing), while avoiding revenue-reducing policy changes. Such a policy would help contain current account and inflation pressures, limit private sector crowding out, and promote the fiscal rule’s success by reducing the adjustment required in 2011. It would also reinforce Turkey’s fiscal discipline credentials by more quickly reducing government debt and adopting a sound fiscal stance for the period ahead.

6.Suggestions and Conclusion

The Turkish crisis which came in the aftermath of an exchange rate-based disinflation attempt, followed all the well-documented empirical regularities of such programs: a demand based expansion accompanied by rising and usually unsustainable trade and current deficits followed by a contractionary phase –in the form of liquidity squeeze; sky-rocketing interest rates, and negative growth. The main weakness of the 2000 dis-inflation program was its exclusive reliance on speculative short term capital inflows as the source of liquidity generation mechanism. Overlooking at the existing structural indicators of financial fragility and resting the liquidity generation mechanism on speculative in –and –out-flows of short term foreign capital, the program has left the economy defenseless against speculative runs and a “sudden stop”.

The failure of the Program cannot be completely tied up to lack of ability of the Government to undertake accurate actions. By deepening the vulnerability of an already shallow and fragile financial system, the underlying liquidity generation mechanism raised doubts about sustainability of the Program itself.

In sum, muddled with short sighted myopia and speculative herd behavior of domestic and foreign financial arbiters, the IMF-directed Turkish disinflation episode all too clearly spells the dangers of restricting the monetary policy of an economy to speculative in-and-out-flows of short term foreign capital, which by itself, is excessively liquid, excessively volatile, and is subject to herd psychology.

The Turkish crisis which came in the aftermath of an exchange rate-based disinflation attempt comes to no surprise to anyone who is somewhat-informed on the international literature on country experiences of macroeconomic stabilization. In fact, the observed growth-crisis path of the Turkish economy is well in line with the "main empirical regularities associated with exchange rate-based disinflation:
(i) slow convergence of the inflation rate (as measured by the CPI) to the rate of devaluation;
(ii) initial increase in real activity –particularly real GDP and private consumption– followed by a later contraction;
(iii) real appreciation of the domestic currency;
(iv) deterioration of the trade balance and current account balance
(v) ambiguous impact response of domestic real interest rates (where) expost domestic real interest rates have generally decreased in the initial stages of orthodox plans" (Calvo and Vegh, 1999).
Given the above empirical regularities of exchange rate-based disinflation, Calvo and Vegh resort to an extensive literature on individual country responses. In the Turkish case, with slow convergence of inflation to the programmed lower rate of devaluation, real rates of interest fell sharply, as well. This initial fall in the real rates of interest together with an appreciating currency led to an increase in aggregate demand, widening the external gap.
The financing of the external deficit was possible by way of increased net inflows of short term (hot money) capital. Thus, given the no-sterilization rule of the Central Bank, increased foreign capital inflows led to an expansion of the monetary base.
Consequently the decline in the real rates of interest was instrumental in both invigorating the economic activity and also in releasing the constraints on servicing costs of fiscal debt. In the meantime, both external and financial fragility of the domestic asset markets were severed and the macro fundamentals deteriorated. It is worth at this juncture to note that reversals of capital flows are often associated with deterioration of the macroeconomic fundamentals in the recipient country. However, as the Turkish episode documents, such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies.
To sum up, muddled with short sighted myopia and speculative herd behavior of domestic and foreign financial arbiters, the IMF-directed Turkish disinflation episode all too clearly spells the dangers of restricting the monetary policy of an economy to speculative in-and-out-flows of short term foreign capital, which by itself, is excessively liquid, excessively volatile, and is subject to herd psychology. The program, by dismantling all the tools of stabilization and monetary control of the Central Bank, has left the economy defenseless against a speculative run and a "sudden stop". Trapped within the confines of a pre-announced program of exchange rate devaluation, and of a monetary rule administered effectively by short term arbitrage speculation, the Turkish Central Bank's monetary effectiveness was reduced to the miniscule role of an "accounting officer". Under this role, the CB lost all its power to steer the economy in the advent of a disruptive shock or a change in the investors' perceptions leading to a "sudden stop".
This, unfortunately had been the case in Turkey just after 10 months of the inception of the exchange rate-based disinflation program under the guidance and monitoring of the IMF.

6.1 Suggestions

Turkish banking system, was not only one of the main factors but also the key trigger of the crises of 2000 and 2001 that has gone on for three years. Since the banking system had some overwhelming risks for the financial sector and for the whole economy, these risks should be defined and then the mechanisms must be ruled which can diminish them before they occur. But the timing is important here and I believe that the statement of Mr. Serdengecti, the Governor of Turkish Central Bank, stands right: "An analysis of the fundamental reasons behind the failure of the disinflation program implemented in 2000 reveals that the problems in the banking system should have been resolved well before the implementation of the program."

The Reconstitution of the Turkish Banking System was a delayed obligation and this process could be carried out in three stages: Financial, operational and structural reconstitution.

1. – FINANCIAL RECONSTITUTION: With the establishment of Bank Regulation and Supervising Agency (BRSA), a good step on this issue was taken. The financial reconstitution should be constituted in accordance with the Basle Principles. The Banking Sector Restructuring and Rehabilitation Program consists of: Strengthening of capital base, elimination of overnight liabilities, substantial reduction of FX open positions and determination of deposit rates uniformly with market rates. It can be underlined

once more that, this is a good step toward a sound banking system but means nothing without taking the other needed reconstitution steps.

2. – OPERATIONAL RECONSTITUTION: Firstly the state banks had to be regulated and secondly, prior to this regulation, the productivity and efficiency of them should be constituted and at last stage they must be privatized. The negative background of Turkish privatization experiment should be considered once more and an efficient privatization strategy must be carried out.

3. – STRUCTURAL RECONSTITUTION: For the financial system, in the middle and long run, there must be nothing more than (i) A legal framework consists of market discipline and transparency (ii) Strong corporate governance culture and adequate risk management practices (iii) Improved global competitiveness and efficient supervision (iv) High quality and transparent off-site and on-site supervision by BRSA and (v) Proper working of the external audit process.

To sum up, my main conclusion is that the root cause of the crisis was the combination of a fragile banking sector and a set of triggering factors that made this fragility crystal-clear.

Analyzing the data for 2000 in isolation, one would immediately observe the poor macroeconomic performance. Public sector borrowing requirement, public debt to GNP ratio, current account deficit, inflation level and liabilities of financial sector to official reserves ratio were all high. Moreover the Lira was appreciated in real terms. However, this would be a misleading picture of the Turkish economy. Turkey started to implement an IMF supported program just at the beginning of 2000. This program addressed to macroeconomic imbalances and indeed succeeded to some extent in reversing this negative trend. Relative to 1999, there was a sharp decline both in the inflation and real interest rates and a significant increase in primary surplus. Consequently, debt to GNP ratio and public sector borrowing requirement decreased.

It is true that rising current account deficit and real appreciation of lira was a source of increasing concerns. However, an important part of the current account deficit was due to an external shock - rising oil prices, and there was a built-in exit strategy from the crawling-peg system, which was the main factor behind appreciation. Moreover, the program envisaged a further fiscal tightening for 2001 that would have been one of the remedies to current account problem.

It is commonly accepted that without a fragile banking system and triggering factors, high current account deficit and real appreciation of the lira would not be enough to precipitate the 2000-2001 crisis. Hence, the banking system was highly vulnerable to capital reversals. However, risk accumulation was not homogenous throughout the system. There were two different types of dichotomization: Private versus state banks and within the private banks. While the state banks were more open to interest rate risk, private ones were more prone to exchange rate risk. Within the private banking system there were some mid-sized banks that were heavily concentrated in government debt instruments business. Moreover, they were carrying these instruments by borrowing extremely short-term.

Given the weakness in the banking system, it is no surprise that the crisis triggering factors were closely related to the banking sector and its mode of carrying government debt instruments portfolios. Main igniting factors were the delays in reforming the banking sector and the actions that caused the dichotomy in the banking sector to come to the surface. This environment made life extremely difficult for those banks that had desperately chosen to borrow in short-term maturity and lend to the government in relatively longer terms along with state banks suffering from duty losses. These banks that had been heavily dependent to over-night funds found themselves in a position not to be able to do the “usual business”.

Finally, we should note that the root cause of the fragility of the banking system was high public sector borrowing requirement and the way it was financed. Note that especially starting from early the 1990s, there was no close link between rising deficits and inflation. The main reason was that budget deficits were mainly financed through government securities. However, the sustainability of this financing mechanism was conditional on the continuation of demand for government securities. In the absence of a program that reduces borrowing requirement, a halt in demand would force authorities to monetize and hence cause a jump both in the exchange rate and inflation rate. This led economic policy makers to do their best to prevent a decline in demand for government securities. Both the upward trend in government debt instruments portfolios of the banks and such policies increased the vulnerability of the banking system.

Turkey’s existing countercyclical inflation targeting framework is an important strength, and from 2011 will be accompanied by a comprehensive fiscal rule that sets prudent deficit ceilings. The draft

fiscal rule legislation, which is expected to be approved next month, sets an annual deficit ceiling that adjusts to cyclical conditions while converging gradually to the medium-term deficit target. The formulation of the rule, choice of parameters, and comprehensiveness of institutional coverage will together establish prudent, feasible, and countercyclical deficit ceilings. The draft legislation also proposes important improvements to Turkey's public financial management procedures, including more transparent and comprehensive reporting of fiscal projections and outturns, tighter oversight of local government borrowing, and strengthened controls to deliver spending outturns more in line with the budget. Mechanisms are also needed to encourage conservative budget forecasts, ensure timely implementation of within-year deficit-reducing measures when needed, and strengthen fiscal coordination between central and local governments. While adoption of the rule will be a major milestone for entrenching fiscal discipline, success will ultimately depend on the strength of commitment to implementing the rule's provisions.

Abbreviations

BRSA: Board of Bank Regulation and Supervision Agency
FX: Foreign Exchange
IMF: International Monetary Fund
SDIF: Saving Deposit Insurance Fund
TL: Turkish Lira

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