

THE POLITICAL ECONOMY OF BANKING SECTOR REGULATION:
THE CASE OF POST-1980 TURKEY

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Thesis Abstract

Cengiz Yönezer, “The Political Economy of Banking Sector Regulation:
The Case of Post-1980 Turkey”

Banking sector is without a doubt one of the most regulated industries in the world, since banks had a central role in financial mediation for centuries. State has regulated the banking sector in order to protect depositors’ money; to ensure the safety of banks; and thus to safeguard the whole economy. However, the methods and modes of banking sector regulation have changed significantly in the 20th century. After World War II, state regulated the banking sector through the involvement of public banks and anti-competition regulatory rules. However, after the worldwide economic crisis in the 1970s, the mode of banking sector regulation has changed toward ‘statutory regulation implemented by independent regulatory agencies’: interest rates and foreign currency regimes have been deregulated; public banks have been privatized; autonomous bureaucratic agencies for bank regulation have been established; and competition in the banking sector has increased. As a result, state’s degree of intervention in the banking sector has diminished. This thesis addresses this change in the mode of banking sector regulation in the case of post-1980 Turkey, first by narrating the story of change in conjunction with international developments, then by analyzing the political economy factors contributing to change. An examination of the evolution of banking sector regulation comes to the conclusion that mode of banking sector regulation in Turkey changed from state administration of the banking sector, toward statutory regulation

implemented by independent regulatory agencies; and international institutions together with domestic political factors engendered the evolution of the mode of banking sector regulation.

Tez Özeti

Cengiz Yönezer, “1980 Sonrası Türkiye Örneğinde Bankacılık Sektörü Ekonomi Politigi”

Bankacılık sektörü, yüzyıllardan beri finansal aracılık yapmasından dolayı, hiç şüphesiz dünyada en çok düzenlenen ekonomi sektörlerinden birisidir. Devlet bankacılık sektörünü, mevduat yatırımların paralarını korumak; bankaların güvenliğini garantiye almak ve böylece ekonominin bütününe korumak için düzenler. Bankacılık sektörünü düzenleme yöntemleri 20 yüzyılda önemli ölçüde değişmiştir. Devlet İkinci Dünya Savaşından sonra bankacılık sektörünü kamu bankaları ve rekabeti kısıtlayıcı kurallar vasıtasıyla düzenlemiştir. Fakat 1970’lerde yaşanan dünya çapındaki ekonomik krizden sonra, bankacılık sektörü düzenleme yöntemi ‘bağımsız düzenleyici kurumlar vasıtasıyla hukuksal düzenlemeye’ doğru değişmiş; faizler ve yabancı para rejimi deregüle edilmiş; kamu bankaları özelleştirilmiş; bankacılık sektörü düzenlemesi için özerk bürokratik kurumlar kurulmuş ve sektörde rekabet artırılmıştır. Sonuç olarak devletin bankacılık sektörüne olan müdahalesi azalmıştır. Bu tez yukarıda anlatılan, bankacılık sektörü düzenlemesi yöntemlerinde meydana gelen değişikliği 1980 sonrası Türkiye örneğinde incelemektedir. Öncelikle, sözü edilen değişiklikler uluslararası gelişmelere paralel olarak anlatılmış, sonrasında da bu değişikliklere neden olan ekonomik ve politik faktörler incelenmiştir. Bankacılık sektörü düzenlemesinin geçirdiği evrimin analizinden çıkarılan sonuç: Türkiye’deki bankacılık sektörü düzenleme yöntemleri ‘bankacılık sektörünün büyük oranda devlet yönetiminden, ‘bağımsız düzenleyici kurumlar

vasıtasıyla hukuksal düzenlemeye' kaymış; ve uluslararası kurumlar yerel politik faktörlerle birlikte bankacılık sektörü düzenlemesinin geçirdiği evrime yön vermişlerdir.

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ABBREVIATIONS

- BIS: Bank for International Settlements
- BRSA: Banking Regulation and Supervision Agency
- CBRT: Central Bank of Republic of Turkey
- CD: Certificate of Deposit
- CPI: Consumer Price Index
- DLP: Democratic Left Party
- ET: The Theory of Economic Regulation
- FSA: Financial Services Authority
- GDI: Government Debt Instrument
- GDP: Gross Domestic Product
- GNP: Gross National Product
- IMF: International Monetary Fund
- IRA: Independent Regulatory Agency
- LOI: Letter of Intent
- MP: The Motherland Party
- NSC: National Security Council
- OECD: Organization for Economic Cooperation and Development
- PSBR: Public Sector Borrowing Requirement
- RPP: Republican Peoples Party
- SAL: Structural Adjustment Loan
- SDIF: Saving Deposit Insurance Fund

SDPP: Social Democratic and Populist Party

SOE: State-Owned Enterprise

TPP: True Path Party

WB: World Bank

WP: Welfare Party

WPI: Wholesale Price Index

CHAPTER 1

INTRODUCTION

Banking sector regulation is a very old concept. Throughout the centuries, states have regulated the banking sector, for one simple reason: in order to protect depositors' money. However, although the rationale behind banking sector regulation has not changed, the ways in which public authorities regulate the banking sector have changed significantly over the years. While in the early years of finance, self-regulation was the most common mode of regulation, in the 1990s, statutory regulation implemented by independent regulatory agencies was the most common mode of regulation.

'Regulation' was the motto of nations who were trying to recover from the losses of World War II. Between WWII and late 1970s, in Western Europe and in developing countries, regulation implied state intervention in the economy. 'Regulation' included large bodies of legal rules, which limited competition and heavy involvement of state-owned enterprises in the economy. In this period, state regulated the banking sector by a wide variety of tools which consisted of public banks, restriction of interest rate competition, restriction on foreign currency transactions and entry barriers to the banking sector. Main justification for this extensive state regulation was to correct market failure and to enhance efficiency in the markets.

However, after the worldwide economic crisis in the late 1970s, extensive state regulation was on the target. Discretionary public expenditure and centralized welfare state were seen as the culprits for the economic crisis. 'Deregulation' was gaining rein.

However, according to Majone (1996), “What is observed in practice is never a dismantling of all regulation- a return to a situation of laissez faire which in fact never existed in Europe-but a combination of deregulation *and* re-regulation” (p.2). While certain components of the regulatory regime were abolished, or more correctly, ‘deregulated’, certain components of the regulatory regime were strengthened. Hence, it was the *mode of regulation* that changed after the economic crisis in late 1970s. The mode of banking sector regulation also changed. While most state-owned banks were privatized and interest rates were liberalized, state introduced extensive body of legal rules in order to contain the emerging risks in the balance sheets of banks.

From the late 1980s, financial liberalization was on the agenda of major industrial countries as well as developing countries. Most of the restrictions on trade were lifted in the early 1980s. From the late 1980s, restrictions on the free flow of money were lifted gradually. Capital account liberalization was the motto of the day. In an environment of free capital flows, importance of a sound and efficient banking system increased tremendously. However, while the power of banks increased, it became harder for public authorities to monitor and supervise banks effectively because of increased variety of financial instruments and increased volume of cross-country transactions. As a result, while the need for regulation increased, the capacity of the state to regulate diminished in the 1980s.

In the 1990s, independent regulatory agencies (IRAs) began to flourish as a solution to this problem. The motivating idea behind establishing IRAs was to regulate the economy by independent technocratic commissions, which are free from political interferences. In other words, ‘de-politicization’ of regulation was on the agenda. While IRAs spread all over the world, regulatory rules were further strengthened by

establishing different prudential regulatory standards in order to contain the different types of emerging risks in the balance sheets of banks. IRAs were established in order to implement more effectively an ever increasing body of rules and monitor banks more effectively.

Banking sector regulation in Turkey, more correctly, *mode* of banking sector regulation in Turkey, have not been isolated from these changes in the world. In this thesis, my goal is to analyze this change in the mode of banking sector regulation in Turkey between 1980 and 2001.

There are two important research questions in this thesis, which seek to analyze this change. The first one is what the changing modes of regulation are in the banking sector between 1980 and 2001 in Turkey. Thus, evolution of the mode of banking sector regulation in Turkey is explained (See Appendix B). The second research question is what political and economic factors, including domestic and international ones, have facilitated the evolution of the mode of banking sector regulation.

In Chapter 2, before delving into the details of regulatory change in the Turkish context, a literature review of the regulation theories and historical background, regarding the changing modes of regulation in different parts of the world are introduced. Regulation theories and explanation of the different modes of regulation help me in answering my research questions and in analyzing the evolution of the mode of banking sector regulation in Turkey. Moreover, theories of regulation are crucial in analyzing the contributing factors to change in the modes of regulation in Turkey.

After explicating the regulation theories and experiences of different countries regarding regulation, different modes of *banking sector* regulation in the world are described and explained. Changing modes of banking sector regulation in Turkey was

categorized and explained according to the findings in this Chapter. Later in the following paragraphs, the evolution of the mode of banking sector regulation in Turkey is narrated according to the categorizations explained in this Chapter.

In the following Chapters 3, 4 and 5, Turkish regulatory regime is analyzed chronologically. The major reason for my choice of chronological analysis is that the *evolution* of the mode of banking sector regulation is analyzed. The time period of 1980 - 2001 is partitioned into three: 1980-1987; 1987-1995; 1995-2001. Major factor that influenced my choice of partitions is the changing domestic political and economic environment surrounding the regulatory regime. In each chapter, both of the research questions, which are stated above, are answered, namely: what is the changing mode of banking sector regulation and what political and economic factors, including domestic and international ones facilitated the change in the mode of banking sector regulation?

In Chapter 3, the period between 1980 and 1987 is analyzed. Year 1980 is an important year for Turkish economic and political history, since in 1980, Turkey embarked upon economic liberalization project. However, according to Cizre (2002), “The shift to economic liberalism was predicated on the creation of a socially disciplined and depoliticized society” (p.84). Therefore, thanks to the limited democracy established by military leaders between 1980 and 1983, IMF and the World Bank were influential in Turkish economic policies, namely the banking sector regulation. In 1987, full-fledged political competition was re-established with the return of former politicians to the political arena. In Chapter 4, the period between 1987 and 1995 is analyzed. In this period, political and economic environment were very different from the previous period. Political competition was high and Turkish financial market was fully liberalized. December 1995 elections marked the end of this period, since the elections

signified the rise of political Islam under the auspices of the Welfare Party. The rise of the Welfare Party and the establishment of the 1st Erbakan Government changed the Turkish political scene drastically. In February 2001, Turkey experienced a major financial crisis in which the banking sector has played an important role. Following the financial crisis, in May 2001, banking sector regulation once again changed significantly because of the fatal role that both the private and the public banks played in the financial crisis. Therefore, in Chapter 5, the period between 1995 and 2001 is analyzed.

Regarding the methodology, several variables are analyzed in each period. Role of international institutions, domestic political environment, economic interests of the banking community and roles of financial crisis, including bank failures were the main factors that contributed to change in the mode of banking sector regulation in the post-1980 Turkey. However, the importance of these factors changed in each period. For instance, while the IMF and the World Bank were the major factors contributing to change in the mode of banking sector regulation between 1980 and 1987, the economic interests of the business community was the major factor between 1987 and 1995. Therefore, while analyzing the contributing factors to regulatory change, Turkish economic and political environment surrounding the regulatory regime should also be addressed adequately.

CHAPTER 2

REGULATION

Introduction

There are two major topics in this chapter. The first one is the theories of regulation and historical analysis of the change in the modes of regulation in Europe and in the USA. Regulation in a more general sense is analyzed. The second major topic is the explanation of the different modes of banking sector regulation and history of banking sector regulation in various countries including not only Europe and the USA but also Argentina and Mexico. More specifically, evolution of the banking sector regulation is analyzed.

After the worldwide economic crisis in the late 1970s, ‘modes of regulation’ and thus the meaning of ‘regulation’ has changed. In the late 1970s, in Continental Europe and in most developing countries, regulation referred to “all the efforts of state agencies to steer the economy” (Baldwin, Scott, & Hood, 1998, p.3). Regulation meant state *administration* of the economy through state-owned enterprises and enforcement of strict rules, which limited free competition between private actors and aimed to minimize market failures. After the economic crisis in the late 1970s, mode of regulation has changed toward a narrower meaning. According to Baldwin et al. (1998): “Regulation refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically a public agency, for monitoring and promoting compliance

with these rules” (p.3). Moreover, these authoritative set of rules became more competition friendly, meaning legal rules began to foster competition instead of hampering it.

There are three major theories of regulation, which aim to describe and analyze the motivating forces behind regulation. Public interest theory of regulation was very popular in academic circles in the aftermath of World War II. It claims that state regulates economic sectors in order to correct market failures and increase efficiency in the economy. Theory of economic regulation gained prominence in the late 1970s, while ‘deregulation’ was the motto of the day. It claims that public regulatory authorities act on behalf of the economic interests of the actors in the regulated economic sector. In other words, any regulatory measure reflects the interests of the private actors. For instance, regarding the banking sector regulation, regulation in the banking sector changes according to economic interests of the banking community. Institutional analysis gained predominance especially in the 1990s, especially by the rise of the institutional strain of agency theory. It criticizes both theories and claims that they are not able to address the institutional adaptation and institutional design effectively in an era of rapid changes in the institutions. Institutional strain of agency theory addresses the multiplicity of influential factors that effect the change in the institutions. For instance, role of international organizations in effecting regulatory change is analyzed by this theory.

Changing modes of banking sector regulation in the world is the other topic of this chapter. Modes of banking sector regulation in Europe and in the USA are examined from a historical perspective.

What is Regulation?

Before explicating the changing ‘modes of regulation’, ‘meanings of regulation’ must be addressed. The reason is that different meanings of regulation imply different modes of regulation. While the mode of regulation changed over the years, meaning of regulation changed also.

Regulation is not an easy concept to define. There are multiple definitions in usage. The major reason was that the notion of regulation evolved and transformed itself over time. In the following paragraphs, I will explicate and discuss the three main meanings of regulation, namely regulation as targeted rules; regulation as direct state intervention in the economy; and regulation as encompassing all mechanisms of social control, by whomsoever exercised (Baldwin et al., 1998). These multiple meanings differ in the degree of state intervention.

According to the first meaning, “regulation refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically a public agency, for monitoring and promoting compliance with these rules” (Baldwin, et al., 1998, p.3). Regulation involves rule-making, and monitoring/enforcement mechanisms employed by regulatory agencies.

The second definition of regulation attracts more attention in the political economy literature. It refers to “all the efforts of state agencies to steer the economy” (Baldwin, et al., 1998, p.3). This second meaning was broader from the first one, since it includes measures like taxation and disclosure requirements other than rule-making and application through enforcement systems. Moreover, it encompasses government tools which rely on government expenditure, such as contracting and public ownership.

A third definition of regulation is broader than the other two definitions. It encompasses different mechanisms of social control by all intentional or unintentional state or non-state processes. According to Baldwin et al. (1998), it extends

It extends to mechanisms which are not the products of state activity, nor part of any institutional arrangement, such as the development of social norms and the effects of markets in modifying behaviour. Thus a notion of intentionality about the development of norms is dropped, and anything producing effects on behaviour is capable of being considered as regulatory. Furthermore a wide range of activities which may involve legal or quasi-legal norms, but without mechanisms for monitoring and enforcement, might come within the definition (p.4).

In narrating the story of the change in the mode of regulation, the above definitions are useful. Over the years, the mode of regulation has changed toward less state intervention and establishment of more rules, so the meaning of regulation converged toward the first definition from the second one. In other words, regulation has had a narrower meaning. Evolution of the mode of regulation can also be interpreted as the evolution of the meaning of regulation from the second definition toward the first one. In short, in this thesis, while the third definition of regulation is excluded, the first and second definitions are important in understanding the change in the mode of regulation. Both of these meanings of regulation “has a clear boundary based on intentional state and self-regulatory activity directed towards the modification of behaviour by reference to systems of authoritative rules” (Baldwin et al., 1998, p.4).

History of Regulation and Modes of Regulation in Europe and in the USA

“Regulation in the sense of rules issued for the purpose of controlling the manner in which private and public enterprises conduct their operations, is of course as old as

government” (Majone, 1996, p.9). Moreover, justification of regulation, namely ‘market failure’ is also as old as the regulation itself. However, modes of regulation, rather than the justification behind it, changed over time. Now, regulation “refers to sustained and focused control exercised by a public agency, on the basis of a legislative mandate, over activities that are generally regarded as desirable to society” (Majone, 1996, p.9).

In this part, two important issues deserve attention. First, there was a paradoxical development in the last quarter of the 20th century: rise of neo-liberalism and independent regulatory institutions coincided. Second, new regulatory authorities are committed to promoting competition through establishing rules. These developments signified a major change in the mode of regulation.

In the first half of the 20th century, regulation was interpreted as rigorous public ownership in the economy. Governments nationalized utilities sectors in order to ensure efficient and accessible public services. Direct government intervention through nationalizations was the buzzword of the time in Europe (Baldwin et al., 1998).

After World War II, economies of most Western European countries were shattered. As a result, redistribution and discretionary macroeconomic management constituted a major part of the post-war recovery agenda. “The market was relegated to the ancillary role of providing the resources to pay for this government largess, and any evidence of market failures was deemed sufficient to justify state intervention, often in the intrusive forms of centralized capital allocation and the nationalization of key sectors of the economy” (Majone, 1996, p.1) In this period, central regulatory agencies began to flourish in Europe both for economic and social purposes (Baldwin et al., 1998). As a result, prevailing mode of regulation was heavy state intervention in the economy through nationalizations and central capital allocation mechanisms. The second meaning

of regulation as defined by Baldwin et al. (1998) came to capture the idea of regulation in this period.

In the 1970s, several economic problems began to undermine the bases of support for the prevailing mode of regulation in the aftermath of the WWII. Rising inflation rate and unemployment were destructing the bases of social democratic consensus about the relative roles of state and market in the managed economy. Discretionary public expenditure and the centralized welfare state were seen as part of the problem. Heavy involvement of state in the economy through state economic enterprises was criticized as producing inefficiency in the economy (Majone, 1996, p.1).

In the 1980s privatization, market liberalization and welfare reform were on the agenda of policy-makers. They were introduced as solutions to the economic problems. Market liberalization and welfare reform were identified, rather misleadingly, as deregulation. However, “what is observed in practice is never a dismantling of all regulation- a return to a situation of laissez-faire which in fact never existed in Europe – but a combination of deregulation and re-regulation” (Majone, 1996, p.2). Notion of re-regulation gained importance in this context. This notion implies that regulatory reforms and liberalization in general, result in new settings of regulation, namely new modes of regulation, rather than in deregulation (Jordana & Levi-Faur, 2004). “Paradoxically, in a period when deregulation has been claimed to be the driving force of public policy under the influence of the neo-liberal strand of New Right ideas, more new central regulatory agencies have been created than ever before” (Baldwin et al., 1998, p.6).

It is important to understand the meaning of ‘regulatory reform’ in this era. Regulatory reform consisted of deregulation and re-regulation. Deregulation is the reduction of economic, political, and social restrictions on the behaviour of social actors

(in our context, mainly business) (Jordana & Levi-Faur, 2004). Privatizations, restrictions on entry into the economic sector and abolition of controls on prices can be interpreted as deregulation. However, re-regulation is the introduction of new regulatory agencies and establishment of competition-friendly legal rules governing the market actors. Combinations of these deregulative and re-regulative measures signified a change in the mode of regulation.

Mode of regulation in Europe changed. “Traditional forms of regulation and control in Europe included public ownership, the assignment of regulatory functions to departments of government under the direct control of political executives, and various self-regulatory arrangements, often [of a] corporatist nature” (Majone, 1996, p.2). These modes of regulation were displaced by statutory regulation exercised by politically independent expert agencies. Privatization of utilities sectors was accompanied by the creation of central regulatory agencies. As a result, the first definition of regulation- ‘targeted rules’- was used increasingly by policy-makers. Governments tended to see regulation of private activity as less interventionist than direct state control or public ownership.

In contrast to Europe, statutory regulation by independent agencies has a long history in the USA. Especially during President Roosevelt’s New Deal Era, several important independent regulatory commissions were established. For instance, the Federal Communications Commission (FCC) and the Securities and Exchange Commission were created in this period. American-style regulation involves powerful regulatory agencies which have all the rule-making, enforcement and sanctioning powers. The regulatory process is highly formalized and legalistic. It is rigid and rule-oriented. American style-regulation is based on the belief that markets work well under

normal circumstances and should be interfered only in special circumstances. Hence, contrary to the European experience, nationalization as a mode of regulation never gained popularity among the political elite in the USA (Majone, 1996).

In the USA, faith in the technical expertise has legitimized the existence of independent regulatory commissions. “Regulatory commissions emerged and became instruments of governance for industry precisely because Congress and Courts proved unable to satisfy the ‘great functional imperative’ of specialization and expertise” (Majone, 1996, p.16). Moreover, Fainsod (1940) stated that “(independent commissions) offered the possibility of achieving expertise in the treatment of special problems, relative freedom from the exigencies of party politics in their consideration, and expeditiousness in their disposition” (p.313).

However, between two styles of regulation, one thing was in common, namely their stance against competition. Until the late 1970s, American-style regulation restricted competition in the economic sectors. Hence, there were important similarities between American-style regulation through independent regulatory commissions and European style-regulation through public enterprises. Both styles of regulation restricted competition. Moreover, they both had accountability problems.

Different regulatory styles engendered different deregulation experiences between Europe and the USA. American deregulation was more successful than European privatizations in introducing competition. First of all, contrary to European experience, independent regulatory commissions in the USA, like FCC, facilitated the deregulation process. Second, the scope of competition introduced after deregulation policies was much more limited in Europe than in the USA. For instance, in the telecommunications sector, the UK had a long painful journey before privatizing British

Telecom and the introduction of competition in the sector. Moreover, at the end, the scope of competition in the sector was much more limited in Europe than in the USA (Majone, 1996).

In the late 1970s, independent regulatory agencies, which are committed to fostering competition, began to flourish in Europe. Especially in 1980s, the number of independent regulatory agencies increased dramatically since governments privatized most of the important public enterprises. In Europe, “privatization is best thought of as re-regulation – the replacement of one mode of regulation, public ownership, by another mode, statutory regulation” (Majone, 1996, Chapter 3, p.54).

In the 1990s, transatlantic difference in the modes of regulation became less visible. As explained in the above paragraphs, before the late 1970s, scholars defined regulation as a state intervention- the 2nd definition- in continental Europe. However, it had a narrower meaning- the 1st definition- in the USA. While independent regulatory institutions have spread, the 1st definition, “targeted rules” was increasingly used both in Europe and in the USA. Moreover, prevailing modes of regulation in Europe and in the USA became competition-friendly.

However, different regulatory styles of Europe and the USA have engendered establishment of different regulatory agencies. In Europe, regulatory agencies are much more dependent on the political system than the regulatory commissions in the USA. “The Secretary of State retains important regulatory powers and the operation of the regulatory body is dependent on prior decisions of the Minister as to the principles to be applied” (Majone, 1996, p.21). Ministries are always heavily involved in the managerial decisions of the regulatory agencies. The reason lies in the European history. The period of nationalization in the post-World War II period blurred the boundaries between the

managers of public enterprises and the regulators of economic sectors. The regulator was subordinated to the manager. However, regulatory commissions in the USA were much more independent from political interferences. Moreover, as explained in the above paragraphs, they pioneered the deregulation policies in the relevant economic sectors.

Historical record shows that when American regulators enjoy the support of the courts, of the Congress, and of academic and public opinion, they can overcome the resistance of the regulated industries and of the executive branch including the President (Majone, 1996, p.22). Hence, American regulatory commissions pioneered deregulatory reforms, and reforms were implemented much more smoothly than in Europe. Despite its criticisms, American-style regulation, which emphasizes independence and expertise, is able to produce incisive regulatory policies, and also to push through deregulation when economic and technological changes necessitate it.

In the 1980s, relations between regulation and competition also changed. In the 1970s, regulation was the enemy of competition (Stigler, 1975). Elimination of regulation was seen as a necessary condition for competition (Jordana & Levi-Faur, 2004). In the 1980s, regulation contained new competition-friendly techniques (Jordana & Levi-Faur, 2004).

Although regulatory commissions in the USA were independent from political interferences, their power rested on the Congress. The Congress gave political support to the Commissions. Although the President appoints the chairmen and the commissioners, he cannot remove members at will, and in particular he cannot remove them because of disagreement over policy. Finally, federal courts review the decisions of regulatory commissions, and have the right to overturn their decisions if necessary. As a result, accountability of regulatory commissions increased.

The quality of their staff is also important for explaining the success of regulatory commissions in overcoming pressure from politics and interest groups, and liberalizing the important economic sectors. They have a pro-deregulation stance even if the deregulation policy threatens the existence of the commission and the size of the staff. “This open-mindedness may be due to the recent rise of professional policy analysts using widely shared standards of argument and problem-solving styles, and to the growing influence of public interest groups, both of which factors balance the influence of bureaucratic ideologies and traditional patterns of behaviour” (Majone, 1996, p.22).

Regulation-*of*-competition and regulation-*for*-competition are other two important notions, which deserve attention in this context. These two notions differ in the degree of intervention by state authorities and in the capacities of the state to monitor and enforce competition. Establishing national competition authorities was an act of regulation-*of*-competition. However, establishing sector-specific regulatory authorities, like the Banking Regulation and Supervision Agency (BRSA) in the case of Turkey, was an example of regulation-*for*-competition. National competition authorities have broader responsibilities than sector specific regulatory authorities. As a result, they can implement less pressure on market actors. Moreover, sector-specific regulatory authorities are proactive in market design and market control, whereas national competition authorities are reactive to anti-competitive actions of market actors (Jordana & Levi-Faur, 2004).

Theories of Regulation

Until the early 1960s, prevailing theory of regulation regarded market failure as the motivating reason for regulatory intervention. This theory is called *public interest theory of regulation*. State acts in the public interest in order to tackle market imperfections. Hence, regulations exist to correct market failures¹ and protect poorly informed consumers from harm. Regulatory intervention occurs primarily to maximize social welfare. In this approach, trust-worthiness of expert regulators is emphasized. Public should trust in expert regulators. Regulation is conceived “as reflecting the public spiritedness of a Hegelian state elite” (Baldwin et al., 1998, p.10). This theory is also called the normative theory of regulation.

In the 1970s, economists began to criticize regulation for being unable to achieve its aims, namely to correct market failure. Instead, they claimed that regulation created more resource misallocation than it cured. Therefore, they drew attention to the influence of regulation on wealth distribution and resource allocation, which public interest theory of regulation failed to explain adequately (Peltzman, 1976). Allocative effects of regulation gained importance in the literature.

Public interest theory of regulation contains several other weaknesses. It underestimates the extent to which regulation is the product of clashes between different interest groups (Baldwin et al., 1998, p.9). Moreover, since it includes functional analysis regarding the sources of regulation, it is unable to identify and analyze

¹ Basic market failures are: monopoly power, negative externalities, information failures, inadequate provision of public goods (Majone, 1996, p.28-29).

adequately the influence of powerful interest groups on the workings of regulatory agencies.

In this context, the theory of economic regulation (ET) gained prominence. At the core of the theory of economic regulation is transfer of wealth (Peltzman, 1976). It was popularized by Stigler (1971). He (1971) claimed that: “The central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources” (p.3).

Regulation is a power game between two groups, namely producers and consumers. Moreover, the producer interest tends to prevail over the consumer interest (Peltzman, 1976). Producers’ interest in restraining competition dominates the political system (Peltzman, 1989). Thus, Stigler’s theory of economic regulation can also be called “producer protection” view in contrast to “consumer protection” view of public interest theory.

According to ET, regulation is a commodity being transacted in the political market between constituents on the demand side and their political representatives on the supply side (Peltzman, 1976). However, theory of economic regulation also seeks to answer the question of which group will have the highest effective demand and thus will be able to receive regulation. Stigler (1971) claims that numerically small, compact groups (producers), which have large per capita stake over the large group, tend to prevail over numerically large groups with diffuse interests (consumers) in the political auction of ‘selling’ regulation. In summary, it characterizes the regulatory process as an interest group competition in which compact, well-organized groups are able to use the coercive power of the state to capture rents for those groups at the expense of more

dispersed groups. According to Stigler (1971), “regulation is not instituted in the public interest (...) but is acquired by an industry and designed and operated for the latter’s benefit” (p.3).

In the theory of economic regulation, politicians are presumed to be utility-maximizers. Their utility function includes securing and maintaining political power. As a result, they seek votes and money in order to gain political power. Organized interest groups, affected by regulatory decisions, supply the necessary resources for political power in exchange of favorable regulatory decisions by politicians (Stigler, 1971). Thus, regulatory processes are part of the politico-economic exchange between politicians and interest groups. According to Peltzman (1989), “self-interested politicians and constituents exchange objects of utility – a price or entry certificate for votes and money- and what matters to each actor is their wealth or utility, not the aggregate social wealth” (p.7). Politicians evaluate the winners and losers of the regulatory interventions in order to promote their re-election chances, since the rents generated by regulation create different groups of winners and losers. For instance, the combination of deposit insurance and directed credit illustrate such rent-sharing between politicians and banking community (Benston & Kaufmann, 1996). As a result, in contrast to public interest theory of regulation, “ regulation is not about enhancing efficiency by correcting market failures, but about redistributing income from some groups in society (typically, consumers and diffuse interests) to others (producers and politicians)” (Majone, 1996, p.31).

Theory of economic regulation has a presumed chain of control. Interest groups control politicians and politicians control regulators, so the interest groups control regulators and achieve their aims through controlling them (Majone, 1996, p.35). In

other words, regulatory agencies are ‘captured’ by interest groups. Therefore, theory of economic regulation is also called *capture theory*.

Another variation of the theory of economic regulation is *the microeconomic theory of regulation*. It focuses on the private rational actor rather than the group, institution, or the state. Organizations and regulatory agencies are analyzed from the perspectives of individuals working in these organizations. “Stress is placed on the propensity of such individual actors to circumvent official regulatory goals by substituting objectives that are self-serving and to act in pursuit of such ends, as job retention or aggrandizement, re-election, or the accumulation of personal wealth” (Baldwin et al., 1998, p.10). Similar to ET, public interest plays a small role. Political activities can also be seen as the outcome of rationally self-interested policy-makers. Organizations and bureaucracies are analyzed with reference to preferences of the individuals that make up such collectives. However, in the end, similar to the theory of economic regulation, regulation was a commodity ‘bought’ by the economically powerful. In summary, regulatory policy making is a power game between winners and losers of the regulatory intervention and it reflects the balance of power between different interest groups.

Theory of economic regulation failed to explain the deregulation process in the 1980s adequately, despite the famous work of Peltzman (1989). Thus, it is attacked on different grounds. “They cannot explain where the preferences in the ‘market’ (taken as given in conventional economic analysis) come from, why they are diverse, how far they vary, and why they change” (Baldwin et al., 1998, p.11). Moreover, actors may not have definite preferences on regulatory issues and they may behave altruistically because of

different reasons. Informational deficiencies may prevent actors to act rationally or in a self-serving way.

Perceived deficiencies in the above theories are filled by *agency theories*. Both public interest theory of regulation and the theory of economic regulation fail to explain adequately the institutional adaptation and design. Moreover, they treat political and bureaucratic institutions as black boxes. A central issue in agency theories is “the cost and difficulty to controlling parties of obtaining information of a quality adequate for effective oversight”. Analysis of informational and transactional restraints helps to understand regulatory behaviour.

According to the ‘institutionalist’ strain of agency theory, institutional and behavioral characteristics of regulatory agencies are important in order to understand the policy changes in the regulatory frameworks. The focus is on monitoring and agency relationships. The reason is that regulators are operating in a complex political environment, which not only includes economic interests but also includes political executives, legislators, rival agencies, political parties, the media, judges and supranational bodies like IMF and World Bank. Moreover, economic interests are not smoothly transferred to regulatory policies. Bureaucratic and political institutions affect the outcome (Baldwin et al., 1998).

Independent Regulatory Agencies

Establishment of independent regulatory agencies (IRAs) is an important step in the evolution of the mode of regulation. IRAs can be defined as “public organizations with regulatory powers that are neither directly elected by the people, nor directly managed

by elected officials” (Gilardi, 2004, p.67). They are part of the regulatory regimes in the world since the 1990s. Most importantly, they imply de-politicization of the regulatory processes, which is a breakthrough achievement in the history of regulation. Thus, while the above explained theories are useful in understanding the change in the modes of regulations, we need different tools and theories in order to understand the factors contributing to the establishment of IRAs.

Functional analysis introduces the necessity of expertise in governmental bodies as a justification for IRAs. The sources of this explanation lie at the American political science literature, which justified the origins of independent regulatory commissions in the USA. The growing complexity of public policy challenged the standard command and control techniques of governmental bureaucracy. Intimate knowledge of the regulated activity is continuously raised as a reason for autonomous regulatory agencies and for granting wide discretion to regulators. Advantages of delegation from politicians to experts were recognized already in the American context, much earlier than in Europe. In the mid-1950s, Marver Bernstein (1955) wrote:

In general, the commission form has been championed by those who believe that administrative regulation requires a high degree of expertness, a mastery of technical detail, and continuity and stability of policy. These requirements, it is alleged, can only be met by a board of commissioners functioning in a neutral environment, free from partisan political considerations (p.4).

Majone (1996) criticized the functional explanations as partial and *ad hoc*. According to Majone (1996), those functional explanations are not theoretically well-grounded. They cannot forcefully address delegation problem and credibility problem which arise from the establishment of IRAs. Moreover, they cannot explain under which conditions

political principals are willing to delegate important policy-making powers to independent bodies (Majone, 1996, p.46).

Majone (1996) combined both institutional and self-interest analyses in explaining the rise of the 'regulatory state' in Europe. According to Majone (1996), the factors contributing to the establishment of independent regulatory agencies in Europe were: American influence, the crisis of interventionist policies, the already mentioned regulatory framework needed for privatization and the cumulative impact of a growing body of community regulations (Majone, 1996, p.46).

Gilardi (2004) analyzes the factors contributing to the establishment of IRAs in Europe by applying the theory of new institutionalism. There are three strains of new institutionalism, namely: rational choice institutionalism, sociological institutionalism and historical institutionalism. New institutionalism focuses more on the relationship between institutions and actors instead of institutions themselves. Institutions shape human behaviour and institutional procedures distort decisions and preferences (Immergut, 1998).

According to rational choice institutionalism, IRAs emerged out of credibility problems of the politicians. In this theory, actors are perceived to be rational utility-maximizers. Their decisions are limited by the surrounding institutions. More importantly, institutions are seen as the result of deliberate human choices. The shape of institutions is determined by the preferences of the relevant actors (Immergut, 1998). As a result, IRAs are created to solve problems of choice over time, namely, credible commitments and political uncertainty. Politicians want to improve the credibility of their policies and to solve the political uncertainty surrounding the problem by establishing IRAs (Hall & Taylor, 1996).

Politicians increase the credibility of their actions by delegating their discretionary powers to IRAs. Credibility is a valuable asset for politicians when they carry out regulatory policy. Policy-makers must credibly signal their commitment to the announced regulatory action. By delegating their powers to IRAs, governments bind themselves and remove their future freedom of actions. In other words, governments prove their commitment to a certain course of regulatory action by delegating their powers to IRAs. Since elected officials have short time horizons and may face incentives to renege on commitments, delegating regulatory powers to IRAs may increase their credibility. IRAs are supposed to be free from opportunism and partisan party politics because of their preferences, legal mandate or time horizon (Gilardi, 2004). For instance, regarding the monetary policy, if the central bank is not independent, economic actors are likely to anticipate government's unwillingness to tighten monetary policy at the wake of the elections and inflation expectations rise. As a result, actual inflation rate rises.

Transnational actors promote the establishment of IRAs. Governments that are entangled with growing regulatory competition are pushed to transfer control through institutionalized forms of delegation as a way to enhance their credentials in the eyes of transnational business (Majone, 1996).

According to rational choice institutionalism, political uncertainty is another problem that influences the creation of the IRAs. In a democratic political system, the right to exercise public authority, the right to make choices about policy and the structure of government, are uncertain because they are bound to be altered periodically because of general elections. Governments tend to change frequently because of periodic elections. This uncertainty forces politicians to set up IRAs in order to protect their

policies, since IRAs provide greater policy continuity. In other words, in the face of uncertainty, politicians may want to insulate policy from politics through IRAs. For instance, Thatcher administration favoured independent regulators in order to prevent capture by the Labour Party (Vogel, 1996). As a result, especially weak governments tend to establish IRAs in order to exercise public authority even after they lose political power.

There are certain weaknesses in rational choice institutionalism. Role of time and history are underestimated. As a result, it is not strong in explaining long-term dynamics that govern change in institutions.

Sociological institutionalism relies on a broader definition of institutions. According to sociological institutionalism, institutions include not only formal rules and procedures, but also norms. It also rejects functional explanations put forward by rational choice institutionalism. Institutional origins and change are not the result of intentional actions of the actors. Institutions may be created not because of their functions that they are expected to perform but simply because of their symbolic properties.

In contrast to rational choice institutionalism, sociological institutionalism claims that governments behave interdependently. They look at other governments before establishing IRAs. The governments may not be goal-oriented when they mirror other governments. For instance, when one country shares similar values and norms with another country, it may imitate the other.

Organizations can be created independently from the functions they can accomplish. Governments may create IRAs in order to divert attention from more substantial concerns like liberalization of utilities. As IRAs become more common in the

world, establishing IRAs help governments to legitimize certain policy choices. In sum, IRAs can be established as a legitimization device. This argument is called *ceremonial adoption*.

Governments may establish IRAs for IRAs may be ‘popular’ at the time. Over time, some organizational forms can become the ‘rule of the day’ regardless of the functions they perform. Governments establish IRAs just because it is the most normal and obvious policy to do in the given context. “Policies or organizations are taken for granted when they are so widespread that there is little question that they are the appropriate choice” (Gilardi, 2005, p. 90). This argument is called *taken-for-grantedness* and it is derived from the sociological literature on organizations.

Symbolic imitation approach resembles *taken-for-grantedness* approach.

Symbolic imitation approach claims that adoption of different regulatory policies is a ceremonial process, which aimed to legitimize the actions of adopters (Gilardi, 2005). In short, according to both approaches, taken-for-grantedness and symbolic imitation, changes in the regulatory policies are independent from actual functional values. Symbolic properties of policies are far more important than their functional properties. Gilardi (2005) brings taken-for-grantedness and symbolic imitation under the label *emulation*.

There are certain advantages and disadvantages of sociological institutionalist explanations. Sociological institutionalism cannot explain adequately the origins of IRAs, which are supposed to be established for some functional reasons. It explains rather the spread of IRAs better. Moreover, it cannot adequately explicate the functional rationales behind institutions. Organizational form is increasingly taken for granted.

However, it is a dynamic theory which explains longitudinal processes better (Gilardi, 2004).

Historical institutionalism focuses on the path-dependent processes in shaping the IRAs. It adds a historical perspective to the discussion of institutions. Preferences of actors can be shaped by institutions. Path dependent processes limit the possibility of change. Once the institution is established at the 'critical juncture', the path is followed in a deterministic manner. There are several mechanisms that contribute to path dependency. "In politics, they include the use of political authority to enhance power asymmetries, the coordination benefits deriving from institutions, and the assets political actors develop on the basis of existing institutions" (Gilardi, 2004, p.80).

These arguments about path dependency are used by historical institutionalism in explaining the creation of IRAs. While rational choice institutionalism proposes functional factors contributing to the emergence of IRAs, historical institutionalism proposes contextual factors. Structural features of the political economic context and state traditions are the major contextual factors contributing to the emergence of the IRAs. For instance, establishing IRAs in the USA was easy since it had a long tradition of regulatory commissions. However, in France it was not easy because of the historical relationship between state and market. As a result, path dependent arguments can also help us understand the resistance to the establishment of IRAs.

There are certain advantages and disadvantages of historical institutionalism. It is strong in explaining the change in institutional arrangements. However, trigger of change is usually functional pressures. It is especially suitable for case studies, rather than broad comparisons. Time and history is fully taken into account in historical institutional explanations.

Role of International Institutions: Diffusion of Regulation

International institutions are crucial in understanding the change in the mode of regulation. However, above theories fail to address role of international institutions adequately, since they focus on domestic institutions and domestic power struggles. However, world is increasingly becoming interdependent and international institutions, which facilitate cooperation among nation-states, have proliferated since the late 1970s. As a result, role of international institutions in generating regulatory change within nation-states should also be addressed in order to capture a better view of the change in the mode of regulation. “Vertical” or “top-down” approaches in the diffusion perspective address the role of the international institutions in engendering regulatory change.

As it is explained in the above paragraphs, mode of regulation has been changing in different parts of the world, yet along similar lines. In other words, modes of regulation in nation-states have been gradually moving toward statutory regulation implemented by IRAs since the late 1970s. Hence diffusion perspective has gained prominence in the academic literature. “Diffusion [perspective] is motivated by this observation that nation-states, or other jurisdictional unit, choose similar institution within a fairly circumscribed period of time” (Elkins & Simmons, 2005, p.34). Diffusion perspective focuses on the interdependencies and contagious aspects of change in the mode of regulation. It “suggests that the regulatory order that was shaped in some leading countries and sectors is then diffused to the rest of the world” (Levi-Faur, 2005, p.24). Sources of this diffusion are mostly the highly developed capitalist countries. When these countries experience structural problems in some sectors, then they change

their internal order. But more importantly, they also change the way they see the world. Their own internal order is then exported to other parts of the world (Levi-Faur, 2005).

In this view, contrary to the theory of economic regulation, domestic interests of private actors are secondary in the analysis of change in the mode of regulation. Primary focus is on the effects of global change on the domestic structures, not on the domestic power struggles between different actors:

The clash of interests is not only quantitatively less important as an explanation, it is causally secondary: the interests of the actors are constituted in response to received models [i.e. diffusion, CY]; they do not pre-exist.... Hence, in Australia we have laws criminalizing rape not because of any titanic struggle between a women's movement (or some other actor) which demanded rape laws and others who resisted them; rather, we acquired them without debate from British criminal law (Braithwaite & Drahos, 2002, p.581-582).

As a result, regulatory change is explained through the analysis of global developments instead of domestic struggles.

The mechanisms of diffusion are also important elements in the diffusion perspective. In other words, one of the central questions in the diffusion perspective is that how institutions spread around the world. "Top-down" or "vertical" approaches in the diffusion perspective, focus on the role of international institutions in generating regulatory change within nation-states. Changes in the regulatory regimes are examined as the responses of national policy makers to pressures from international institutions on national policy communities. "Their [international institutions] financial power and the terms of conditionality that they enforce, as well as their monopoly on advice to governments, serve to explain systemic change in general and the rise of regulatory capitalism in particular" (Levi-Faur, 2005, p.25). In short, according

vertical diffusion perspective, coercion by international organizations is important in facilitating regulatory change within nation-states.

However, there is a gap in the vertical diffusion perspective. It is not able to address the mechanisms through which policy-makers adopt the policy recommendations of international institutions adequately. The question that is not answered sufficiently in the vertical diffusion perspective is that in which conditions policy-makers are more likely to implement the policy recommendations of international institutions.

In an article about financial market liberalization, Christopher Way (2005) aimed to fill this gap by emphasizing the learning process of policy-makers. The question he asked was that on which conditions policy-makers were receptive to policy advice from international organizations and deregulated domestic financial markets. In his analysis, he focused “on the micro-foundations of diffusion by emphasizing the incentives facing office-seeking leaders” (p.126). In contrast to vertical approach in the diffusion perspective, he adopted a “horizontal” approach and analyzed the role of international institutions in generating regulatory change as well as the choices of policy-makers. Office-seeking leaders were treated as pivots acting between the pressures originating from international institutions and international environment, and the pressures emanating from domestic political environment. His main conclusion is that “politically insecure leaders are potent agents of diffusion because they are particularly likely to “learn” the lessons of financial market reform” (Way, 2005, p126).

There are several reasons for this “quick-learning of politically insecure leaders” (Way, 2005, p.127). Primary reason is that immediate aftermath of

financial market liberalization is often characterized by an economic boom. Increased borrowing opportunities, new credit instruments, and capital inflows facilitate credit-driven consumption and investment boom, which boost economic growth (Wyplosz, 2001). As a result, Way (2005) argues that economic boom generated by capital inflows can provide a source of political strength for politically insecure leaders.

Moreover, there are distinct psychological traits of political insecure leaders, which make them more receptive to the pressures emanating from international institutions. Politically insecure leaders are generally prone to wishful thinking and thinking in terms of short-time horizons. Combining these distinctive psychological traits with the specific dynamics of domestic financial market reform, which are explained in the above paragraph, suggests that politically insecure leaders are likely to initiate financial market liberalization.

Second reason is that political insecure leaders simply jump on the liberalization bandwagon and emulate other nations, when they observe that other countries liberalize their capital accounts and experience economic booms in the aftermath of financial liberalization. This argument is consistent with the *symbolic imitation* or *taken-for-grantedness* approaches in the sociological institutionalism. According to Way (2005),

Leaders struggling to hold on to power will be searching for alternative policies that can deliver the goods necessary to bolster their chances of staying in power. Trends in nearby countries will surely be noticed, and countries apparently benefiting from reform will provide powerful and persuasive examples for others to emulate (p.132)

As a result, politically insecure leaders are more likely to imitate policies of other countries.

Third reason is that politically insecure leaders are more receptive to policy recommendations of international financial institutions. This hypothesis aims to fill the gap in the vertical diffusion perspective. Way (2005) claims that

They [politically insecure governments] have motivated biases (“wishful thinking”) both to believe the efficiency claims of liberalizers and strong reasons to seek a semiofficial “seal of approval” for their policies. Leaders who are otherwise resistant to the advice of international financial institutions (IFIs) may see things differently when their political needs are great (p.127)

As a result, regional trends toward liberalization and the role of international institutions in generating financial market reform interact positively with domestic political insecurity and engender financial market liberalization in nation-states.

Regulation of the Banking Sector

Now, it is time to pass on to a more specific and narrow subject in the large literature of regulation: banking sector regulation. Banking regulation is not a new concept. It has been discussed since the beginning of the 20th century. However, the rationales and the modes of banking sector regulation have changed over time.

As explained in the above paragraphs, public interest theorists claim that regulation exists in order to correct market failures. This is especially true regarding the banking sector. As Kaufman (2000) states:

Market failures in banking are often seen as more damaging than market failures in other industries, in large part because the public appears to understand less well the industries, such as banking, that deal in intangibles than those that deal in tangibles, such as manufacturing and mining. The operations of banks appear shrouded in mystery. As a result, failures are

more frightening and become cause of alarm about system breakdown (p.113).

In short, major rationale for regulation of the banking sector is to correct market failures.

In order to understand the idiosyncrasies of the banking sector regulation, major characteristics of the banking sector must be understood. Confidence is at the core of banking services. There are two aspects of confidence. One aspect is that confidence the individual or organization has in the bankers responsible for managing funds and in the regulators monitoring the financial system. The other aspect of trust is the expectation of the community that there are certain rules that govern financial services. The extent to which these rules are known and shared by financial sector players is one of the principal components in establishing trust in the system (Francis, 1993, p.187-188).

As a result, a proper regulatory regime must first aim to maintain the confidence in the banking sector². “It aims to protect consumers against risk, by defining acceptable risk in financial transactions, sorting out responsibility for the risk at issue, and devising appropriate strategies of risk reduction” (Francis, 1993, p.180). At the same time, governments encourage risk taking behaviour in order to increase available funds in the economy. These seemingly conflictual objectives constitute the basic characteristics of financial regulatory regimes.

The critical role of the banking sector in the overall economy necessitated regulatory intervention of the governments. Bank failures were perceived to be more detrimental and costly to the economy than collapses of private firms. According to Kaufman (2000), bank failures would:

²According to Turkish Banks Act No.3182 enacted in 1985, there are two major goals of banking sector regulation. The first goal is to protect the depositors. The second goal is to manipulate the assets in the banking sector for the benefit of the whole economy.

1. Reduce deposits and thereby reduce the aggregate money supply and hamper trade,
2. Reduce the most liquid wealth holding of a large number of lower-income and middle-income households,
3. Reduce the availability of the major source of credit to households, business enterprises, and governments, and
4. Give rise to fears that the failures would spread to other banks and beyond to the financial system as a whole, to the macro economy, and to other countries – that is, produce systemic risk (p.116).

Banks are better equipped with the information asymmetry problems, thus they have crucial roles in increasing the overall economic efficiency. Banks have important advantages over other financial intermediaries in solving information asymmetries. Banks have easier access to information about private firms and thus they decrease asymmetric information problems. As a result, banks increase overall economic efficiency. Hence banking failures may cause a wide range of problems in the economy. Private firms, who borrow from banks, may go bankrupt because banks may call back their loans in times of distress. In addition, if many banks fail, then information in these banks also disappears and thus asymmetric information problem becomes worse. In summary, the government aims to ensure the safety of banks through regulation, since banks increase overall economic efficiency.

Bank regulation is also focused on using banks to pursue the economic, political, or social goals of the government through directed credit and provision of revenue to the government. In other words, regulation of the banking sector is achieved through the manipulation of state-owned or state-controlled banks in the banking sector. In addition, banks provide credit to governments. “In many countries, the first banks were chartered by the governments to make loans to itself, chartered in exchange for part of the revenues the banks would generate” (Kaufman, 2000, p.114). For instance, the earliest

state-chartered banks in the USA were thought as public utilities. The tradition of state-owned or state-controlled banks continued in the 20th century.

Bank regulation aims to prevent excessive economic concentration and encourage competition. The reason is that control over money and credit is viewed as more dangerous than control over other sectors.

Ensuring the safety of banks is not an easy task. Government aims to ensure the safety of banks through prudential regulation. Regulatory regime must address the fragilities of the banking sector adequately. Banks are conceived as structurally fragile. The perceived fragility arises from three sources:

1. Low cash-to-assets ratio (fractional reserve banking);
2. Low capital-to-assets ratio (high leverage);
3. High demand debt (deposit)-to-total debt (deposit) ratio.

However, in the 1980s, banking sector regulation gained much more attention due to several factors. New justifications for regulation emerged, namely, preventing fraud and preventing systemic economic collapse. First of all, domestic financial markets were liberalized and they were opened to foreign competition. Second, state's heavy involvement in the financial sector through public banks began to diminish. As a result, banks began to become major financial actors in the international financial arena. They contain more systemic risk than ever. Possible bank failures may endanger the whole international economy.

Fragilities in the banking sector and bank failures increased worldwide since the late 1970s. For instance, according to a survey done by the IMF in 1996, two-thirds of IMF-member countries experienced banking sector problems since 1980. Moreover,

domestic cost of resolving insolvent banks has almost always exceeded 10 percent of the country's GDP (Kaufman, 2000, p.109).

Banking sector vulnerabilities seemed to trigger financial crisis. In 1988, the Basel Committee on Bank Supervision published the Capital Accord, which defined new capital adequacy ratios that should be imposed on banks, with the goal of preventing bank failures and systemic risks. More importantly, financial crisis was not limited to national borders, because of the international connections of the banking sector. As a result, international standards for bank regulation became necessary, especially after the East Asian financial crisis in 1997. The IMF and the World Bank got interested in the issue. They stressed the importance of prudential regulations of the financial sector especially in the emerging market economies, namely, licensing, public bank activities, and depoliticizing the regulation process. Basel II, published by the Basel Committee in 1999, defined new risks, namely, market risk and operation risk. Moreover, International rating agencies and audit firms were attached to the regulation process.

Banking sector frequently have liquidity problems. Liquidity shortage occurs when banks experience massive deposit withdrawals. Banks usually recognize this risk and take precautions:

by holding a sufficient amount of liquid assets to meet depositors' demands, by making arrangements with other banks to advance funds, and by conducting their affairs and holding a sufficient amount of capital so that depositors would not withdraw their funds" (Benston & Kaufman, 1996, p.692).

However, if one single bank fails to take these precautions adequately, then a possible run on this bank may cause other bank runs on even solvent banks. The reason is that depositors are not able to distinguish solvent and insolvent banks. Liquidity shortage may engender solvency problems. As a result, government supervises the banking sector

closely. For instance, it regularly observes the fractional reserves of banks. It introduces deposit guarantee schemes in order to prevent bank runs.

Government regulation of banks can reduce uncertainties about the value of bank-produced money. As a result, positive externalities may be produced. The value of bank cheque and deposits that serve as money rests on two important expectations of the bank customers. First, bank customers expect that a bank on which cheque is drawn will not fail. If bank customers have uncertainty about the health of the bank, the value of bank cheques as money and the value of bank deposits as stores of value diminish. Second expectation is that the purchasing power of money, including bank money, will not change abruptly. Hence, governments must regulate and supervise the banking sector.

History of Banking Sector Regulation and Modes of Banking Sector Regulation

There are different modes of regulation applied throughout the history. Self-regulation, disclosure requirements and risk-containment regulations are the major modes of regulation. However, Gual (1999) categorized the modes of regulation that emerged after World War II.

Self-regulation of the financial sector was the most ancient mode of regulation applied in the world. Bankers often possessed their own rules of conduct. These rules were sustained by the knowledge that bankers have of each other (Francis, 1993). At the beginning of the 20th century, when the powers of private banks grew considerably, states like the UK, and the USA, tried to regulate the banking sector by establishing central banks.

Disclosure requirements were the major regulatory measures implemented in the first half of the 20th century. Later segmentation of the financial sector occurred as a basic regulatory measure, especially in the USA. For instance, in the USA, there were three types of financial institutions, savings and loan organizations, commercial banks and securities industries. These institutions have different objectives and different regulatory standards. For instance, savings and loan organizations are able to offer higher interest rates on deposits than commercial banks. However, until the 1980s, S&Ls had to invest their funds only in housing projects. In other words, certain financial institutions were able to engage in certain allowed financial activities. There were also geographical restrictions on opening branches by commercial banks (Francis, 1993).

Risk containment regulation gathered momentum in the late 1970s. The major method is to establish reserve and insurance requirements for banks. Reserve requirements allow a reasonable portion of the banks' clients to be able to withdraw their funds. The rationale is that unless there is a reasonable amount of funds kept in the banks' safes, there is the prospect of a run occurring on the bank. Risk containment regulation may also promote spreading risks of loss so that a possible failure of one of banks' clients will not endanger the solvency of the bank. However, ultimate measure of risk protection is deposit insurance scheme. It is often underwritten by the state. "The state assures investors that they will be reimbursed for some or all of their funds placed under supervision of the financial house" (Francis, 1993, p.191). Deposit insurance schemes have been especially popular in the USA since the 1930s.

Aside from self-regulation and disclosure requirements, Gual (1999) identified three major categories of regulatory interventions in the banking sector. These categories

of regulatory interventions help us to understand the changes in the banking sector regulation from the late 1970s. According to Gual (1996):

1. First type of regulations softens domestic competition. This category includes controls on credit, interest rates and fees, restrictions on entry and mergers and acquisitions, and controls on capital flows.
2. The second group is regulations that limit the scope and scale of banks. This category involves restrictions on domestic branching and establishment in foreign markets, and limits to activities within conventional banking, insurance, and securities.
3. The last group is mainly concerned with regulations that alter the external competitive position of banks. This final category deals with reserve and investment coefficients, solvency and capital adequacy regulations, deposit insurance schemes, and restrictions on ownership linkages with non-financial firms (p.4).

From the 1980s onwards, the deregulation process involved massive changes in the above mentioned three areas of regulatory interventions all over the world. While the first and second category of regulatory interventions were lifted gradually, prudential regulatory standards were increasingly applied, especially in the first half of the 1990s. Moreover, privatization of public banks, especially in the continental Europe accompanied the process. Hence, the mode of regulation shifted from the involvement of state through public banks into statutory regulation implemented by independent agencies.

In Europe³, regulatory measures which curtail domestic competition-first type of regulatory interventions- were lifted earlier than the other two sets of regulatory measures. Restrictions on domestic interest rates and credit controls were lifted gradually. In the 1980s, deregulation of interest rates was complete. In

³ European countries that are analyzed in terms of regulatory regimes are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, the United Kingdom.

the same European countries, capital flows were liberalized at the beginning of the 1990s (Gual, 1999).

The second set of regulations limit the range of activities that can be undertaken by banks. It includes limitations on opening branches in foreign countries. Moreover, it includes segmentation. Segmentation means that banks cannot invest their funds on certain financial instruments like securities or selling insurance policies. The goal is to limit risky investments of banks. However, the second group of regulatory interventions was lifted gradually at the beginning of the 1990s. The EU directives have played an important role in lifting these restrictions. First Banking Directive of the EU allowed national banks to open branches in other member countries. The second Banking Directive provided a single passport for all European banks. For instance, banks were allowed to invest in other member country's stock exchange. Hence, segmentation was gradually lifted (Gual 1999).

Prudential regulations, which were under the heading of the third group of regulatory interventions, replaced the first and second group of regulatory interventions in most of the EU countries. Prudential regulation involves restrictive equity requirements, restrictions on banks' investments, solvency and capital adequacy ratios. Deposit insurance schemes may also be included in this heading. According to Gual (1999):

Many EU regulations have been devoted to harmonising prudential requirements. The objective has been to create a level playing field by imposing minimum standards on regulations which, on the grounds of solvency and stability, impose costs on domestic banks. The EU directives include legislation on solvency ratios, the definition of own funds, large exposures and others (p.7).

At the beginning of the 1990s, most of the EU countries adopted prudential regulations.

The experience of banking sector regulation in the USA is also important. Banking sector was heavily regulated in the USA until the late 1970s. The reason was that excessive competition was seen as the enemy of the stability in the banking sector after the financial crisis in 1929. Contrary to European mode of regulation in the aftermath of World War II, mode of regulation in the USA never included nationalizations or the heavy involvement of state-owned banks in the banking sector. Instead, statutory regulation constituted the backbone of the US banking sector regulatory regime. Regulatory regime was not competition-friendly. Extensive product, geographical and price regulations were introduced after the Great Depression. There were various regulatory agencies composing a complex regulatory framework for the banking sector.

Deregulation of the banking sector gained momentum in the 1980s in the USA, similar to the experiences in the EU. The Major impetus for deregulation was the bank failures and the failures of Savings and Loans organizations in the 1980s. Between 1980 and 1994, no less than 1617 banks failed which constituted 9.14% of all banks with deposits of US\$ 206 billion or 8.98% of the deposits of the whole banking system (Busch, 2002, p.13). The goal of the deregulatory measures was specifically to save the Savings and Loans (S&Ls) which were going down. The first and second group of regulatory interventions, which were defined by Gual (1999), were gradually lifted. For instance, geographical restrictions on opening branches were relaxed. Moreover, regulatory regime was simplified and unified. S&Ls were allowed to invest their funds

on different financial instruments other than housing projects. Hence segmentation in the banking sector was relaxed.

In the UK, contrary to continental Europe, banking sector regulation was traditionally very lax. Regulatory system was flexible and informal. The Bank of England was the main regulatory agency. It was nationalized only after World War II. Informal self-regulation was the primary mode of regulation in many years. Francis (1993) stated that “the force of tradition is particularly apparent in British financial services, where trust in banking and securities exchanges was sustained by the belief that the banking community was just that – a community that, over time, had generated its own norms” (p.188). Since the number of financial service practitioners was small, informal self-regulation worked well until the 1980s.

In 1997, there was a major reform in the regulatory framework for the banking sector. Mode of regulation was changed. Bank of England was stripped of its supervisory role. Financial market supervision was delegated to the Financial Services Authority (FSA) created in 1997. Hence, the UK adopted statutory regulation through independent regulatory agencies as a mode of regulation. Moreover, the UK adopted most of the EU directives, which imposed prudential regulatory standards to member countries. However, self-regulation continued to prevail in the banking sector. Similar to the US experience, the institutional reform in the UK was triggered by the bank failures in 1991(*BCCI*) and in 1995 (*Barings Bank*). International developments in the banking sector regulation were not crucial in generating reform in the British regulatory framework for the banking sector.

Banking sector in Mexico, was heavily regulated until the late 1980s. Mode of regulation included credit allocation through large public banks, interest rate ceilings,

and restrictions on entry. It was a classical case of financial repression (Gruben, 2000, p.246). In 1989, financial market was liberalized:

Mexico introduced reforms to eliminate controls on interest rates generally and to eliminate prohibitions on paying interest for traditional bank deposits and restrictions over terms upon which deposits and credit were made available; it eliminated forced loans to the public sector at below-market interest rates and eliminated governmental edicts on the industry-by-industry allocation of funds (Gruben, 2000, p.246).

In 1991 and 1992, 18 state-owned banks were privatized. However, full deposit insurance scheme continued to operate. As a result of these reforms and thanks to full deposit insurance scheme, Mexican banks began to engage in risky behaviour. This was an important factor in precipitating the Tequila crisis. The problem was that while first and second category of regulatory interventions was lifted, Mexico failed to implement prudential regulation in order to contain risky behaviour of banks. Moreover, full deposit insurance scheme in an environment of free capital flows generated a moral hazard, which in turn engendered risky behaviour by private banks.

In Argentina, the financial market was not as heavily regulated as in Mexico, prior to the deregulation process. For instance, there was no control on interest rates. In addition, Argentine banking sector was small since high inflation rate in the 1980s discouraged Argentinean citizens from holding Argentinean peso. However, credit allocation was not completely market driven at the time, and government's presence in the financial market continued till the late 1980s. Prior to the Tequila Crisis, around 39 percent of total deposits were held by public banks and 42 percent of total loans were granted by public banks (Gruben, 2000).

Deregulation efforts began in the late 1980s. Market-based regulation and discipline was introduced between 1989 and 1992. Prudential regulation based on strict

reserve and capital requirements along with privatizations of public banks constituted the backbone of the new regulatory regime of Argentina. Starting with the Convertibility Plan in 1991, deposit insurance was gradually eliminated. In 1995, a new deposit insurance scheme was introduced. This new deposit insurance scheme was totally funded by private banks and offered a limited coverage depending on the maturity and the interest rate paid. In contrast to the Mexican experience, minimal bailout guarantee limited excessive risk taking of private banks. In addition, Argentinean government introduced high reserve requirements and forced banks to remain highly liquid. Higher capitalization requirements were also introduced in order to discourage risky behaviour. Privatization began in 1993. Major privatizations of the state-owned banks took place in 1995 and 1996 (Gruben, 2000).

Conclusion

In this chapter, regulation in general, and more specifically, banking sector regulation are examined. Especially after the 1980s, despite the popularity of ‘deregulation’, what we experienced was changes in the modes of regulation. The state changed its methods of regulation. Instead of putting a heavy tax burden on private banks and establishing state-owned enterprises, introduction of independent regulatory agencies and statutory regulation were the main pillars of the new mode of regulation that emerged in the 1990s.

There are also several different theories which try to capture this change in the mode of regulation. Most important ones are the theory of economic regulation, public interest theory of regulation and institutional analysis. Each one has its advantages and

disadvantages. Ultimately, they all provide important tools for us to understand the changes in the mode of regulation. However, “top-down” approaches in the diffusion perspective introduces role of international institutions as an important variable in understanding regulatory change within nation-states.

In the next chapter, I turn my attention to Turkey. Change in the mode of banking sector regulation, according to the categorizations of Gual, between 1980 and 1987 was analyzed. The following question in the next chapter is whether international developments regarding the change in the mode of regulation was consistent with the changes in Turkey in this period. Moreover, I will analyze the factors contributing to the change in the mode of regulation in the Turkish context. Theories of regulation explained in this chapter may provide important tools in analyzing the factors in the Turkish context.

CHAPTER 3

1980-1987: STABILITY AND CHANGE

Introduction

Turkey embarked upon deregulation of its economy with the notorious January 24 decisions, taken in 1980, just nine months before the September 12 *coup d'etat*. The major goal was to strengthen competitive markets and to reduce the state's intervention in the economy. Key elements of this transformation were trade, capital account and financial sector liberalization.

The 6th Demirel Government initiated the liberalization of the Turkish economy with the announcement of the Economic Stabilization Program (January Program) on January 24, 1980. Domestic financial and commodity markets were liberalized. Trade restrictions were lifted gradually throughout the 1980s; current account was fully liberalized in the mid-1980s. Finally, at the end of the decade, capital account was liberalized and domestic financial market was opened to capital flows.

In this Chapter, evolution of the mode of banking sector regulation between 1980 and 1987 in Turkey is analyzed since mode of banking sector regulation has changed along with the general mode of regulation in the Turkish economy.

The Turkish financial system, like most other financial systems, has always been, and continues to be, neither totally regulated, nor fully liberalized, but somewhere in between. Thus, to try to capture change in terms of 'degree of state regulation' is to confuse the issue. The question is not more or less state regulation but what the state seeks to regulate and how. The dynamics

of change in Turkish financial markets in the 1980s' decade has to be sought in the logic and mode of state intervention rather than in its 'degree' (Öncü & Gökçe, 1990, p.100).

In other words, in the 1980s, while the mode of regulation has changed, this change cannot be explained by the degree or scale of state intervention in the financial sector. The state continued to have heavy dominance over the financial sector in this decade. However, the logic behind regulation has changed in this period.

Anatomy of the financial sector remained unchanged while the mode of state intervention or mode of regulation continued to change. Moreover, philosophy and objectives of banking sector regulation did not change as they traditionally tried to protect the interest of depositors and maintain the public confidence in banking. For instance, at the end of the decade, despite important changes in the regulatory framework, state banks still continued to dominate the financial sector by accounting for almost half of the total banking sector assets. Hence, change in the mode of banking sector regulation implied a change in the logic and methods of regulation, rather than a change in the degree of state intervention in the economy.

In order to show the changing mode of banking sector regulation, the categorization of Gual (1999), which classified different modes of regulation, is adopted. In the long-run, while the first and second category of regulations, which soften domestic competition and which limits the scope and scale of banks, were gradually abolished, the third category of regulations was increasingly adopted⁴. Prudential

⁴First type of regulations softens domestic competition. This category includes controls on credit, interest rates and fees, restrictions on entry and mergers and acquisitions, and controls on capital

regulatory measures⁵ were increasingly imposed on private banks which were increasing their profit margins, and their scopes of operations.

Changing mode of banking sector regulation toward the third category of regulations included deregulation and re-regulation at the same time. Deregulation of interest rates and foreign currency transactions were the core elements of change in the mode of regulation. Thus, deregulation did not mean the abolition of the whole regulatory regime of the banking sector. Deregulation involved restraining first and second category regulatory measures, while introducing prudential regulations. Namely, deregulation policies involved liberalization of interest rates, easing of the restrictions on entry, authorization to open foreign currency accounts and finally the liberalization of the capital account regime. Re-regulation involved preparation of a new Banks Act in 1985 and certain reversals in earlier deregulation policies, like liberalization of interest rates. Hence, policies of re-regulation and deregulation constituted a single chunk which implied a new mode of banking sector regulation.

Although deregulation policies reached its climax with the capital account liberalization in 1989, this chapter does not address this specific change in the regulatory regime, namely, the capital account liberalization. The reason is that after 1987, the Turkish political regime became more democratic and

flows. The second group is regulations that limit the scope and scale of banks. This category involves restrictions on domestic branching and establishment in foreign markets, and limits to activities within conventional banking, insurance, and securities. The last group is mainly concerned with regulations that alter the external competitive position of banks. This final category deals with reserve and investment coefficients, solvency and capital adequacy regulations, deposit insurance schemes, and restrictions on ownership linkages with non-financial firms (Gual, 1999, p.4).

⁵ Prudential regulations cover licensing provisions as well as operational guidelines and bank rating criteria. Licensing provisions include requirements and guidelines for bank ownership and management requirements for opening new branches domestically as well as abroad. Operational guidelines include capital adequacy requirements, legal lending limits, and limits and net open position. The rating system is based on the quantitative evaluation of capital, asset quality, management, earnings, liquidity (CAMEL) (Binhadi, 1994).

distributional pressures on politics increased significantly. Therefore, the analysis of the capital account regime requires different tools and an analysis of different variables from the ones used in this chapter.

Turkish mode of banking sector regulation was shaped by the effects of economic crises and by the policy advice of international institutions, namely the World Bank and the IMF. Moreover, similar developments in the international environment influenced the Turkish policy-makers and thus, facilitated the change in the mode of regulation. Hence, the diffusion perspective and the sociological institutionalism provide better theoretical tools than the theory of economic regulation and public interest theory of regulation in understanding the regulatory change. The international institutions fostered the deregulation policies in the banking sector, namely the deregulation of interest rates and liberalization of the foreign currency regime. Especially, conditionality attached to the Structural Adjustment Loans of the World Bank between 1980 and 1984 was influential in deregulating the banking sector. Moreover, the economic crisis in the late 1970s and the Brokerage Houses crisis in 1982 encouraged the Turkish policy-makers to reverse some of the earlier deregulation policies and to strengthen prudential regulations.

In the final part of the Chapter, certain idiosyncrasies of the change in the mode of banking sector regulation are analyzed, namely the policy oscillation regarding the regulatory framework for the banking sector. Evolution in the mode of banking sector regulation was not a smooth process. In other words, policies regarding the change in the mode of banking sector regulation oscillated between deregulation, re-regulation and various policy reversals. As a result, my

final research question is what factors contributed to policy oscillation, regarding the regulatory framework for the banking sector.

In order to answer to this final research question, the political structure between 1980 and 1987 should be grasped. In the 1980s, the political regime of Turkey was not a well-established democracy. Between 1980 and 1983, there was a military regime. Moreover, between 1980 and 1987, major political parties of Turkey were closed and major political leaders of the pre-1980 period were banned from politics for ten years. As a result, in my analysis of the policy oscillation, policy insulation of the decision-makers from economic and social interests is a major factor contributing to policy oscillation. In this period, Turkish policy-makers were neither rational utility-maximizers as economic theory of regulation assumed, nor were they idealist state bureaucrats isolated from distributional pressures and acting on behalf of public, by correcting market failures.

The final issue in the analysis of policy oscillation is the response of banking community to policy oscillation and confusion in the regulatory framework. Banking community was silent in this period and did not respond aggressively to policy insulation of the political elite. There were two reasons. First, they cannot communicate their views on the change in the mode of banking sector regulation since channels of communication were closed down during the military interim government. Second reason was that the banking sector increased their profit margins and hence, although they could not influence the changes in the regulatory regime, they were economically satisfied with the results of this change. New avenues of profit emerged in this period.

Anatomy of the Turkish Banking Sector: Oligopoly

In order to understand the changing mode of banking sector regulation in the 1980s, anatomy of the banking sector at the end of the decade should be understood. The argument is that after nearly a decade of economic restructuring, the anatomy of the Turkish financial system remained unchanged. Centrality of the state in the financial sector remained intact. At the end of the decade, several state banks continued to account for almost half of the total assets of the banking sector. Moreover, state banks were still closely linked with private conglomerates and private banks.

There were several features of the Turkish financial system. According to Öncü and Gökçe (1991), “The strong presence of the state in the banking sector and the high degree of interpenetration between finance and industry are a historical legacy of the early decades of the Republic” (p.106). Throughout the 1930s and 1940s, the state created several public banks in order to carry out the state initiatives aimed at creating an industrial base in the country. These banks provided certain sectors of the economy with cheap credit that were deemed crucial in the industrial development of the country. In this period, private banks, like private enterprises, were marginal in the banking sector.

In the post-1950 period, state banks continued to play a pivotal role in the banking sector by channeling domestic public credit as well as foreign aid and foreign credit to private enterprises, which flourished under the protectionist economic policies of the state. Moreover, interlocking ownerships of banks and corporations gained momentum especially during the inflationary expansion of the economy in the 1960s and 1970s. Large conglomerates, which were called ‘the Groups’, began to own

commercial deposit banks in order to increase their competitive advantage in the markets.

Oligopolistic structure of the banking sector had three interlinked features. First of all, banks dominated the financial sector in Turkey. Other financial institutions played a limited role. For instance, bank deposits constituted two thirds of all financial instruments. As a result, 'financial sector' meant more or less 'banking sector' in Turkey. According to Işık, İhsan and Hassan (2002):

In comparison with their North American and Western European peers, Turkish banks do not face any serious competition from non-bank companies because most of the insurance, factoring, leasing, and brokerage companies are affiliated with banks through a holding company structure encompassing financial and non-financial entities (p.721).

Secondly, Turkish banking sector was highly concentrated. At the end of 1988, four major banks, namely Ziraat Bank, İş Bank, Ak Bank, and Yapı Kredi Bank, dominated the banking sector. They controlled around 60 percent of total credits and 65 percent of total deposits in the banking sector (Öncü & Gökçe, 1991).

Moreover, state banks accounted for a substantial component of the total assets. There were 10 specialized state banks in the Turkish banking sector, at the end of 1988. They accounted for 51.5 percent of total assets of the banking sector. They were founded between 1923 and 1946 in order to provide credit and facilitate investments in certain sectors of the economy as well as to collect deposits regularly. They provided credits for a wide array of industrial and commercial enterprises. As a result, they became equity holders in a variety of private enterprises and also some of them were owners of several SOEs. Private industry and state were linked together through state banks.

Final feature of the Turkish financial system is that banks, including state and private ones, had equity holdings in affiliated companies, often with controlling interest.

As a result:

Interlocking ownership of financial institutions and corporations has meant that the distinction between 'public' and 'private' banks is often not so clear cut as it initially appears. Hence it may be more appropriate to talk about 'oligopolistic public-private conglomerates' in the Turkish banking system (Öncü & Gökçe, 1991, p.109).

In summary, oligopolistic nature of the banking sector and heavy involvement of state banks in the banking sector were important characteristics of the Turkish banking sector. Mode of banking sector regulation changed in this environment.

Mode of Banking Sector Regulation Prior to 1980

The first and second categories of regulations, as defined by Gual (1999), were prevalent in the Turkish banking sector prior to 1980. Banking sector regulation rested on state control on the allocation of two critical resources in the economy, namely foreign currency and credit. The price of foreign currency, i.e. exchange rate, and the price of credit, i.e. interest rates, were administratively determined below market rates.

Central Bank of Republic of Turkey (CBRT) had monopoly over foreign currency transactions. In addition, CBRT implemented an over-valued exchange rate policy. Commercial banks, state or private, were prohibited from holding foreign currency in deposit accounts or in reserves (Öncü & Gökçe, 1991).

Interest rate controls were another component of the prevailing mode of banking sector regulation. The state influenced the cost of credit and thus manipulated the

allocation of credit in the financial market through determining interest rates on deposits and credits. In the 1970s, the rates were below market rates, and throughout the decade real interest rates were negative. As a result, the financial market was shallow in this period.

The state also employed various other administrative controls, like specific quantity directives, interest surcharges and rebates, and preferential tax treatments. It was estimated that only one quarter of total credit was free from government controls (Öncü & Gökçe, 1991, p.110). In addition, direct credit programs absorbed almost 75 percent of loanable funds (Denizer, 1997). As a result, various economic sectors were subsidized through low cost credit.

Bank executives described the pre-1980 period, as “riskless banking”, since short-term fluctuations in world currency markets did not affect the Turkish banking sector. Banks developed an elaborate network of branches in order to capture deposits at administratively determined levels, since they were not able to compete through manipulating interest rates.

Before liberalization, Turkish banks were restricted with respect to the explicit interest rates they could pay depositors. In case of interest rate regulation, competition could only take place through quality and convenience to clients, which led to a frantic expansion of branch offices all over the country (Işık, Gündüz, Kılıç, Uysal, forthcoming, p.2).

Banks built big buildings and established places for their customers to do leisure time activities. In addition, they spent large amounts of money on advertisement. As a result, banking sector was not operating efficiently in the 1970s.

In summary, state directly controlled the banking sector through various means. It manipulated allocation of credit through controlling the price of the foreign currency and interest rates. Moreover, public banks had the largest share of assets and credit in the

banking sector. As a result, mode of regulation in this period was tight administrative control of the banking sector by the state. Moreover, “tight regulation refers to the existence of an elaborate edifice of bureaucratic regulations built up to control the price and allocation of foreign currency and credits” (Öncü & Gökçe, 1991, p.111).

Evolution of the Mode of Banking Sector Regulation in the 1980s

In this part, evolution of the mode of banking sector between 1980 and 1987 is explained. Domestic economic liberalization, albeit partial, constituted the core of the evolution of the mode of banking sector regulation. International organizations, including the IMF, the World Bank and the OECD, were the most important agents that influenced the mode of banking sector regulation and that pushed for financial and economic deregulation. Moreover, Turkish economic crisis in the late 1970s was another important factor that has facilitated the change in the mode of banking sector regulation. As a result, the Turkish government embarked upon deregulation of the Turkish economy and began to change the mode of banking sector regulation with the January Program adopted in 1980.

In the rest of the decade, the mode of banking sector regulation continued to be influenced by the international institutions, by the developments in the international environment and by the economic crises. Policies regarding the regulatory framework oscillated between deregulation and re-regulation. However, at the end of the period, despite policy oscillations and confusion in the minds of policy-makers regarding the regulatory regime, mode of banking sector regulation changed and banking sector was deregulated significantly.

Role of International Institutions

In order to understand the reasons behind deregulation in the 1980s, Turkish economic crisis in the late 1970s should be understood. According to Öniş and Kirkpatrick (1991) “Turkey had pursued an inward-oriented development strategy, combined with an extensive involvement by the public sector” (p.125) in the 1960s and in the 1970s. Macro planning, import substitution and SOEs were major elements in this development strategy. This strategy generated impressive growth performances between 1963 and 1977. The average growth rate of GNP was 7 percent in this period. Several exogenous factors contributed to this success. Primary commodity boom in world markets engendered a rapid increase of Turkish exports in the early 1970s. Other factors were remittances from Turkish workers, who worked abroad and short-term capital inflows from the Euro-currency market.

These exogenous factors helped to disguise the weaknesses of the Turkish economy, “namely an excessive dependence on imports and intermediate goods, with no corresponding ability to increase export earnings to finance the necessary import bill” (Öniş & Kirkpatrick, 1991, p.126). In reality, Turkish economy was vulnerable to external shocks.

In the late 1970s, Turkish economy was unable to meet its external obligations. In other words, Turkey experienced a balance of payments crisis. Public sector deficits had been rising rapidly. Moreover, public deficits had been covered by foreign borrowing. However, export earnings did not cover the external obligations of Turkey. Economic crisis of the late 1970s was compounded by political instability. Between

March 1975 and September 1980, there were five coalition governments, led alternately by Ecevit and Demirel.

During the crisis of the late 1970s, the IMF was involved in negotiations with Turkey. It started negotiations during the 5th Demirel Government (July-December 1977) and its involvement continued until the end of the decade. Primarily, the IMF advocated for the abandonment of the ISI strategy. It advocated a tight monetary and fiscal policy, reduction in government spending and a high rate of devaluation of the domestic currency. These advocated major changes clearly contradicted the governments' underlying philosophy of development. Hence, until the 6th Demirel Government was established in November 1979, Turkish governments were hesitant in embracing the IMF policy proposals. Especially, "external donors had little confidence in the Ecevit Government's ability or commitment to implement what they considered to be the necessary adjustment measures" (Öniş & Kirkpatrick, 1991, p.127).

The newly elected 6th Demirel Government, with Turgut Özal as the person responsible for economic affairs, announced the new Economic Stabilisation Program (January Program), which involved fundamental reorientation of economic policy, on January 24, 1980. The main pillars of the Economic Stabilisation Program was the replacement of an inward-looking strategy with an export oriented strategy and the attraction of foreign investment, and reduction in state involvement in production activities. In order to attain these goals, several policy measures were introduced. One of the major policy measures was the devaluation of the domestic currency by 50 percent. The second set of measures included liberalization of internal prices. Price controls on most SOE products were removed. The third set of measures included institutional changes like the establishment of a Money and Credit Committee, chaired by Turgut

Özal. The goal was to isolate economic policy-making from political, bureaucratic and social pressures. As a result, Özal would be able to implement the economic program without any opposition from ministers, bureaucrats and society.

IMF was one of the architects and supporters of the January Program. Moreover, it continued to influence Turkish policy-makers in the first half of the decade. Since relations with the IMF were a politically sensitive issue, the 6th Demirel Government did not engage in formal negotiations with the IMF during the preparation of the January Program. However, Özal and his team of high level technocrats made informal contacts with the IMF officials prior to the agreement. As a result, IMF was the disguised architect of the January Program. Finally in June 1980, Turkey signed a three-year stand-by agreement for SDR 1.25 billion with the IMF. The extended credit was 6.5 times of Turkey's quota. This agreement was also a historical event for the IMF itself. This was the first three-year stand-by in Fund's history and the credit given to Turkey was the highest amount of credit extended by the IMF. At the end of 1983, the newly elected government cancelled the existing arrangements with the IMF. However, in April 1984, it signed a final one-year arrangement amounting to SDR225 million (52 percent of the quota). In summary, IMF was directly involved in the deregulation process in Turkey.

The World Bank was another international institution that monitored and advocated the economic reforms, which were implemented during the first half of the 1980s. It extended five consecutive Structural Adjustment Loans (SALs) totaling US\$ 1.6 billion between 1980 and 1984. These loans were extended provided that the continuation of policy reforms intended to shift the economy from an inward-looking strategy to an outward-looking strategy. Moreover, Turkey was the first test case for the

success of SALs. As a result, the Bank was enthusiastic and supportive of the economic policies (Öniş & Kirkpatrick, 1991).

Turkey was also a suitable testing ground for the implementation of the new form of World Bank-IMF cross conditionality. The World Bank collaborated with the IMF in this period. Indeed, from 1980, the Bank was the dominant partner in engineering the Turkish economy more than the Fund. However, both institutions agreed on the new economic orientation of Turkey. While the IMF focused more on monetary policy, fiscal policy, the exchange rate and public sector financial management, the World Bank was more focused on the SOE reform, trade liberalization, export promotion, and rationalization of public investment.

The OECD was also another international institution that promoted economic deregulation because of geopolitical considerations about Turkey. Long before the establishment of the 6th Demirel Government, OECD was willing to provide substantial external funding to Turkey provided that Turkey reached an agreement with the IMF and implemented the policies advocated by the IMF. Geopolitical considerations lay at the heart of the OECD's willingness in giving financial support to Turkey. "Turkey was seen as a key element in the NATO Alliance and her economic and political weakness would render the NATO southern flank vulnerable to Soviet influence" (Öniş & Kirkpatrick, 1991, p.128). Moreover, Iranian revolution increased the strategic importance of Turkey in the NATO southern flank. NATO's southern flank was threatened by the Islamic revolution in Iran, which declared that the USA was its main enemy.

International environment is also important in influencing the change in the mode of banking sector regulation, namely deregulation of interest rates. Experiences of

financial deregulation in several Latin American countries are introduced in order to add a comparative perspective to developments in Turkey in the relevant time period. As evidence suggests, Turkey was not the only country that rapidly deregulated interest rates and experienced an economic crisis and consequently reversed its earlier policies.

Financial deregulation experience of Turkey was similar to experiences of several developing countries. Regarding the similarities, financial markets were rapidly deregulated around the same time periods. Rapid deregulation periods were ended by economic crises and policy-makers reversed the deregulation process and introduced re-regulation. Therefore, policy oscillations were common in the deregulation process. Argentinean, Chilean and Brazilian experience of financial deregulation, namely abolition of the controls on interest rates was very similar to the Turkish experience. They all rapidly deregulated interest rates and reversed their policies several times. Argentina, Brazil and Chile rapidly deregulated interest rates and abolished direct credit programs earlier than Turkey at the end of 1970s. Moreover, entry into the banking sector was made easier. However, similar to the Turkish experience, because of the economic crisis in the beginning of 1980s, they reversed some of the earlier policies of deregulation. In 1982, controls on interest rates and credits were re-introduced in Chile and Argentina, while Brazil re-introduced controls earlier than the two, in 1979. In Argentina and Chile, controls on interest rates were abolished once again in 1987 and 1985 respectively (Williamson & Mahar, 2002). As a result, there were important similarities between these Latin American countries and Turkey regarding financial deregulation.

As a part of the new economic reform agenda, government launched financial sector reforms at the beginning of the decade. “The goal was to develop a competitive

and efficient financial system that would support a more liberal economy” (Denizer, 1997, p.12). In order to achieve this goal, banking sector was deregulated rapidly, while the banking law No. 7129 stayed intact without major changes until 1983. Major components of deregulation in the banking sector were the elimination of controls on interest rates and significant liberalization of the exchange rate regime. In addition, the government made entry to the banking sector easier and direct credit programs were reduced.

Deregulation of Interest Rates

Deregulation of interest rates signified a major change in the mode of banking sector regulation. One of the first category regulations defined by Gual (1999) was abolished. Role of international institutions, namely the World Bank and the IMF, were crucial in understanding the change in the mode of banking sector regulation.

Major factors contributing to deregulation of interest rates were the World Bank and the IMF. Deregulation in the banking sector, namely the liberalization of interest rates, was advocated by the stand-by agreement with the IMF and by the SAL I, signed in March 1980, just three months after the announcement of the January Program. On July 1, 1980, banks were allowed to determine interest rates on deposits and loans. Moreover, banks were allowed to issue negotiable certificates of deposits (CDs). Major goal behind the deregulation of interest rates was to deepen the financial market in Turkey by increasing the competition between private banks. In addition, it was expected that high positive real interest rates would help the government in controlling

the inflation rate. The slogan was July Banking in Turkey (*Türkiye’de Temmuz Bankacılığı*) (Akgüç, 1998, p.131).

Turkey deregulated domestic interest rates rather hastily compared to other European countries. Before July 1980, only Britain deregulated interest rates on deposits. In the rest of the EU countries, deregulation of interest rates occurred between 1979 and 1993. Aside from Britain, only the Netherlands and Germany deregulated interest rates at the beginning of the decade but later than Turkey. Regarding the credit controls, Britain lifted restrictions in 1980. But rest of the EU countries lifted restrictions much later (Gual, 1999).

1982, Brokerage Houses Crisis, decreased the pace of deregulation process in the banking sector and engendered certain policy reversals. However, before explicating the reasons and consequences of the Crisis, factors contributing to the establishment of brokerage houses should be explained briefly. Most of the brokerage houses were established around 1979. In the same year, industrial corporations began to issue bonds and thus the bond market began to flourish in Turkey. Development of the bond market was one of the important factors that contributed to establishment of the brokerage houses. Another factor was the restricted entry into the banking sector. Some ‘bankless’ industrial conglomerates established their own brokerage houses in order collect funds (Atiyas, 1990).

There were two reasons behind the 1982 Brokerage Houses Crisis. First, there was fierce competition between banks and brokerage houses. Banks sold certificate of deposits to the public and collected deposits through brokerage houses. Especially small banks were very ambitious and they wanted to capture more market share from larger banks. According to Atiyas (1990), smaller banks struggled to prevent larger banks from

forming cartels and from setting interest rates at lower levels. Big banks tried to keep the interest rates low by ‘gentleman’s agreement’. This competition led to extremely high interest rates and eventually brought about the disaster. The second reason was that, prior to deregulation of interest rates; Turkey did not establish the necessary legal framework for the interest rate competition in the banking sector (Kibritçioğlu, 2005).

After deregulation of interest rates, interest rates tripled and even quadrupled in a short time. In 1981 and 1982, real interest rates were very high. As a result, total amount of deposits in the banking sector increased rapidly in a short time. High inflation and fierce competition between brokerage houses and banks were the major factors behind high interest rates.

Profitability in the financial sector rose rapidly. As a result, number of brokerage houses increased. They offered high interest rates to collect deposits. In addition, even official banks (31 out of 38 banks) sold CDs to these brokerage houses in order to collect deposits. In 1981, there were approximately one thousand brokerage houses. Around US\$ 1.5 billion was collected. For instance, Cevher Özden – also known as Banker Kastelli – collected TL 100 billion. Two third of the total collected deposits in this period belonged to his brokerage house.

There were several ominous signals embedded in this development of financial deregulation. One of the dangers was that these brokerage houses offered around 10 percent monthly interest rates to deposits while the annual inflation rate was only around 30 percent. Moreover, these brokerage houses lent heavily to those involved with limited access to bank credits. These borrowers did not service their debt regularly. As a result, solvency of the brokerage houses depended upon a continuous flow of CDs and the collection of deposits. Clearly, this situation could not be sustained forever.

As a result, in the fall of 1981, some of the brokerage houses and five private banks declared bankruptcy. Kaya Erdem, just prior to the collapse of the system, stated that “citizens gambled their money by giving it to the brokerage houses”. As a result, depositors ran to the brokerage houses to get back their money. More brokerage houses went bankrupt and the firms that they did business also went bankrupt. On June 18, 1982, all 40 banks, operating in Turkey, decided to stop selling CDs to banks, by the pressure of big banks and the government. Kastelli’s brokerage house became insolvent and he escaped to Switzerland. In 1983-1984, the state intervened and took over the management of five banks and declared them bankrupt. The liabilities of four of the banks (İstanbul Bank⁶, Hisarbank⁷, Odibank and Bağbank) were transferred to Ziraat Bank. Liabilities of the fifth bank (İşçi Kredi Bank) were taken over by the largest private bank. Three of these banks formed their own brokerage houses. Moreover, each of these five banks was owned by industrial conglomerates (Atiyas, 1990). One month later, on July 13, 1982, both Erdem and Özal resigned from their offices. It was estimated that rescue operations cost around 2.5 percent of the GNP.

Following the bankruptcies, the first response of the government was to reverse some of the deregulation policies implemented at the beginning of the decade. Hence, government tried to correct the market failure, which has emerged after the deregulation of interest rates, as public interest theory of regulation has envisaged. On January 1, 1983, the Turkish government put an end to the interest rate race and liberal interest rate policy was abandoned (Akgüç, 1998). Banks were allowed to determine interest rates on credits only. On December 1983, the CBRT was authorized to determine deposit rates

⁶ Özer Çiller was the head of İstanbul Bank.

⁷ Hisarbank was owned by the Çavuşoğlu-Kozanoğlu Group.

and to review the rates every three months. However, CBRT continued to determine the interest rates on deposits according to the inflation rate periodically until 1988. For instance, in this time period, it intervened three times in order to increase deposit rates. CBRT's goal was to keep real interest rates at positive levels in the inflationary environment. The reason was that the large banks were often reluctant to raise deposit rates to positive levels. Moreover, positive real interest rates prevented the escape of deposits from private banks and hence CBRT aimed to protect private banks by keeping interest rates at positive levels.

However, this reversal of policy did not mean the cancellation of the whole deregulation project. It signified a change in the mode of regulation. Mode of regulation continued to change toward the third category of regulations, namely, prudential regulations. It is understood that change in the regulatory regime of the banking sector was a delicate business, which was to be handled carefully.

Deregulation of the Foreign Currency Regime

As part of the deregulation program, controls on the price of foreign currency were abolished. In other words, the second category of regulations which limits the financial instruments of banks used and offered by banks, were gradually lifted. Again, deregulation of the foreign currency regime signified a further change in the mode of regulation.

CBRT adopted crawling exchange rate regime from May 1981 onwards. Along with this change, CBRT's monopoly over transactions in foreign currency was lifted. In

1984, commercial banks were allowed to engage in foreign currency operations.

According to Öncü and Gökçe (1991):

A series of discrete measures were progressively introduced through special decrees, permitting commercial banks to hold foreign currency in their legal reserves, granting them autonomy to use proceeds from export sales, transfer the income and sales proceeds of foreign direct investments, generate short-term foreign credits for themselves directly and to extend foreign currency loans and determine the exchange rate for large transactions, as well as allowing individual depositors to open domestic foreign currency accounts (p.111).

As a result, CBRT's role in foreign currency markets was reduced to be a regulatory and supervisory one.

Other Policies of Deregulation

Several other deregulation policies continued to change the mode of banking sector regulation. The mode of regulation continued to change toward the third category of regulations. Preferential credit system, which belonged to the first category of regulation, was simplified. "Banks were no longer obliged to lend a certain proportion of deposits to specific sectors and differential reserve ratios to specific credits were abolished" (Değirmen, 2002, p.48). The World Bank and the IMF were the main agents that promoted these policies.

The Bank and the Fund advocated for several more deregulation policies regarding the Turkish financial system. Another important component of deregulation was the reduction in tax burden on private banks, which was advocated and promoted by the World Bank through SAL IV and SAL V. SAL IV, and SAL V advocated financial deregulation including a reduction in tax burden on private banks. Financial transactions

tax rate decreased between 1983 and 1986, as advocated by SAL IV. It was reduced from 15 percent in 1983 to 3 percent in 1984 and 1 percent in 1986. Moreover, tax on interbank transactions was eliminated on the advice of the Bank.

The Bank also advocated strengthening the regulatory regime by increasing the efficiency of accounting. The goal was to prevent fraud in the banking sector. Thus, it advocated a preparation of a review of a standardized accounting system for banks; issue and diversification of the means of marketing treasury bonds; and a study of fiscal incentives to induce banks to reduce operating costs.

The government eased the restrictions limiting the entry to the banking sector in order to increase the competition between private banks. This deregulation policy signified a change in the mode of regulation. The second category of regulations, which limited the scale and scope of banks, were gradually lifted with this decree. As a result, between 1980 and 1990, the number of banks increased from 43 to 66. There were 31 *de novo* entries, of which 19 were foreign and 11 were national, into the banking sector, considering that 8 banks were liquidated or merged with other banks in this period. In the same period, the number of foreign banks in Turkey increased from 4 to 23 (Kibritçioğlu, 2005). The number of state owned-banks diminished from 12 to 8 between 1980 and 1990.

In summary, deregulation was not altogether abolition of state control over the banking sector, but it involved change in the mode of banking sector regulation. Moreover, engines of this change were the World Bank and the IMF.

Banks Act No. 3182

There were two important changes in the legal framework for the banking sector in this era. These changes signified a further change in the mode of banking sector regulation. Mode of regulation changed toward the third category of regulations, namely prudential regulations. At the beginning, according to Ersel (2000), “reformers naively believed that promoting competition is sufficient for securing sound and safe development in the banking system”. Especially after the Brokerage Houses Crisis in 1982, it was understood that deregulation of interest rates necessitated strengthening regulatory standards by changing the legal framework. Government aimed to strengthen the regulatory regime in order to decrease market inefficiencies, as public interest theory of regulation has predicted.

Before understanding the change in the legal framework for the banking sector in the post 1980 period, legal framework in the pre-1980 period should be understood. In the 1930s and 1940s, legal regulatory framework for the banking sector was established in order to prevent fraud. The first banking law, which was called Law of Protection of Deposits No. 2243 (*Mevduatı Koruma Kanunu*) was enacted in 1933. The second banking law, No. 2999, was enacted in 1936, and it was used for 22 years.

In the post-1950 period, private conglomerates began to move into the financial sector by owning private banks in order to gain access to cheap credit. Newly emerging large conglomerates began to buy private banks. Regarding the regulatory framework for the banking sector, banking law, No. 7129, which was enacted in 1958, facilitated this process by removing the credit ceilings on lending to enterprises in which banks were themselves equity holders (Öncü & Gökçe, 1990). This situation was labeled as

holding banking. Firms used the funds deposited in their private banks. Firms also gradually began to issue bonds and equities. Thus capital market began to emerge in this decade. Banks Act No.7129 was later changed drastically by the Governmental Decrees No. 22 and No.70 and ceilings on credits were re-imposed.

In July 1983, Banks Act No. 7129 was changed by the Governmental Decree No. 70 as a response to the financial crisis in 1982. The problems of the banking sector were acknowledged in the introduction part of the Governmental Decree. Accordingly, the public lost their trust in banks since unauthorized persons collected deposits in this period. In addition, most of the private banks were owned by a few people; therefore, oligopolistic character of the banking sector was acknowledged by the state. Finally, connected lending was stated as another problem since major banks were owned by holding companies and these banks extended high amounts of credits to group companies.

With this change in the Banks Act No. 7129, amount of capital necessary to establish a bank was raised. It became harder to establish branches of foreign banks. Previously, council of ministers' decision was sufficient to give permission to foreign banks, which wanted to establish branches in Turkey. However, with this change, extra opinions had to be given to the government by the proper administrative unit.

One of the goals of the Governmental Decree was to monitor and supervise banks more closely. Previously, in the executive board of banks, there existed an official from the Ministry of Trade. With this governmental decree, Ministry of Finance gained the right to send a bureaucrat to executive boards of banks. Internal auditors of banks (*banka genel kurul denetçileri*) had to present reports every three months. Moreover, they continued to present annual reports to the board of directors. In order to better

monitor the owners of the bank, 75 percent of the capital had to belong to real people or partnerships founded by real people. In addition, bank executives must display their private properties regularly.

For the first time, the government aimed to limit connected lending. In the Article 41 of the Governmental Decree No. 70 about the Banks Act No. 7129, it was stated that “Banks cannot give credit more than banks’ equity capital to its partners, who have 5 percent of the banks’ capital; and to the real persons and institutions who engage in indirect credit relationships with the partners of the bank.” Moreover, the Governmental Decree put a limit to credits. Total credits could not exceed twenty fold of its equity capital.⁸

Ministry of Treasury gained the right to appoint a new board of directors to a bank, whose balance sheet deteriorated and the existing executive board was unable to heal the financial situation of the bank. If this remedy did not work, then council of ministers had the right to transfer or merge the assets of the banks. Ultimately, council of ministers had the right to cancel the banking license.

In order to restore confidence in the banking sector, explicit deposit insurance⁹ scheme was introduced after the collapse of the brokerage houses. Introduction of deposit insurance scheme belonged to the third category of regulations according to Gual (1999). Therefore, it was clear that the mode of regulation in the banking sector was changing. According to the deposit insurance scheme, there was a nominal upper limit for each savings account. In 1986, this article was amended and council of

⁸ Equity capital (*özkaynak*) equals to the combination of paid capital (*ödenmiş sermaye*) and reserves (*yedek akçeler*).

⁹ Deposit insurance scheme covered 100 percent of deposits amounting up to 3 million TL. 60 percent of total deposits in the banking sector was in this range.

ministers became authorized to determine the upper limit of the insurance scheme. More importantly, Governmental Decree established the SDIF. Only savings deposits were protected and the SDIF was connected to the CBRT.

Banks Act No. 3182, which was enacted on 25 May 1985, replaced the Banks Act No. 7129. This new Act was crucial in understanding the regulatory and supervisory structure of the banking sector, which survived without major changes until 1999. Like Governmental Decree No.70 about Banks Act. No. 7129, new Banks Act No. 3182 was a response to bank failures of 1982. This new banking law clearly showed that Turkish regulatory regime transformed toward statutory regulation. Since the external openness of the financial sector was still limited, the third category of regulation, i.e. prudential regulation, was not on the agenda of the politicians. Despite the fact that state's dominance in the banking sector continued through the existence of public banks, regulation and supervision of the banking sector was delegated to bureaucratic institutions with this new banking law.

IMF and the World Bank were heavily involved in formulating the Banks Act No.3182. Treasury was made responsible for supervision and regulation of the banking sector. The Board of Sworn Bank Auditors, which was connected to the Treasury, examined banks' legal compliance and banks' financial accounts. It was responsible for on-site inspection. This banks act also introduced provisions for a minimum capital base for banks and a capital adequacy ratio in line with Bank for International Settlements (BIS) requirements.

Moreover, the CBRT was included as part of the supervision process. CBRT was responsible for off-site inspection, and monitored capital adequacy, profitability, asset quality and liquidity. Until this banking law, Treasury had been solely responsible for

limited inspection and supervision of the banking sector. The CBRT monitored performance of the banks. Banks had to disclose their balance sheets regularly to the CBRT. If it was found out that the bank performed unsatisfactorily, then the situation was reported to the Minister of Finance. The minister decided whether to place the bank under the surveillance of the Treasury (under Article 64) or not (Soral, İşcan & Hebb, 2006).

Banks were required to have external auditing every year by independent auditing firms authorized by the Treasury and the CBRT. There was also internal auditing procedure. At least two auditors prepared reports every three months. These reports were sent to the Undersecretariat of Treasury and Foreign Trade. There were also inspectors, who monitored the activities of the banks and checked whether these activities were legal according to the Banks Act. In addition, banks had to expose their balance sheets four times a year to the Undersecretariat of Treasury and Foreign Trade and the CBRT. There had to be one official from the Undersecretariat of Treasury and Foreign Trade in the board of directors.

Credits given to a single customer or related parties were tightly limited. Banks could not give more than three fold of its equity capital to its related firms.¹⁰ Moreover, the law aimed to limit connected lending. Banks could not give more than its equity capital and 5 percent of its total credit stock to partners, who owned at least 5 percent of bank's shares (Article 41, Banks Act.3182).

If the above measures were not enough to restore the financial health of the banks, then the Council of Ministers could decide to transfer the banks' assets to another bank or demand the merger of two banks. If these measures were still not sufficient, the

¹⁰ Related firm means *iştirak*, in which banks have at least 15 percent share.

banking license was abolished. Then the control and audit of the bank was taken over by the SDIF.

In summary, deregulation of interest rates and foreign currency regime and the new Banks Act constituted a total chunk that signified a change in the mode of regulation from the first and second category of regulations toward the third category of regulations. Regulatory policy oscillated between deregulation and re-regulation. International institutions, namely World Bank and the IMF were major factors that contributed to this change in the mode of banking sector regulation.

As shown in the above paragraphs, transformation in the mode of regulation was fraught with inconsistencies, economic crisis and bank failures, despite apparent support of the Bank and the Fund to the changes in the mode of banking sector regulation. However, the trend was inevitably toward deregulation. Mode of regulation was changed and competition-friendly statutory regulation was increasingly adopted. Now the research question that I seek to answer in the rest of the chapter is what factors contributed to policy oscillation.

In answering this question, I evaluate the theoretical tools introduced in the Chapter 2. Then I focus on the policy-making structure in Turkey, and analyze its role in engendering policy oscillation regarding the regulatory regime. My argument follows that policy insulation of the ‘economic team’ of the prime minister from the pressures of economic interest groups was the major factor that contributed to policy oscillation.

In this final analysis, there are several other research questions that need to be answered in order to support the general argument of this Chapter. The first research question is that what the contributions of regulation theories are in understanding the

regulatory change in Turkey. The second research question is what the response of the banking community to regulatory change is.

Turkish Politics between 1980 and 1987

The problem in this picture was that the change in the mode of banking sector regulation was not a unilinear or a smooth process. It involved twists and turns. Policy pendulum oscillated between deregulation and re-regulation throughout the 1980s, although the direction was clearly toward the deregulation of the banking sector (Boratav & Yeldan, 2001, p.4). General strategy of deregulation was fraught with inconsistencies, delays, periodic readjustments and unexpected developments in the sequencing and application of actual policy measures (Öncü & Gökçe, 1990).

Turkish political regime of the 1980s and the relationship between policy-makers and economic interest groups must be understood in order to grasp the reasons behind policy oscillation. During the military regime between 1980 and 1983, the government under Bülend Ulusu- a former general- introduced serious measures to depoliticize the economy. A new constitution was adopted in 1982. The executive branch of the state was strengthened. Especially prime ministerial power was increased in relation to bureaucracy. Social and organizational rights of interest associations were seriously curtailed. The main goal behind these massive changes was to inject stability into politics and remove political interferences in the operations of the market in order to apply the market reforms successfully (Öniş, 1997). Implementation of market reforms

required political and social stability since these reforms might have altered the existing distribution of wealth in the society.

Military government introduced several policy measures in order to stabilize both politics and economy. The keyword was again 'stability'. Political parties of the pre-1980 period were closed down and important political figures of the pre-1980 period were banned from politics for ten years. Military regime blamed extreme fragmentation of politics for the political and social fights in the pre-1980 period. It also introduced 10 percent threshold as an electoral rule in order to further stabilize the politics by limiting the entry to the parliament. Military leaders wanted to create a two-party system in which centre-right and centre-left parties competed (Öniş, 1997).

In the 1980s, "the Turkish experiment with liberalization of financial markets has been accompanied by a progressive insulation of actual policy-making and implementation within an inner circle of technocrats directly attached to the prime minister" (Öncü & Gökçe, 1990, p.100). Traditional associational and bureaucratic channels as well as political channels of influence through party networks were closed down during the premiership of Turgut Özal. Öniş and Kirkpatrick (1991) stated that:

The degree of continuity and the centralized nature of the policy-making process is epitomized by the fact that except for a period in 1982 when he resigned following the financial crisis, Özal remained in charge of the economy during three remarkably distinct phases: the Demirel Government, January to October 1980; the Military Interlude, October 1980 to November 1983; and the Motherland Party Government, November 1983 to the present [1991] (p.138).

Rise of the Motherland Party (MP), under the leadership of Turgut Özal, who had been the chief architect behind the economic policies of the 6th Demirel Government and also the military interim government, in this period was important in order to understand the political environment. The MP won the first general elections, made after the September

12 *coup d'état* in November 1983. It won 45 percent of all validly cast votes. The reason was that MP was able to bring the elements of centre-right under a single umbrella. Centre-right had been fragmented into three political parties: the Justice Party (liberal), National Salvation Party (religious right) and Nationalist Action Party (nationalist right) prior to the military intervention of 1980. These parties were closed down and their leaders were banned from politics. Moreover, non-parliamentary associations which autonomously organized social and political groups lost their power because of the military intervention; masses were excluded from politics. As a result, MP was able to succeed in becoming the ruling party of Turkey after the military intervention.

Turgut Özal excluded the cabinet ministers from the actual economic policy-making processes. His emphasis was on 'effective governance' rather than 'competition' and 'interest articulation'. According to Cizre (2002): "Effective governance involved a new kind of policymaking in which elected representatives brought in their own team of experts from outside the bureaucracy as heads of agencies or adviser" (p.84). Cizre (2002) called this situation as "political entrepreneurship".

Technocratic rationality of the banking sector reform presupposed a substantial degree of autonomy from coalitional challenges and compromises. Thus, he created an 'inner circle' within the government, insulated from political as well as bureaucratic challenges. Hence, his 'inner circle' did not 'waste' their time on reconciling different interests of the banking community or on calculations of political feasibility among coalition partners.

There were some important organizational changes that contributed to the formation of the 'inner circle'. Undersecretariat of Treasury and Foreign Trade, which

was connected to the Prime Minister's Office, was created. As a result, powers of Ministry of Finance and Ministry of Commerce were diminished. The newly-established Undersecretariat of Treasury and Foreign Trade had the powers of a ministry. Moreover, the Prime Minister appointed the head of it and the post remained outside of the cabinet. Two new departments were created in order to centralize certain economic activities: Department of Foreign Investment, Department of Investment and Export Promotion and Implementation. These were also under the control of the Prime Minister. Also during the military rule between 1980 and 1983, a High Coordination Council of Economic Affairs had been created. The Prime Minister was the head of the Council. Deputy prime ministers, Ministers of Foreign Affairs, Finance, Trade, Agriculture, Industry and Energy also attended the Council. As a result, top executives of the economic policy-making apparatus of the state were directly linked to the Prime Minister¹¹. In summary, the 'inner circle' included the Head of CBRT, the Undersecretary of Treasury and Foreign Trade, Undersecretary of State Planning Organization, Head of the Board of Mass Housing and Public Participation Fund, Head of the Economic Affairs High Coordination Council and finally the directors of two largest state banks, Ziraat Bank and Emlak Bank. The members of the inner circle were insulated from the political pressures of the Cabinet members or bureaucratic pressures through the institutions that they were heading. More importantly, even the top

¹¹ According to Öniş (1991):

The underlying motive in the creation of new forms of bureaucracy such as the Board of Mass Housing and Public Participation Fund and the Undersecretariat of Treasury and Foreign Trade has been the concern with instituting a managerial bureaucracy in place of the traditional patrimonial bureaucracy. Installing such a bureaucracy in the form of a select group of technocrats, largely independent from both societal and intra-bureaucratic pressures, was seen as a necessary condition for the consistent implementation of the economic program (p.33).

executives of the financial community were unable to reach to the ‘inner circle’ (Öncü & Gökçe, 1990, p.105).

There were important consequences of this policy insulation on the formulation of the regulatory framework. A major repercussion of this pattern of policy making was unpredictability in banking sector regulation and policy oscillation between deregulation and re-regulation throughout the decade.

As shown in the above paragraphs, several measures aimed at deregulating the banking sector were soon either reversed or contained by establishing legal regulatory underpinnings. Unpredictability surrounded the financial reform agenda of the government. The financial community was unable to influence the decision-making procedures. Decisions were first formulated within the ‘inner circle’ and were implemented. Then mostly Prime Minister explained the decisions to cabinet members and strived to placate the financial community either by initiating special meetings or at the regular meetings of various associations such as the Association of Turkish Banks.

In summary, mode of banking sector regulation changed in the midst of a fog, without directions from the banking community, since decision-makers were insulated from political and bureaucratic pressures. Moreover, private bank owners, due to their economic power, were not well organized or powerful enough to influence the politicians. As a result, mode of banking sector regulation changed erratically.

Response of the Banking Community to Regulatory Change

Private bank owners were content with the ongoing change in the regulatory framework although they were not able to communicate their wishes regarding banking sector

regulation. They were the primary beneficiaries of the change in the mode of banking sector regulation despite the irrationality in the application and timing of regulatory reforms. As a result, banking community did not criticize the policy-makers for their irrational way of policy-making.

In order to understand the quiescence of the banking community, effects of the change in the mode of banking sector regulation on the banks' profit margins should be examined. My argument follows that increasing profit margins toward the end of the decade engendered silence in the banking community regarding regulatory reforms. In short, banking community was content with the changing mode of banking sector regulation, even though policy-makers did not adequately take their views into account.

Especially in the first half of the decade, financial crisis and policy reversals regarding the regulation of the financial sector limited the profitability of the banking sector. After the Brokerage Houses Crisis in 1982, the public began to deposit their savings in public banks. Public banks distorted the financial system by their substantial deposit base. Moreover, interest rate ceilings prevented competition and profitability among private banks.

However, in the second half of the decade, private banks increased their profitability by engaging in trade-financing and investing in GDIs. Increasing access to foreign currency enabled private banks to finance trade in Turkey. Moreover, rising public deficits engendered the flow of GDIs into Turkish financial market. In short, the Turkish banking sector began to move away from traditional banking activities, and profit margins increased in these new avenues of operations. For instance, financial sector grew substantially, although interest rate competition was limited especially in the first half of the decade. "By the end of 1990, the stock of financial assets reached 47.7

percent of GDP from around 28 percent in 1980 while the M2/GDP ratio rose to 25.6 percent from about 21 percent in 1980” (Denizer, 1997, p.14). As a result, despite misgivings about the pattern of policy-making of the MP governments, the Turkish banking sector was ultimately content with the MP governments’ financial sector reforms because of the rising profit margins.

Interest rates offered on GDIs increased since the public sector borrowing requirement (PSBR) began to rise after 1985. There were several factors contributing to the rise of PSBR. First, public investments increased. Second, deficits of SEEs increased. The most important factor was the sharp rise in interest payments on domestic and external debt. According to Akyüz (1990):

As the financing of public sector deficits was largely shifted from the Central Bank, new debt had to be raised in domestic markets at terms competitive with expected return on foreign exchange assets, and interest payments on domestic debt as a proportion of GNP more than tripled (p.110).

Toward the late 1980s, governments began to finance public deficits by issuing government securities to private markets instead of resorting to CBRT reserves. In May 1985, an auction system for the sale of treasury bills and notes was introduced. In February 1987, CBRT began to do open market operations, and secondary market for government bonds and treasury bills emerged. Banks and security firms were allowed to participate in the auctions. As a result, banks became major investors in treasury bills and the public sector became the single most important supplier of securities. In 1986, more than 90 percent of trading on ISE was in public sector securities.

Investing in GDIs engendered higher profit margins for the banking sector because of the high interest rates offered on GDIs and compensated for the losses that emerged because of the interest rate ceilings on deposits. Moreover, GDIs had several

other advantages over other financial assets. They were exempt from withholding tax, and their yields exceeded those on other domestic financial assets. They were held against liquidity requirements by commercial banks and used as collateral in the interbank market¹² (Akyüz, 1999, p.102). This enabled successive governments to bypass many of the legal regulations and protocols constraining their fiscal operations (Cizre-Sakallıoğlu & Yeldan, 2000, p.489). As a result, banking sector was increasingly detached from traditional activities like deposit taking and credit giving and involved increasingly in funding public deficits.

As a result of the liberalization of trade account and foreign currency regime, banks were involved in trade-financing activities, which increased their profit margins. They competed with each other in order to collect the foreign currency earnings of exporters. Moreover, they also competed with each other in order to give loans denominated in foreign currency to importers (Betil, 2002). In short, trade-financing became the major activity of banks in the 1980s. Banks became brokers in foreign currency transactions. Traditional banking activities like deposit taking and credit-issuing were not as profitable as trade-financing operations. A new generation of trade-financing banks emerged, either in joint ventures with foreign banks or independently. Esbank, Netbank, Finansbank, İktisat Bank, Ekonomi Bank, Adabank belonged to this new generation (Öncü & Gökçe, 1991).

Another repercussion of the emergence of new avenues of profit, was that small and medium size banks began to grow by expanding their deposit base, although competition in interest rates was low in the first half of the decade, For instance, in the

¹² In April 1986, an interbank money market in domestic currency began to operate. Banks operated in the interbank market in order to finance their overnight liquidity needs. CBRT acted as an intermediary.

early 1970s, the banking industry was highly concentrated. 5 and 10 largest banks accounted for around 75 percent and 90 percent of all bank deposits, loans, and assets. However, in the 1980s their share diminished to about 50 percent and 75 percent respectively. However, the Turkish financial market, compared to Western European and American markets, was still extremely concentrated, oligopolistic and oversized at the end of the decade (Işık et al., forthcoming).

Evaluation of the Theories of Regulation

The theory of economic regulation is not an adequate tool in understanding the regulatory change in Turkey between 1980 and 1987. The major reason is that this theory is derived from the experiences of major industrially developed countries, which have relatively well-established democratic systems. Therefore, certain assumptions of this theory are not valid in the Turkish context. ET introduces the power struggle between banking community and public authorities as the main source of change in the mode of regulation. Private actors are assumed to organize themselves effectively and communicate their wishes to politicians without major interruptions. But this is not the case in Turkey in the 1980s. Private interest groups, namely banking community, were not organized and powerful enough to transmit their views on the regulatory regime. Moreover, the political regime of Turkey was limiting the communication channels between private actors and public authorities. Turkish political regime was not democracy between 1980 and 1983; democracy was not fully established until 1987. Hence, although private bank owners benefited from regulatory reforms, the communication channels between bank owners and politicians were closed. Changes in

the regulatory framework could not be attributed to pressures from the domestic banking community.

Public interest theory of regulation is useful in understanding certain components of the change in the mode of banking sector regulation. However, it fails to capture the whole episode of change in the mode of banking sector regulation between 1980 and 1987. Specifically, it illuminates the reasons behind the brief episodes of re-regulation, while it is not able to capture deregulation in the mode of banking sector regulation between 1980 and 1987. After the Brokerage Houses Crisis in 1982, Turkish policy-makers changed the regulatory framework and reversed some of the earlier policies of deregulation in order to correct the market failure, which emerged after the liberalization of interest rates. Moreover, in 1985, the legal framework for banking sector regulation was strengthened in order to prevent future market failures and inefficiencies that might result from bank failures. As a result, public authorities acted on behalf of the general interest by introducing re-regulation or reversing earlier policies of deregulation.

Vertical diffusion perspective and sociological institutionalism provide more comprehensive views on regulatory change than the theory of economic regulation and public interest theory of regulation, since they focus on the role of international institutions in generating regulatory change within nation-states. As it is shown in the above paragraphs, the IMF and the World Bank cross-conditionality in engendering regulatory change is far more important than domestic interests of the banking community in generating change in the mode of banking sector regulation. These institutions engineered the change and coerced Turkey to implement certain regulatory reforms as the vertical diffusion perspective has predicted. Most of these regulatory

changes were first adopted and originated in the developed countries and these changes were then exported through international institutions to developing countries.

Sociological institutionalism, more specifically, *taken-for-grantedness* and *symbolic imitation*, is complementary to vertical diffusion perspective in capturing the regulatory change in Turkey between 1980 and 1987. These approaches focus on the role of international developments in generating regulatory change within nation-states. According to the theory, policy-makers adopt certain policies simply because these policies are “popular” in neighboring countries. Symbolic properties of these policies are far more important their functional properties.

As it is explicated in the above paragraphs, major Latin American countries and European countries experienced similar changes in their regulatory regimes. Turkish policy-makers might have imitated those changes in these countries. In the 1980s, financial deregulation was at the core of regulatory change in different parts of the world. Turkish policy-makers, more specifically the economic team of Turgut Özal, were clearly influenced by these international developments. While this hypothesis requires rigorous analysis of the policy-making processes, which this thesis cannot address adequately, it is obvious that Turkish policy-makers were not acting independent from regulatory changes occurring in different parts of the world since most of them had worked in international institutions, like the World Bank (Öniş, 1997). Therefore, they had sufficient knowledge of the international developments in the mode of banking sector regulation. As a result, sociological institutionalism may provide important insights in understanding the sources of regulatory change.

Conclusion

In this chapter, change in the mode of regulation of the banking sector between 1980 and 1987 is examined. First, change in the mode of regulation is addressed. It is claimed that while the first and second category of regulations were gradually lifted, Turkish governments introduced the third category of regulations. Second, sources of these changes in the mode of regulation are analyzed, while theories of regulation, which has been introduced in Chapter 2, is evaluated according to the analysis.

Major conclusion of this chapter is that role of international institutions, namely the World Bank and the IMF are the most important factors that facilitated the change in the mode of banking sector regulations. Vertical diffusion perspective and sociological institutionalism provide better tools in understanding the change while theory of economic regulation and public interest theory of regulation fail to capture the whole history of regulatory change between 1980 and 1987. While the banking sector is deregulated in different parts of the world, international institutions have been the main agents of this transformation in developing countries. Turkish policy-makers changed the mode of banking sector regulation because of the conditionality attached to World Bank and the IMF Programs. Moreover, they imitated the international developments in other countries as sociological institutionalism has predicted.

In this period, change in the mode of regulation was not a smooth process. It involved major policy oscillations, despite the fact that in major areas banking sector was deregulated. For instance, currency regime and interest rates were deregulated rapidly. However, although Turkish policy-makers kept on liberalizing the currency regime, deregulation of interest rates was reversed after the Brokerage Houses Crisis in

1982. Therefore, these inconsistencies are analyzed by focusing on the political decision-making processes.

Finally, the banking community was content with the policies, even though the government did not consider their ideas about the regulatory regime. Private banks increased their profit margins by investing their funds in GDIs and also involving in trade-financing activities. They compensated for their losses that emerged out of frequent oscillations in the regulatory framework, and limited competition in the interest rates. As a result, they were not raising their voices against frequent policy oscillations.

After 1987, Turkish political scene changed drastically by the return of former politicians into the political arena, who had been banned from politics after the September 12 *coup d'etat*. In the next chapter, change in the mode of banking sector regulation between 1987 and 1994 is analyzed.

CHAPTER 4

1987-1994: CHANGE IN THE MIDST OF POLITICAL AND ECONOMIC INSTABILITY

Introduction

The main topics of Chapter 4 are the changes in the mode of banking sector regulation between 1987 and 1995, and the analysis of the factors contributing to change in this period.

In this period, there are three important changes in the regulatory framework, namely: capital account liberalization, change in the Banks Act No.3182 by the Governmental Decree No. 538 and full deposit insurance scheme, which was introduced after the economic crisis in 1994. These changes implied that mode of regulation continued to change toward the third category of regulations. In other words, Turkish regulatory regime increasingly adopted prudential regulatory standards, while gradually lifting the regulations that soften competition and that limit scope and scale of banks. Regarding the factors contributing to regulatory change, distributional pressures, international institutions and the economic crisis were major factors that influenced Turkish politicians in changing the mode of banking sector regulation. Finally, the Chapter covers the period between 1989-capital account liberalization and 1994-establishment of a full deposit insurance scheme.

In 1989, there were several important changes in the mode of banking sector regulation. First, in August 1989, MP Government liberalized the capital account regime of Turkey. Capital account liberalization engendered massive changes in the whole Turkish economy. However, in this Chapter, it is analyzed as a change in the mode of banking sector regulation, since it implied deregulation in the area of the second category regulations, which include restrictions on the scale and scope of banks. As a result, deregulation of the foreign currency regime was completed and Turkish economy was opened to capital flows.

The “politically insecure” MP government aimed to increase its political power and to stop its declining popularity among public, by generating economic growth through free capital flows. Moreover, Turkish policy-makers also imitated other countries which had liberalized their capital accounts and experienced economic booms in the aftermath of capital account liberalization. As a result, Way’s (2005) theory of political insecurity and financial market liberalization is important in the analysis of capital account liberalization. In understanding the level of “political insecurity”, the Turkish economy and political environment prior to 1989 should be understood. Stagnating economy, declining economic growth and return to full-fledged democratic competition after 1987, were the main elements in the political economy of Turkey prior to the capital account liberalization. These elements generated political insecurity in the MP Government.

Second, in October 1989, the Treasury issued a notification No. 6 which introduced capital adequacy ratios to banks in line with international standards, namely BASEL I. The goal was to strengthen prudential regulations of the banking sector. As a

result, this notification signified a further change in the mode of banking sector regulations toward the third category of regulations.

The role of international institutions, namely Bank for International Settlements (BIS), was important in understanding the Notification of the Treasury No.6. This Notification described a new capital adequacy ratio, and set this new ratio at 8 percent. This new capital adequacy ratio was prepared according to the standards designed by the Basel Committee on Banking Supervision. However, regarding the implementation of this new capital adequacy ratio, Notification also introduced a transition period, again in accordance with the Capital Accord.

In 1994, regulatory regime of the banking sector changed significantly with the Governmental Decree No. 538 about the Banks Act No. 3182. This Governmental Decree changed the Banks Act No. 3182 drastically. Interpretation of this change in the legal framework is not an easy task because of the turmoil that Turkish economy was experiencing at the time. However, government aimed to make bank entry into the banking sector easier and also to strengthen the powers of the SDIF in taking over banks.

Role of domestic factors are more important than the role of international institutions in understanding the Governmental Decree No.538. In order to understand the factors contributing to this change in the legal framework, Turkish economy, banking sector and political environment prior to 1994, and economic crisis in 1994, should be understood. Government strengthened the powers of the SDIF and reduced moral hazard that emanated from the application of the Banks Act No.3182 Article 64. These measures were clearly responses of the government to bank failures in the aftermath of the economic crisis in 1994.

Close relationship between politics and banking community during the Çiller government was also important in understanding the Governmental Decree No. 538. Banking sector profits increased prior to 1994, since banks invested their funds in high-yielding GDIs. As a result, financing public deficits became a major source of revenue for banks. In this environment, Çiller Government made bank entry into the banking sector easier with the Governmental Decree, in order to increase the number of banks and thus to ease the financing of public deficits.

The third important change in the mode of banking sector regulation was the introduction of full deposit insurance scheme. Moreover, prudential regulatory standards were strengthened and tax burden on banks was reduced after the 1994 economic crisis. These changes signified a further change in the mode of banking sector regulation toward the third category of regulations. The economic crisis, the IMF support of the government program and bank failures were important factors in understanding the establishment of the full deposit insurance scheme, reduction of the tax burden on the banking sector and strengthening of prudential regulatory standards regarding the net open foreign exchange position of banks.

The time period that this chapter covers ends with the year 1994. In December 1995 general elections, Refahyol coalition government was formed. Political developments during and in the aftermath of the Refahyol coalition government were very different from the ones between 1989 and 1995. Different political factors contributed to the change in the mode of regulation after 1995. As a result, partition of this chapter ends in 1994.

Mode of Banking Sector Regulation in 1989

MP Government introduced major changes in the regulatory regime of the banking sector. Mode of banking sector regulation continued to change toward the third category of regulations in 1989. Capital account was liberalized and the Treasury issued a notification, which introduced a new capital adequacy ratio, in order to strengthen prudential regulations.

“Politically insecure” MP Government liberalized the capital account regime in order to generate short-term economic growth and thus to maintain its political power. Moreover, international environment was also important in understanding the change in the regulatory regime. At the end of the 1980s, different countries have increasingly been liberalizing their capital account regimes. The MP Government imitated financial market reforms in other countries and jumped on the bandwagon of financial market liberalization.

Understanding the Capital Account Liberalization

Financial deregulation, which was initiated in 1984, was finalized with the capital account liberalization in 1989. Although capital account liberalization was a tremendous event regarding the whole Turkish economy, in this thesis, it is analyzed as a major change in the mode of banking sector regulation.

The “politically insecure” MP Government liberalized Turkish capital account regime in order to generate short-term economic growth and to revitalize its political power. Moreover, international developments, regarding capital account liberalization,

affected the MP Government. Major European countries and most of the Latin American countries embarked upon capital account liberalization at the end of 1980s. Most of these countries experienced short-term economic boom periods in the aftermath of capital account liberalization. Hence “politically insecure” Turkish policy-makers jumped on the bandwagon of capital account liberalization. In this analysis, Way’s (2005) theory of financial market liberalization is more helpful than the theory of economic regulation. The theory of economic regulation fails to illuminate financial deregulation, since it claims that domestic economic interests engendered capital account liberalization, which was not the case in Turkey.

International Environment

Sociological institutionalism, more specifically *taken-for-grantedness* and *symbolic imitation* approaches are helpful in understanding capital account liberalization. This approach emphasizes the role of international developments in engendering regulatory change, namely the capital account liberalization. Turkish policy-makers jumped on the bandwagon of capital account liberalization when they observed that different countries experienced economic boom in the aftermath of capital account liberalization.

Turkish politicians stated that their major aim in liberalizing Turkey’s capital account was to further integrate Turkey with international capital markets and in particular with the European Union. However, Turkey was one of the earliest countries to liberalize its capital account compared to other 15-EU member states. For instance, Greece, Spain and Portugal liberalized their capital account in 1994, 1992 and 1992,

respectively. Only Denmark, Germany, Ireland and the United Kingdom liberalized their capital accounts earlier than Turkey (Gual, 1999).

Several Latin American countries, including Colombia, Venezuela, Argentina, Peru and Brazil liberalized their capital accounts fully at the end of 1980s, around the same period in which Turkey liberalized its capital account. Similar to Turkey, capital account liberalizations in most of these Latin American countries occurred in the midst of macroeconomic instability and poor fiscal balances (Williamson & Mahar, 2002).

For instance, Argentina embarked upon liberalizing its foreign currency regime and capital account, when Argentinean government allowed foreign credit in 1978. It lifted some of the restrictions on capital flows between 1978 and 1982. However, because of the economic crisis in 1982, it reversed liberalization of capital account and re-introduced restrictions on capital flows. However, it finally liberalized its capital account in 1991 (Williamson & Mahar, 2002).

Turkish Politics and Economy between 1987 and 1989

The MP Governments have lost political power toward the late 1980s. This loss of power has generated “insecurity” in the MP Government. As a result, “politically insecure” MP Government liberalized capital account regime in order to generate short-term economic growth and thus to re-establish popularity and political power.

Öniş (1991) partitioned 1980s into three sub-periods; January 1980- November 1983; November 1983-November 1987; and finally 1987-early 1989. The major difference between the period 1987-1989 and the first two periods is that in the period between 1987 and 1989, external constraints, namely conditionality of the IMF and the

World Bank, on Turkish politics diminished significantly. Turkish policy-makers became more receptive to populist pressures in this period. Rising populist pressures and full-scale political competition generated political insecurity in the MP Government.

As it is explained in the previous Chapter, between 1980 and 1987, Turkish politics were relatively autonomous from populist pressures. The military regime between 1980 and 1983 implemented major restrictions over trade union rights and labor's bargaining power. These restrictions continued to prevail even after the transition to democracy in November 1983 until 1987.

Turkish political structure became more receptive to populist demands after 1987. In 1987, former politicians, Bülent Ecevit, Süleyman Demirel, Alpaslan Türkeş and Necmettin Erbakan, returned to the political arena; therefore, political competition increased (Öniş, 1996). Social groups, who had materially lost in the pre-1987 period began to organize themselves and to aspire to recover the losses they had incurred over the years. Especially, the TPP under the leadership of Süleyman Demirel, aspired to represent 'the losers of the Özal era'. Öniş (1996) stated that "Hence, a striking feature of Turkey during the late 1980s and the early 1990s was the emergence of an overt distributional conflict in a reconstituted democratic environment" (p.517). In this environment, MP's political power was challenged by the increased political competition.

Populist pressures on politics increased toward the late 1980s since Turkish economy has lost its earlier pace of growth. The MP lost its popularity due to the rising inflation, stagnating export revenues and economic growth. In 1987 and 1988, Turkey experienced negative GDP per capita growth. Hence, MP Government was feeling more "politically insecure."

In the period of 1980-1988, the main goal of the MP Governments was to increase the export capacity of Turkey. They implemented different incentives in order to raise the export revenues. Turkish Lira was significantly depreciated in this first phase of deregulation. Most of the trade restrictions were lifted and current account was liberalized. Competitive exchange rate regime together with domestically repressed real wages¹³ engendered impressive export performance especially throughout the first half of the decade. Between 1983 and 1987, export revenues increased at an annual rate of 10.8 percent (Boratav and Yeldan, 2001, p.5).

In 1988, prior to capital account liberalization, it was clear that the Turkish economy lost the momentum that it gathered in the first half of the 1980s. According to Boratav and Yeldan (2001): “The export-led growth path, which was dependent on wage suppression, depreciation of the domestic currency, and extremely generous export subsidies reached its economic and political limits by 1988” (p.7). Turkey was not able to sustain its impressive export performance toward the end of the decade. Wage suppression and currency depreciation had been primary incentives which were used to promote exports. The government did not address the structural problems that started to inhibit export growth. For instance, the manufacturing sector was the engine of Turkey’s export sector but between 1983 and 1987, the rate of growth of private manufacturing investments was only 7.7 percent per annum, and could not reach its pre-1980 levels in real terms until the end of 1989 (Boratav and Yeldan, 2001, p.5). However, housing investments increased at a rate of 24.5 percent in the same period.

¹³ “The suppression of wages was instrumental both in lowering production costs and also in squeezing of the domestic absorption capacity. The share of wage-labor in manufacturing value added receded from its average of 35.6% in 1977-80, to 20.6% in 1988” (Boratav and Yeldan, 2001, p.5).

Toward the end of the decade, public deficit began to increase, which further exacerbated the economic problems. The major factor behind rising public deficit was the growing populist pressures on the government. Market reforms implemented between 1980 and 1983 had changed the income distribution significantly. Wage earners, other fixed income groups, lower level bureaucrats and the farming community emerged as the principle losers from this process (Öniş, 1991, p.34). After the return of former politicians to the political arena in 1987, the MP Government engaged in populist policies in order to gain the support of the farmers, workers and industrialists. The government relaxed fiscal discipline and followed an expansionary strategy. For instance, According to Celasun, Denizler and He (1999) one of the factors contributing to rising public deficits was the dramatic increase in real wages in 1989 and 1990. Moreover, real exchange rate began to appreciate after 1989. It is stated in Celasun et al. (1999): “The appreciation of the exchange rate not only eased the servicing of foreign official debt, but the slower crawl of the exchange rate also implicitly served as a nominal anchor and helped to control inflation in an environment of deteriorating fiscal deficits” (p.11). As a result, PSBR continued to rise toward the end of the decade.

Introduction of fiscal austerity in 1988 further contributed to the diminishing popularity of the MP Government. Following the mini-crisis in 1987, the government introduced austerity measures in February 1988. In 1988, Consumer Price Index (CPI) rose to 73.7 percent from 38.8 percent. Moreover, GNP growth diminished to 1.45 from 9.81 percent in 1987 (Yentürk, 2005). PSBR rose steadily and in February 1988, the government implemented certain measures in order to contain the rising PSBR. Some of the prices of the state owned enterprise (SOE) products were increased sharply. In

addition, the government devalued TL in order to prevent the worsening of the current account deficit. These measures further diminished Özal government's popularity.

As a result of diminishing popularity and full-scale political competition, on March 28, 1989 local elections, MP won only 21.8 percent of the total votes and became the third party, following the Social Democratic People's Party (SDPP) and the True Path Party (TPP), while in 1987 general elections, MP had rendered 36 percent of the total votes. In October 1989, Turgut Özal became the President, and Yıldırım Akbulut formed the new government. Therefore, as the 1987 general elections and 1989 local elections proved, the government's popularity decreased significantly.

Capital Account Liberalization

In this environment of full-scale political competition and rising populist pressures, it became harder for the government to continue suppressing real wages and sustain the export promotion regime. Moreover, deteriorating public finances limited government's borrowing opportunities. As a result, the Turkish government aspired to benefit from foreign capital markets in financing the rising public deficits. CBRT had already put a 15 percent limit to budgetary appropriations in order to prevent monetization of fiscal deficits and also external financing of public deficits was limited. Capital inflows would help the government in sustaining the PSBR by increasing the available funds in the economy. MP wanted to get its way out by borrowing from abroad. In short, the Turkish export-oriented growth strategy came to a halt and the "politically insecure" MP government wanted to revitalize economic growth through capital inflows, and thus to revitalize its political power.

After the capital account liberalization, the Turkish economy entered into a boom period. The GNP growth became 9.4 percent in 1990. The ratio of capital flows to the GNP rose to 2.65 percent from 0.72 in the previous year. However, short-term capital flows constituted 1.97 percent of the GNP. PSBR continued to ascend and became 7.6 percent. Moreover, CPI was reduced by only 3 percent and became 60 percent, which was still very high relative to the inflation rate in the first half of the 1980s (Yentürk, 2005).

In April 1989, Foreign Exchange and Foreign Banknote Markets were established. By this time, foreign exchange deposits had started to surpass the volume of the TL denominated deposits in the banking sector. Moreover, Turkish banks started making business abroad by purchasing banks or opening branches and representative offices in foreign countries. In addition, they began to operate in international markets dealing with extensive off-balance sheet activities such as swaps and forward agreements (Işık et al., forthcoming).

In August 1989, the MP government under the premiership of Özal, liberalized Turkey's capital account regime with the Governmental Decree No.32 about the Law of Protection of the Turkish Lira (*Türk Parasının Kıymetini Koruma Hakkında Kanun*). Liberalization of the capital account regime was one of the components of the changing mode of banking sector regulation.

According to Gual (1999), restricted capital account regime limited cross-border banking, and thus softened competition. Hence, restricted capital account regime is in the first category of regulations. As a result, Turkey abolished one more component in the first category of regulations, and regulatory framework continued to move toward the third category of regulations.

There are several important components of the capital account liberalization. TL became convertible to foreign currencies. Non-residents were allowed to invest in TL or foreign currency and buy securities in the Turkish domestic financial market. Moreover, residents were allowed to invest in foreign stock exchanges or government securities issued by foreign countries. As a result, external financial liberalization process, which was initiated in 1984 when Turkish residents were allowed to hold foreign exchange denominated deposit accounts was completed by this Decree.

The Notification of the Treasury No.6

In 1988, Basel Committee on Bank Supervision declared the Basel Capital Accord, which set the international standards for capital adequacy. The Committee was established by the central-bank governors of the Group of Ten countries in 1974. “One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate” (para. 4) However, the decisions of the Committee did not have any legal force. The Committee (BIS):

formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques (para. 3)

In October 1989, the Treasury issued an important notification regarding capital adequacy of banks. Since this Notification was based on the Basel Capital Accord (BASEL I), it is clear that the MP Government was influenced by the international environment regarding banking sector supervision. However, the Capital Accord did not have any legal binding force.

This new notification announced the new capital adequacy ratio for banks. The new ratio was set at 8 percent. However, the Notification also introduced a transition period, in which banks would have adopted their capital adequacy ratios to the announced levels. In 1989, the ratio was set at 5 percent. It would gradually increase to 8 percent until 1992. Despite the announced transition period, the Turkish Banking Association (TBA) stated that implementation of this Notification might create future problems in the banking sector (Bankalarımız, 1990). However, this Notification signified a further change in the mode of banking sector regulation, toward the third category of regulations, namely prudential regulations.

Understanding the Change in the Legal Framework: Governmental Decree No. 538

Governmental Decree No. 538 about the Banks Act No. 3182 was an important development regarding the mode of banking sector regulation. The prime Minister Tansu Çiller stated that goal of the Governmental Decree was to supervise banks more effectively and in accordance with the international standards. Establishing banks became easier, while SDIF's powers to take over banks increased and moral hazard created by the Article 64 of the Banks Act. No 3182 was reduced. The government aimed to prevent future bank failures by reducing moral hazard and increasing the

SDIF's powers. Moreover, it aimed to increase the number of banks by making bank entry easier, since commercial banks financed public deficits. The government would be able to service domestic debt more easily, when the number of banks rose.

Turkish Politics and Economy between 1989 and 1994

Politicians in this era, engaged increasingly in populist policies in order to maintain political power. The TPP Governments, which include SDPP also, came to power by the votes given by the 'losers of the Özal era'. As a result, they wanted to keep their bases of support intact by applying populist policies. Populist policies engendered high public deficits. Since, banking sector was the main investor in GDIs, change in the regulatory framework is easily traced back to the populist policies of TPP Governments.

In October 1991 general elections, the MP became the second party after the TPP. TPP won the 27 percent of the validly cast votes, while MP got only 24 percent. As a result, the election results proved that the MP's policies to regain popularity did not succeed. The TPP formed a coalition government with Social Democratic and Populist Party (SDPP). This coalition government lasted two years. Certain characteristics of this government are necessary in order to understand the politics of banking sector regulation in this period.

TPP, under the leadership of Demirel, tried to garner the support of the masses by stressing the importance of the social state, and civilianization of the regime. Finally, he underscored democratization with strong emphasis on human rights. Demirel opposed the economic and conservative discourse of the Özal governments, which increasingly dominated the political arena after especially after 1989 local elections. Moreover, TPP

adopted an anti-militarist discourse, and claimed that MP was the tail of the *coup* (Cizre-Sakallıoğlu, 1996).

Regarding the economy, the idea of social state was revived by the TPP. It stressed the dislocating social effects of free-market capitalism unleashed by the Özal governments. TPP's target constituency was the losers of the Özal era, namely the lower middle classes, the small and medium sized entrepreneurs and the peasantry. The idea was to pay the cost of social services by the growth inducing potential of free-market economy. SOEs were going to be used to implement "an economic rationale with social content". In summary, the TPP had the motto of "combining societalism and liberalism" (Cizre-Sakallıoğlu, 1996).

The TPP's short-term economic program had the name of economic stability, reparation and revival (*Kısa Dönem Ekonomik Dengeleme Onarım ve Canlandırma Programı*). The primary goal was to reduce the inflation rate and "repair" the economy. The government was going to implement a tight monetary policy, which involved limiting the growth in the monetary base. Moreover, devaluation of the domestic currency was going to be slowed down. In order to support the monetary and exchange rate policies, the government was going to adopt a tight fiscal policy, which aimed at reducing PSBR to 5 percent in the following two years, 1992 and 1993.

The government's main curiosity regarding the regulatory framework for the banking sector was the heavy tax burden on the financial sector. The goal was to reduce the public's dominance in the financial sector. The government was going to implement a financial sector reform in order to reduce the interest rates on domestic debt and thus support the fiscal policy. The major component of the financial sector reform was to reduce the tax burden on the financial sector. Liquidity ratios and reserve requirements

would be reduced. Banking insurance tax (*BSMV*) would also be reduced. As a result, it was expected that interest rates would diminish and fiscal balances would improve. The government acknowledged the fact that public securities inundated the domestic financial market and banking sector's assets. Moreover, it was expected that credit stock would increase since fiscal pressure on the domestic financial assets would diminish as a result of lower interest rates.

Strengthening the regulatory framework for the banking sector was not on the agenda of the Demirel Government. There were several reasons. First of all, banking sector fragilities were not severe enough to threaten the whole economy. Second, governments were unaware of the emerging new types of vulnerabilities in the banking sector in a liberal capital account regime. Government regulated the banking sector primarily through manipulating the tax rates on financial instruments and the liquidity ratios and reserve requirements for the sake of monetary policy.

In 1992, it was clear that Demirel government failed to keep its promises regarding the financial sector. The financial sector continued to have a heavy tax burden. The fast growing economy, along with increasing PSBR and CPI, were the characteristics of the Turkish economy under Demirel's government. GNP rose by 6.4 percent and GNP per capita became US\$2.700. Fast growth veiled the populist agenda of the government and the negative developments in the Turkish economy. These negative developments were basically the continuing rise in the CPI and the PSBR. The CPI kept rising and became 66 percent. Moreover, the PSBR continued to rise and became 10.6 percent. External debt stock was 55 billion, while domestic debt stock was TL194 trillion. Current account deficit rose.

In June 1993, Tansu Çiller, who had been the minister in charge of economic affairs in the previous Demirel Government, established a new coalition government with the SDPP. Çiller deviated from the earlier welfarist discourse of Demirel. She was the head of the liberal wing in TPP and her victory in the June 1993 Party Congress signaled an end to earlier socially sensitive policies of the TPP-SDPP coalition government. Reducing the inflation rate was again the major economic goal of the government. However, different from the previous government, privatization of the SOEs was on the agenda of the government. (Cizre-Sakallıoğlu & Yeldan, 2000, p.501).

Regarding the financial sector, coalition protocol did not contain detailed policy objectives in contrast to Demirel Government's coalition protocol. It was briefly stated that major goal of the coalition government was to establish İstanbul as one of the trade and finance centers of the world. Moreover, similar to the previous government, the financial sector would be promoted through tax breaks. However, a couple of months later, the Çiller Government made drastic changes in the regulatory framework of the banking sector.

Economy and the Banking Sector between 1989 and 1994

Understanding the Turkish economy in this period is important for several reasons. First, it illuminates the increasing interdependency between the banking sector and the state. This interdependent relationship was generated by the fact that public deficits were increasingly financed by the banking sector in this period Turkey's capital account regime was liberalized in the midst of acute distributional pressures and political crashes. Rising public deficits together with an open capital account regime generated

important problems in the Turkish economy. The crucial repercussion of the capital account liberalization on the banking sector was that private banks became mediators in this environment of free capital flows and rising public deficits. As a result, private banks began to invest increasingly on GDIs and borrow in foreign currency. Because of this interdependency between the banking sector and the state, government made entry to the banking sector easier by the Governmental Decree No. 538.

Second, the economic crisis in 1994 should be understood since it was important in understanding the change in the regulatory framework, namely the Governmental Decree No. 538. Rising public deficit and current account deficit were major problems in the Turkish economy. These deficits were financed by the surplus in the capital account. In other words, capital inflows covered up these deficits. However, a significant part of capital inflows was short-term. As a result, the Turkish economy experienced a major economic crisis and three banks failed in 1994. Government responded by increasing the powers of the SDIF in taking over banks and bank take-overs became easier. The goal was that SDIF would act faster in taking over troubled banks before these banks threatened the stability of the whole banking sector.

Turkish Economy between 1989 and 1994: Rising Public Deficit

The fiscal position of the state rapidly deteriorated prior to the financial crisis in 1994. PSBR increased dramatically and became 12.1 percent of the GNP in 1993 from 7.4 percent in 1990. Moreover, consolidated central budget deficit rose to 6.8 percent of the GNP in 1993 from 3.1 percent in 1990.

Consolidated central budget income increased only moderately after 1980 and it became 19 percent of the GNP in 1993, while it was 17.2 percent in 1980. However, consolidated budget expenditures rose rapidly. It rose to 24 percent of the GNP in 1993 from 16.9 percent in 1989. Hence at the start of the decade, public expenditures rose faster than public income.

The rise in the current expenditures and transfer payments were the major reasons behind the rise in the consolidated central budget expenditures. Net factor income generated by state economic enterprise system fell, since the SOEs worked inefficiently. Moreover, real wages increased because of pressures from organized labor. Real wages rose 18.5 percent in 1990 and 64.9 percent in 1991 and stayed more or less at the same level in 1992 and 1993 since the major part of the organized labor was located in the public sector. The share of current expenditures in the budget increased from 8.4 percent of GNP in 1990 to 10.3 percent of GNP in 1993. Finally, farmers were compensated by an increase in the agricultural support prices. As a result, share of transfer payments in the budget increased from 2.9 percent of GNP in 1990 to 5.5 percent in 1993 (Öniş, 1996, p.518).

The rise in interest expenditures was another factor contributing to the rise in the consolidated central budget expenditures. Interest expenditures constituted 6 percent of the GNP in 1994, whereas it was only 3.9 percent in 1989 and 0.6 percent in 1980. The major reason was that real interest rates on GDIs rose from -5.4 percent in 1990 to 14.2 percent in 1993 (Yeldan, 1998).

As another factor contributing to the deficit in the consolidated central budget, social security institutions drained the budget funds. In 1993 and 1994, 1 percent of the

GNP was transferred to these institutions from the central budget (Sak, Özatay & Öztürk, 1996).

Public deficit is a wider term than budget deficit. Between 1992 and 1994, the public sector spent more than its disposable income. The ratio of the public sector expenditures to the public sector disposable income reached its peak in 1994 and became 128 percent. It was 68.3 percent in 1987. Moreover, between 1987 and 1994, public sector expenditures exceeded public sector savings. The ratio of public sector expenditures minus public sector savings to GNP increased dramatically after 1990. It became -10.1 percent in 1993, whereas it was -2.1 percent in 1989.

Rising current account deficit was another major problem in the economy. Overvalued exchange rate was the primary factor behind rising current account deficit. Because of the overvalued exchange rate, imports rose faster than exports.

Both public deficits and current account deficits were financed by two sources. The first source was the private sector. The private sector had savings surplus, which was 5 percent of the GNP in 1993. The second source was external borrowing (Sak et al., 1996). External borrowing was reflected as surplus in the capital account. In 1987 capital account surplus was \$US 1.9 billion; however, it became \$US 8.9 billion in 1993.

Domestic instability in the public balances and rising current account deficit were transposed into instability in the capital account balance. In order to understand the instability in the capital account balance, nature of capital inflows in this period should be understood. Between 1989 and 1990, short-term capital inflows increased dramatically. Foreign direct investment was very low, and it was around \$US700 million between 1990 and 1993. Especially in 1990, there was a surge in the short-term capital inflows to GNP ratio. It rose from -0.49 percent in 1989 to 1.69 percent. In addition in

1992, portfolio investments to GNP ratio rose from 0.36 percent in 1990 to 1.50 percent. Between 1989 and 1990, short term speculative capital inflows to GNP ratio increased from -0.49 percent to 1.69 percent (Yentürk, 2005).

In order to attract foreign capital, domestic interest rates must be higher than foreign interest rates plus the expected devaluation rate of the domestic currency. There is also risk premium regarding the realization of the devaluation rate at the expected rate. In short, portfolio investments are affected by domestic interest rates in Turkey. High domestic interest rates attract capital inflows. In 1988 and 1989, real interest rates were negative. However, despite expectations to the contrary, after the capital account liberalization, real interest rates rose dramatically. Between 1991 and 1993, real interest rates were around 20 percent. In 1994, it rose to 52 percent.

It is a paradoxical development that after Turkey liberalized its capital account, domestic interest rates did not fall. According to logic of free market economy, since the available funds in the domestic economy increased as a result of capital inflows, domestic interest rates should be reduced. So, the question is why domestic interest rates continued to rise in the aftermath of capital account liberalization.

There were several reasons for this paradoxical development. The major factor was that public deficits continued to rise in this period as explained in the above paragraphs. As a result, the public drained the available funds in the domestic market. The rate of increase in the PSBR exceeded the rate of growth of the total financial assets. Hence, there was an upward pressure in the domestic interest rates. Moreover, risk premium on the GDIs was on the rise because of the continuous upward trend in the domestic debt of the public sector. As a result, domestic interest rates tended to rise.

There were also other factors, mostly related to developments in the capital and current accounts of Turkey. First, regarding the capital account, external debt of Turkey continued to rise in this period. Second, rising current account deficit generated jitters in the foreign markets, who heavily invested in the Turkish financial assets denominated in domestic currency. Since CBRT did not sterilize the inflows¹⁴, monetary base increased. As a result, TL became overvalued and current account deficit increased¹⁵. In the fourth quarter of 1993, currency appreciation and current account deficit reached unprecedented levels and became \$US 6.4 billion, whereas it was only \$US 1 billion in 1992. Expectations of devaluations also increased. As a result, domestic interest rates continued to rise.

The rise in real interest rates engendered rise in the volume of capital flows. Gross capital inflows increased from \$US 50 billion in 1991 to \$US 120 billion in 1995. Moreover, high real interest rates attracted short-term capital inflows rather than foreign direct investment.

Turkish Banking Sector between 1989 and 1994: Rising Profitability

High public deficits created disequilibrium and instability in the domestic financial sector, thus also in the banking sector. PSBR's magnitude relative to the domestic financial sector was crucial. High domestic debt stock and high domestic interest rates

¹⁴ The Gulf War and early elections in 1991 destabilized the money market. In 1990, for the first time CBRT publicly announced its monetary policy. However, between 1991 and 1994, the CBRT did not announce monetary policy and only acted in order to stabilize the exchange rate and try to control the excessive liquidity in the money market (Kesriyeli, 1997).

¹⁵ There were also other reasons behind the surge in the current account deficit. Domestic consumption began to increase from the beginning of the decade, except in 1991. Especially in 1993, rising domestic consumption fueled imports and thus trade deficit reached dramatic levels. Trade deficit rose to around \$US14 billion, while the current account deficit was around \$US6.4 billion.

encouraged banks to invest in GDIs. Banks borrowed abroad in order to finance their GDI portfolios. Hence open positions of the banking sector rose rapidly. As a result, banking sector became vulnerable to both interest rate shocks and devaluations. Moreover, the banking sector began to turn away from its core activities like deposit collecting and lending loans and to turn into a mediator which brought the funds abroad in order to finance the public deficits.

In 1990s, state resorted to domestic borrowing more than external borrowing in order to finance the rising public deficits. Between 1989 and 1993, around 80 percent of budget deficits were financed through domestic borrowing (Yentürk, 2005). Stock of domestic debt grew rapidly and became 12.7 percent of the GNP in 1993 from only 1.1 percent in 1990. Interest payments on domestic debt as a share of GNP doubled between 1990 and 1993 and became 4.6 percent (Yeldan, 1998, p.398). There were several repercussions of these developments.

Major repercussion of this development was that public sector began to drain the available funds in the economy and private banks channeled their funds into this 'black hole'. Moreover, interest rate risk of the banking sector increased because of their increasing exposure to GDIs. Domestic debt to total domestic financial assets¹⁶ ratio increased. It rose from 22.9 percent in 1989 to 35.6 percent in 1994. Moreover, stock of domestic debt to GNP ratio increased from 6.3 percent in 1989 to 13.9 percent in 1994 (Sak et al., 1996). Securities portfolio of the banking sector rose in this period. The rates of increase between 1991 and 1993 were around 98 percent, 78 percent and 88 percent, respectively. In other words, private banks began to invest their funds increasingly on

¹⁶ Domestic financial assets include credit given by the banking sector and the CBRT, and public securities (GDIs) and private securities.

GDI. As a result, their balance sheets became exposed to sudden changes in the interest rates. For instance, a possible interest rate hike would decrease the value of the GDIs and thus hurt the asset structure of the banking sector.

There were several parameters that operationalize the public sector's dominance in the financial sector. The basic measure was the ratio of PSBR to M2¹⁷. It rose to 88 percent in 1993 from 26 percent in 1989. Regarding the domestic financial assets, public sector's share rose. It was around 40 percent in the second half of the 1980s. However, it rose to 52 percent in 1994. In other words, in 1994, public securities and credit given by the public banks and CBRT constituted 52 percent of the domestic financial assets (Sak et al., 1996). More importantly, share of public securities, namely Treasury Bills and Bonds, in the domestic financial assets rose much faster than the share of public sector in the domestic financial assets. In 1983, it was 9 percent. In 1989, it rose to 21 percent and in 1994 it became 37 percent (Sak et al., 1996). Moreover, maturity of the GDIs was short. 1-9 month due GDIs, i.e. government bonds, constituted the biggest portion of total GDIs (Yentürk, 2005). In summary, the banking sector began to invest increasingly in GDIs which offered high returns and had short maturities.

Another vulnerability in the banking sector generated by the economic environment of Turkey was its vulnerability against speculative attacks on the domestic currency. Thanks to the liberal capital account regime and rising public deficits, external debt of Turkey and also external debt of the banking sector rose after 1990. The banking sector became vulnerable to sudden changes in the exchange rate because of its rising foreign liabilities and open positions (Boratav and Yeldan, 2001, p.11). The ratio of short-term external debt of the commercial banks to total external debt rose from 10

¹⁷ M2 consisted of currency in circulation, sight and time deposits denominated in domestic currency.

percent to 16 percent in 1993. In 1993, total external debt of Turkey was around US\$67 billion, whereas short-term external debt of commercial banks was US\$11 billion. It was only around \$US7 billion in 1992, and was around \$US 5 billion in 1991 and 1990 (Bankalarımız, 1994). At the end of 1993, net open foreign exchange position¹⁸ of the banking sector was around US\$5 billion (Bankalarımız, 1995), whereas it was only around US\$1 billion in 1990. The ratio of open position to equity capital increased continuously since 1990. In 1990, it was around 40 percent, while prior to the crisis in 1993, it rose to around 105 percent. As a result, the banking sector became extremely vulnerable to the devaluation of the domestic currency.

In this period, F/X deposits rose rapidly. The rate of increase in the F/X deposits was 137 percent, 110 percent, and 91 percent between 1991 and 1993 (Bankalarımız, 1994). Moreover, these rates surpassed the rate of increase in the TL deposits. The ratio of F/X deposits to TL deposits rose to 111 percent in 1993 from 32 percent in 1990 (Bankalarımız, 1995).

Consumer credits also rose rapidly because of the consumption boom generated by overvalued domestic currency. In the period 1989-1994, the rate of increase in the consumer credits surpassed the rate of increase in the credits given to the real sector (Yentürk, 2005). Rate of increase in the consumer credits was 87 percent in 1993, whereas it was 62 percent in 1991.

Profitability increased in this period. For instance, net profit of the banking sector increased to 42 percent in 1993. However, high real interest rates, high taxes, high reserve requirement and liquidity ratios and unstable exchange rate limited the profitability. Although the Turkish banks were much smaller than their counterparts in

¹⁸ Open position = on-balance-sheet foreign assets – on-balance-sheet foreign liabilities.

the EU, their profit margins were much higher (Sarısu, 1996). Return on average equity capital (*Ortalama Özkaynak Karlılığı*) increased from 36 percent in 1990 to 55 percent in 1993 (Bankalarımız, 1995).

Governmental Decree No. 538

In September 1993, Council of Ministers allowed banks to issue bonds and securities which were absent from reserve and liquidity requirements. The goal of the government was to deepen the financial market. As a result, mode of banking sector regulation continued to change since one of the second category of regulations, which limit the scope and scale of banks, was abolished.

In the same month, Banks Act No.3182 was changed by the Governmental Decree No.512. This change in the legal framework for the banking sector was far more important than the change stated above. However, in November 1993, Governmental Decree No.512 was annulled by the constitutional court. The Çiller Government changed the Banks Act with another governmental decree in June 1994. This new Governmental Decree No.538 contained most of the provisions of the Governmental Decree No.512 and also involved other important provisions. The stated goal was to strengthen the regulatory framework for the banking sector.

Interpretation of this legal change is not an easy task. For instance Recep Önal (2000), Minister of State responsible for Economic Affairs in 2000, claimed in the Turkish Parliament that government should not have changed the Banks Act, since the Banks Act had been strong enough to ensure the safety of the banking sector at the time. He also claimed that Governmental Decree No. 538 changed the Banks Act in a negative

way. Prudential regulations were softened by this governmental decree. He stated regarding the goal of the change that the Governmental Decree No.538 prepared a legal framework for bank failures. However, a close examination of the articles of the Governmental Decree shows that the Çiller Government, contrary to the claims of Recep Önal, aimed to strengthen prudential regulations in order to prevent future bank failures. As a result, there is ambiguity regarding the goals of the Governmental Decree.

The Governmental Decree made establishing banks easier. Previously, the Banks Act No.3182 stated that banks had to be anonymous partnerships and 100 partners were needed to found a bank. Governmental Decree No.538 annulled the requirement of 100 partners for the establishment of a bank. 5 partners were sufficient to establish an anonymous partnership; therefore, 5 partners were able to establish a bank also. As a result, according to Recep Önal, this change made it easier for family firms to own banks.

The Governmental Decree made establishing branches easier too. Previously, permission of the Ministry of Finance was required. The Governmental decree No.538 stated that unless the bank owner wanted to establish more than 10 branches in a year, notifying the Secretary of Treasury before establishing a branch was sufficient. If the bank owner wanted to establish more than 10 branches, then the permission of the Secretary of Treasury was necessary. However, in each case, Ministry of Finance's approval was not required.

Regarding the audit of banks, there were several important contradictory changes in the Banks Act. First, the Treasury was not obliged to send a bureaucrat to the board of directors of the banks. The reason was that since the number of banks rose significantly, it became harder for the Treasury to send a bureaucrat to the board of directors in order

to monitor them more closely. As a result, the auditing mechanism of banks was relaxed. However, Article 27 stipulated that independent audit firms must audit the balance sheets of banks. Although temporary articles in the Governmental Decree No. 538 delayed the implementation of this Article, this Article signified that auditing mechanism of banks was strengthened.

Credit given to affiliates, in which banks had at least 15 percent of the shares, was restricted. It could not be more than twofold of the bank's equity capital. Previously, the limit had been threefold of the bank's equity capital. However, there had been another ceiling in the Banks Act No. 3182, which stated that the above mentioned type of credit could not exceed 15 percent of the total credit stock. This limit was abolished by the Governmental Decree.

Limits on the connected lending were changed. Banks could not give more than half of its equity capital to partners who owned at least 10 percent of the capital of the bank. In the previous law, connected lending had been described with regard to the partners who owned at least 5 percent of the capital of the bank. Moreover, Banks Act No. 3182 had had another ceiling on connected lending, which had been 5 percent of the total credit stock. This ceiling was also abolished.

Moral hazard created by Article 64 was diminished. Definition of moral hazard should be given. Moral hazard is the danger that bank will engage in risky investments because of the protection given by the state. Article 64/3 was abolished. As a result, the Minister was not able to decide the merger of two banks or transfer of a bank's assets to another bank in order to strengthen the financial structure of a bank. The goal was to reduce the financial burden on the state, which emerged after the above mentioned operations.

The most important change in this article was that the Minister in charge of Foreign Trade and Treasury could decide on the takeover of a bank by the SDIF more easily. The bank might not be under the 64/1 surveillance. The Minister could at any time decide to transfer a bank's governance to the SDIF. Previously, the SDIF was only able to help the banks in order to increase their liquidity. Moreover, it was able to take over the banks only after their banking licenses were cancelled. In other words, SDIF was not able to take over an operating bank. With this Decree, if the Article 64 measures did not help the bank, there were two options. Either, the Minister could decide to transfer the bank to the SDIF, and the bank continued operating, or the Minister could decide to cancel the banking license of the bank. In the aftermath of the annulment of the banking license, the SDIF had the right to transfer the bank's assets to another bank or decide the merger of two banks. As a result, SDIF was turned into a hospital for banks. The SDIF controlled the management of 'sick' banks and tried to rehabilitate them with various methods.

According to Article 29 of the Governmental Decree No. 538, signature authorizations of bank employees who endangered the financial situation of a bank and act against the Banks Act were abolished. However, these persons were not obliged to resign from their offices.

Article 33 of the Governmental Decree No.538 changed the article 69/1 and 69/2 of the Banks Act No. 3182. This article was about the personal responsibilities of the bank executives and bank partners, who owned at least 5 percent of the total shares of the bank. The original Article 69/1 stipulated that personal responsibilities of bank executives and bank partners were questioned only if the bank's assets were transferred to another bank or merged with another bank. In other words, if the state implemented

Article 64/3 measures on a bank, then the personal responsibilities of the bank executives and bank partners were questioned. Article 33 of the Governmental Decree No. 538 changed this article and stated that if the state implemented Article 68 measures on the bank, then the personal responsibilities of the bank executives and bank partners were questioned. So, Article 64/3 was more encompassing than Article 68.

Another major change was that the offshore banking was held out of some of the provisions of the Banks Act. As a result, offshore banking operations were exempt from the legal requirements stated in the Banks Act No. 3182.

The government also introduced temporary articles which delayed the implementation of certain articles of the Governmental Decree. The goal was to protect private banks for a temporary period since they were barely recovering from the economic crisis in 1994. As a result, although the Governmental Decree contained important elements which aimed to strengthen the regulatory regime, these temporary articles prevented the strict implementation of these articles. For instance, auditing of banks by independent firms was delayed until January 1996. Previously extended credits, which conflicted with the new articles, had to be adjusted to these changes until the end of 1996 (Temporary Article No. 2). Most of the ceilings introduced on credits were gradually implemented (Temporary Article No. 5).

In summary, it is crucial to understand the macroeconomic picture of Turkey and the place of the banking sector in this picture. Public deficits continued to rise and banking sector increasingly invested its funds in GDIs. Public's dominance in the financial sector was apparent in this period. This relationship between financial sector and state influenced the changes in the regulatory framework during Çiller administration. The government increasingly became dependent on the capital flows

through the banking sector in order to finance the rising PSBR. The government recognized the importance of the banking sector in generating growth by financing the fiscal deficits. As a result, it made the entry into the banking sector easier by the Governmental Decree No. 538.

Economic crisis in 1994 complicated the situation. Government felt obliged to strengthen the Banks Act No. 3182 by the Governmental Decree No.538 in order to prevent future bank failures. The SDIF's power to take over banks was increased and bank take-over process was shortened. Government aimed to prevent unhealthy banks endangering the stability of the whole banking sector.

Understanding the Full Deposit Insurance Scheme and the Other Changes

In May 1994, the Çiller Government introduced full deposit insurance scheme. The goal was to re-establish confidence in the banking sector. Introduction of full deposit insurance scheme signified a change toward the third category of regulations in the mode of banking sector regulation. The major factor contributing to the establishment of full deposit insurance scheme was the economic crisis in 1994 and its effects on the banking sector.

Economic Crisis in 1994 and Its Effects on the Banking Sector

Prior to 1994, Turkish economy was growing rapidly. Domestic consumption was also increasing. However, public deficits were also rising and putting upward pressure on the domestic interest rates which were already very high. Current account deficit reached

unprecedented levels. Short-term capital inflows covered up the current account deficit. The Turkish economy, in a liberal capital account regime, was walking on a tight rope. In this picture, vulnerabilities of the banking sector also rose. Private banks carried high stock of GDIs. Moreover, external short-term debt of the banking sector increased rapidly. As a result, possible upward shocks in the interest rate and a possible devaluation of the domestic currency would push some of the private banks off the edge. That was actually what happened to three banks in April 1994.

1993 became the year when the economic fragilities reached its peak. Again, the economy kept growing fast and GNP growth became 8.1 percent. The number was even higher than the one predicted in the 6th Five Year Development Plan. GNP per capita rose to US\$3.000. However, PSBR reached dramatic levels and became 11.2 percent. External debt stock increased and became \$US67 billion. But the rise in domestic debt stock was astounding. It rose to TL356 trillion; hence in one year span it rose almost twofold. CPI also kept rising and became 71.1 percent.

In 1993 and in the beginning of 1994, the Çiller government took office and declared that their major goal to be to reduce the interest rates and thus the domestic debt burden. In July 1993, the Central Bank director resigned from office over the disagreements between him and Çiller. According to Celasun (1998):

Thereafter until the beginning of 1994, instead of trying to correct the fundamentals that led to this problem, the government tried to control the interest rates, that is, attacked the symptoms of the problem rather than the cause. This attempt of trying to lower interest rates on debt at such high levels of PSBR (12.4 % in 1993) proved to be a very dangerous one (p.11).

Since domestic debt stock was very high, financial markets were very sensitive to government's policies. The goal was to reduce domestic debt stock and interest rate expenditures. Toward the late 1993, the Treasury resorted to arbitration court (*tahkim*)

and additional budget in order to bypass domestic borrowing. Moreover, CBRT resources were used excessively. This artificial bypassing of domestic financial market created instability. At the beginning of 1994, the Treasury was not able to borrow from domestic markets. As a result, in addition to the existing problem of high PSBR, now the Treasury was not able to cover up public deficit through domestic borrowing (Bankalarımız, 1994). In January, credit rating of Turkey fell and thus external borrowing opportunities also became limited.

Since domestic financial actors were not financing domestic debt, excess liquidity emerged in the domestic financial market. Financial players began to invest excess liquidity at hand in the foreign currency market. As a result, expectations of devaluation increased. CBRT sold \$US5 billion in the first four months of 1994 in order to satisfy the demand for foreign currency. Because of the March 1994 local elections, the government declared its economic program in April 1994, which was very late. In this period, the CBRT's reserves were depleted. Moreover, overnight interest rates were raised because of the same reason.

In 1994, the Turkish economy experienced a major economic crisis. The GNP fell by 6 percent and the GNP per capita diminished to US\$2200. The CPI reached 125 percent. More importantly, 600,000 people became unemployed. The government overcame its inability to borrow from domestic financial markets by offering high-yielding government bonds which offered high interest rates and had short maturities. As a result, real interest rates jumped to 58 percent from 12 percent in 1993. Domestic debt stock reached 20 percent of the GDP, whereas it was only 2.4 percent in 1990. Moreover, maturities of the domestic debt stock shortened.

The most affected sector of the Turkish economy from the economic crisis was the banking sector. Especially the developments in the first half of the year engendered weak balance sheets in the banking sector. In 1994, financial pressure of the public sector reached dramatic levels. Domestic savings also decreased. Moreover, because of high reserve requirement ratios and liquidity ratios, the cost of assets was high. As a result, domestic financial market dwindled. Value of the total assets of private banks in US\$ shrank by 32 percent. Especially, banks spent their liquid assets in order to cover their domestic and foreign liabilities. Share of liquid assets in total assets shrank to 39 percent from 41 percent (Bankalarımız, 1995).

The banking sector entered 1994 with high open positions and high stock of GDIs. High interest rates and devaluation engendered disastrous effects on the balance sheets of banks. In 1994, despite adverse developments in interest rate and exchange rate, the banking sector was nevertheless able to pay back its foreign liabilities thus prevented the spread of the financial crisis. In other words, banking sector risks were not converted to country risks. The banking sector paid back net \$US7 billion short-term external debt.

TL deposits rose by around 30 percent in 1994. The major reason was that Turkish citizens opted to invest their funds in public securities or REPO or investment funds, which offered higher yields than deposits. In time deposits, maturities were shortened. 90 percent of the total deposits was converted to time deposits which had maturities under 3 months. F/X deposits continued to rise. In 1994, it rose by 207 percent and constituted 52 percent of the total deposits.

Banking sector assets shrank by 30 percent (in \$US) in 1994. Equity capital fell by 33 percent in 1994 and reached 1989 levels (Bankalarımız, 1995). Net profits

decreased by 56 percent. The major reason was that interest income decreased while interest expenditures rose. Interest income denominated in \$US decreased by 7 percent, while interest expenditures increased by 3 percent.

Bank Failures

In April 1994, council of ministers cancelled the banking licenses and authorizations to collect deposits of TYT Bank (Turkey Tourism Investment and Foreign Trade Bank-*Türkiye Turizm Yatırım ve Dış Ticaret Bankası*), Marmara Bank and IMPEX Bank (former Turkey Import and Export Bank-*Türkiye İthalat ve İhracat Bankası*). As a result, total number of banks operating in Turkey was reduced to 67. These banks were small banks oriented toward financing exporters. They were established in the 1980s, during Özal governments. For instance, Ahmet Özal's Channel 6 had partnerships with all of the three banks. Moreover, large conglomerates owned these banks.

In seven years, SDIF spent US\$1.7 billion on these banks, whereas it was able to collect only \$US50 million. Due to high open positions, total external debt of these banks was \$US300 million. In 1999, Council of State gave the authorization to take over the properties of the bank owners.

Lapis Holding was the owner of the TYT Bank. It bought it in 1988. There were solid connections between Ahmet Özal and Lapis Holding. Lapis Holding owned 30 percent of the shares of Artı Holding and Channel 6, which was owned by Ahmet Özal. Moreover, Channel 6 did business with all of the three banks. Connected lending and non-performing loans were the major problems.

Mehmet Eliyeşil bought the Impexbank in 1991. Bülent Şemiler, who was the son-in-law of Mehmet Eliyeşil, was the head of the board of directors. He was one of the 'princes' of Turgut Özal. During Özal governments, he was the head of Emlak Bank for some time. He was also the partner in Interpress, which was owned by Ahmet Özal. The bank collapsed as a result of the increase in the non-performing loans. It turned out that the bank gave loan to Bülent Şemiler's firms like Hermes Holding and Nokta Publishing House. Prior to the takeover, some of the debt of creditors denominated in foreign currency was converted to TL. As a result, devaluation risk of creditors was gone.

The Marmara Group headed by Atilla Uras owned the Marmara Bank. Connected lending and non-performing loans were again the root causes of the bankruptcy. 66 percent of total credit stock was given to the Group companies. Capital increases were never real.

The problem was that although the CBRT and the Board of Sworn Auditors warned the Minister of Finance about the illegal activities and growing risks in these banks, politicians did not act take the necessary precautions. In August 1993, CBRT told the Treasury that unless some precautions were taken about these banks urgently, they were going to collapse. But these banks continued to collect deposits denominated in TL and foreign currency. Even public banks continued to open deposit accounts in these banks, after the warning of the CBRT. After the bankruptcies, Vakıf Bank's loss was US\$3.5 million, Kalkınma Bank's US\$24 million, Halk Bank's US\$24 million, and Emlak Bank's US\$2.5 million. The reports of the Board of Sworn Auditors were not carefully taken into account.

The bankruptcy of these banks proved the existence of intricate and corrupt relationships between the banking sector and politics. The inability to prevent the fraud

and illegal activities stemmed from this plain fact. Political authorities, especially The Ministry of Finance, ignored the reports delivered by the Board of Sworn Auditors and the CBRT. These banks were owned by large conglomerates. More importantly, these banks gave loans to large and powerful companies. As a result, political authority did not prevent excessive lending in these banks. Rise in non-performing loans was ignored.

April 5 Decisions

The financial crisis and the IMF urged the government to change the regulatory framework for the banking sector. On April 5, 1994, the Çiller government announced a new economic program. The main goal of the program was to decrease the public deficit by maintaining financial discipline. The government introduced new taxes: economic stability tax (*ekonomik denge vergisi*), net asset tax (*net aktif vergisi*), additional real property tax (*ek emlak vergisi*), and additional automobile tax (*ek motorlu taşıtlar vergisi*). The government put a limit to advances from the CBRT. In 1994, CBRT advances constituted 15 percent of the consolidated budget expenditures in 1994. This ratio was set to 12 percent for 1995, 10 percent for 1996, 6 percent for 1997 and 3 percent for 1998 (Bankalarımız, 1995).

International financial institutions supported the program. As a sign of support of the economic program for 1994 and 1995, in July 1994, the IMF approved a 14-month stand-by credit of US\$ 806 million. In April 1995, IMF extended the stand-by arrangement for six months and gave a stand-by credit of US\$ 160 million.

After the crisis, the Çiller Government introduced several regulatory measures. The most important one was the full deposit insurance scheme. Moreover, the tax burden

on banks was reduced. Finally, prudential regulation containing the external risks of banks was strengthened. Major goal of these measures was to release the financial burden on banks created by the tax regime and to re-establish the confidence in the banking sector. As a result, mode of regulation continued to change toward the third category of regulations.

Mode of regulation continued to change toward the third category of regulations, which include restrictions on the external competitiveness of banks. In other words, prudential regulation, at least in legally binding documents, was strengthened in Turkey. The government became aware of the growing dangers emerging especially in the foreign positions of the banking sector. As a result, in March 1995, the Treasury issued a notification about the net open foreign exchange positions of banks. Accordingly, net open foreign position to capital base ratio could not exceed 50 percent. These changes were consistent with the changes in most of the EU members. All of the EU-15 countries, adopted prudential regulations in the first half of the 1990s (Gual, 1999). However, political interference in the regulatory framework, which was exposed in the latest bank bankruptcies, diverted attention from the existing regulatory framework to the implementation of the regulatory measures.

After the bankruptcies, government introduced full deposit insurance scheme, which covered all the TL and F/X deposits of the real persons, including residents and non-residents. Deposit insurance scheme belonged to the third category of regulations, which limit the external competitive position of banks (Gual, 1999). Hence, mode of regulation continued to change toward the third category of regulations. This scheme was helpful in generating confidence in the banking sector in the heydays of the financial crisis. TL and F/X deposits began to increase toward the end of the year.

Moreover, the banking community supported the full deposit insurance scheme wholeheartedly (Bankalarımız, 1995). Full deposit insurance scheme and financial stability sedated the markets.

However, this scheme must had to be temporary. But it lasted almost 5 years. This insurance scheme created moral hazard in this period. When a bank experienced illiquidity because of the sudden withdrawal of deposits, financial burden would be on the shoulders of the state. Because of this insurance, bank's 'gambled on resurrection' and banks began to take excessive risks since deposits were guaranteed by the state (Williamson & Mahar, 2002).

Finally, the government aimed to release the burden on the banking sector by reducing the required reserve ratios and by abolishing liquidity ratios. Moreover, a new liquidity ratio on the liabilities other than the deposits was introduced. The goal was to attract deposits and to reduce the cost of deposits and increase the usable funds of the banking sector (Bankalarımız, 1995).

Conclusion

In this chapter, changes in the mode of regulation between 1989 and 1995 are analyzed. The most important change was the capital account liberalization in 1989. With this change, Turkish regulatory regime continued to move toward the third category of regulations. Way's theory of financial market liberalization and political insecurity is useful in understanding the Turkish capital account liberalization period. The major conclusion is that the "politically insecure" MP Government aimed to revitalize economic growth by capital account liberalization. The MP Government has lost its

popularity due to rising economic problems and increased political competition toward the late 1980s.

During the 1st Çiller Government, there were important changes in the regulatory framework. In 1994, the Governmental Decree No. 538 changed the Banks Act drastically. Establishing banks became easier. Moreover, the SDIF's power in taking over banks was increased. Economic crisis in 1994, and interdependency between state and banking sector were important in understanding the Governmental Decree No. 538. The government increased the powers of the SDIF in order to prevent future bank failures, since three banks collapsed after the economic crisis in 1994. However, the government also made entry into the banking sector easier, since public deficits were financed by the banking sector. Banks invested in GDIs and their profitability rose in this period thanks to high interest rates offered on GDIs. As a result, state and banking sector were interdependent. Because of this interdependence, Çiller Government made entry into the banking sector easier.

In 1994, Turkey experienced a major economic crisis. As a result, the government adopted a stabilization program with the support of the IMF on April 5, 1994. This program entailed changes in the regulatory framework for the banking sector. The major regulatory measure was the introduction of the full deposit insurance scheme and release of the tax burden on banks. Bankruptcies in three banks after the crisis and the economic program advocated by the IMF were major factors contributing to these regulatory measures.

In the next chapter, regulatory change in the mode of regulation between 1995 and 2001 is going to be analyzed. The political scene was unstable during the period. Especially after the fall of the Refahyol Government, rising radical Islam and growing

economic problems were on the main agenda of the following governments. In this environment, regulatory framework for the banking sector changed drastically and an independent regulatory institution was formed in 1999.

CHAPTER 5

1997- 2001: ROAD TO THE BRSA

Introduction

Mode of banking sector regulation changed in this period toward statutory regulation implemented by IRAs. Establishment of the BRSA, reforms in the public banks, and strengthening prudential regulations were the core elements in the new mode of banking sector regulation. However, the most important, if not revolutionary, change in the mode of regulation was the establishment of the BRSA in 1999. The draft law for the establishment of the BRSA was prepared during the 3rd Yılmaz Government and it was passed during the 5th Ecevit Government, which was established after the April 1999 general elections.

There were several factors that contributed to the establishment of the BRSA. In analyzing the factors contributing to the establishment of the BRSA, I adopted a rational choice institutionalist perspective. As a result, my argument follows that credibility concerns of the governments were the main motivating force in establishing the BRSA. The notion of credibility is explained and it is claimed that credibility of the governments was declining prior to the establishment of the BRSA.

In understanding the declining credibility of the governments, domestic political environment should be understood. Moreover, role of the IMF in re-establishing the

credibility of the governments is also analyzed. These two sources of influence intermingled and provided a stimulus for governments to establish the BRSA.

First, domestic political environment in the aftermath of the fall of Refahyol government was an important factor in contributing to the change in the mode of regulation. After the fall of Refahyol Government and the National Security Council decisions on February 28, 1997, a new pattern of politics began to emerge in Turkey. Rise of radical Islam was at the core of the political debates. Populist governments and economic problems of Turkey lay at the core of these political debates. In other words, inflation rate, rising public deficits, failures in private banks, deteriorating income distribution, and corruption, in which populist governments had a major part, were seen as the culprits that facilitated the rise of radical Islam. Public began to lose their trust in politics and politicians. As a result, Yılmaz and Ecevit Governments, which were formed after the Refahyol government, aimed to re-establish trust in politics by curing these long-standing problems of the Turkish economy. Solving economic problems of Turkey, namely reducing the inflation rate, was associated with the survival of the Turkish Republic. In this context, Yılmaz and Ecevit Governments embarked upon a banking sector reform, of which establishment of the BRSA was the core component, as part of their economic reform agendas. In summary, the government wanted to establish an independent regulatory agency in order to re-establish credibility.

Bank failures between 1997 and 1999 pushed further for the establishment of the BRSA, since implementation problems in the regulatory regime came to the fore. Eight banks failed between 1997 and 1999. Moreover, the 3rd Yılmaz Government lost office because of the corruption charges regarding the sale of Türkbank. High connected lending and fraud proved that existing regulatory framework was not able to monitor

banks effectively. In other words, it was understood that there were grave problems regarding the implementation of prudential regulations, and political interference was at the core of the implementation problems. As a result, establishing an IRA for the regulation of the banking sector and removing political interferences from the regulatory process seemed to be the best solution to the implementation problems.

However, the role of the IMF in promoting the establishment of the BRSA was also very important. IMF was increasingly involved in the Turkish economy after the Staff-Monitored Program in 1998. It promoted the banking sector reform and the establishment of the BRSA. The establishment of the BRSA was a prior action in the stand-by arrangement, which was signed in December 1999. Moreover, during the implementation of the Stand-By arrangement, it closely monitored and supervised the banking sector reform.

The international environment was also important in facilitating the establishment of the BRSA. Especially, the East Asian Financial Crisis in 1997, showed that banking sector fragilities lay at the core of financial crisis. As a result, controlling and assessing the banking sector risks effectively gained importance in the debates in various international institutions. In this context, establishing IRAs and removing political interference from banking sector regulation have seemed to be the solution to the problem.

Finally, regulatory regime was drastically changed in May 2001. Financial crisis in February 2001 and the IMF were important factors in engendering the change in the regulatory framework. Only after the 2001 financial crisis and with the changes in the regulatory framework for the banking sector, BRSA was established solidly.

Understanding the Establishment of the BRSA

Turkish Politics in the Period of 1997-2001

In this period, the major issue in the political arena was to re-establish the credibility of Turkish politics. Trust in politics gradually diminished. There were several factors that engendered the loss of credibility. The most important factor was that Turkish political parties were incapable of solving the economic problems of Turkey. They were not even able to introduce different solution sets to these problems. In addition, politics was seen as the major culprit for the huge economic and social problems of Turkey. In this environment, in the aftermath of the fall of the Refahiyol Government, the governments strived to re-establish credibility of the politics. As part of this strategy, Yılmaz and Ecevit Government adopted drastic economic and political reform agendas. Establishing an independent regulatory agency, namely the BRSA, was introduced in this period as part of the economic reform agenda. The goal was to separate politics, in which public lost trust, and banking sector regulation, which was incapable of monitoring and supervising banks adequately because of political interferences.

Çınar (1997) used the term “the end of politics”, and Cizre and Çınar (2002) used the term “politics of inertia” in order to characterize Turkish politics in the aftermath of the Refahiyol Government and during the ‘28 February Process’. These terms emphasize the incapability of Turkish politics in generating solutions to problems of Turkey. In other words, major political parties of Turkey lost credibility rapidly in this period. Çınar (1997) explained the term “the end of politics” clearly:

Turkish political parties display a passive style of politics, lack ideology or a societal project and imaginative thinking. The primary question of politics, which is "what makes a good society" and the subsequent query "how can it be achieved", are no longer put to debate. Conventional policies for all key issues are accepted without debate. The only competition is over "who" will implement the policies. It has thus become increasingly difficult to distinguish among the parties, except for their leaders. Turkish politics, in reality, has been reduced to "administration" (para.2).

Rise of the Welfare Party and '28 February Process' are very important in order to understand the Turkish politics sufficiently. These developments further exacerbated the credibility problem in Turkish politics. First, rise of the Welfare Party and '28 February Process' are analyzed. Then repercussions of these developments on Turkish politics and their contribution to the establishment of the BRSA are examined.

The WP steadily increased its votes in every general and local elections since its inception in 1983. It replaced social democratic municipalities in major metropolitan cities in March 1994 local elections, since leftist municipalities had been hurt severely by corruption charges. Then it got 21.4 percent of the total votes in the December 1995 elections.¹⁹

There were several important factors contributing to the rise of the Islamist WP. The first factor was the failure of social democracy in the 1990s. Second, military interim government between 1980 and 1983 strived to promote Islam in order to decrease the fragmentation in the society. Religion courses have been made obligatory for primary and high schools. Moreover, number of schools for preachers and clergy

¹⁹ In December 1995 general elections, the WP garnered 21.3 percent and the TPP garnered 19.7 percent of the total validly cast votes. Erbakan coalition government was supported by 293 MPs. WP had rendered only 7.2 percent in 1987 general elections. In March 1994 local elections, party managed to capture the mayorships of two metropolitan cities, namely, İstanbul and Ankara. Öniş (1997) stated that, The emergence of RP as a major political force undoubtedly represents a paradoxical phenomenon for observers of the Turkish scene, a phenomenon which many interpret as a fundamental constitutional challenge to the secular foundations of the Republic, raising deep questions concerning the compatibility of a strong Islamic party with the process of consolidating liberal democracy (p.743).

(*imam hatip okulları*) has increased. As a result, religious sentiments in the society was strengthened and the WP enlarged its social base. Third, political right in Turkey was deeply fragmented, especially after the return of the former politicians to the political arena in 1987. The TPP and the MP, which were called enemy twins, created deep cleavages in the centre-right, although these two major parties of the Turkish centre-right had similar political ideologies and party programs. These major political parties of the centre-right were unable to unify their political powers because of superficial disagreements and thus they were incapable of solving the economic and political problems of Turkey. As a result, this incapability of centre-right political parties in solving economic and social problems in Turkey together with the backdrop of social democracy created a political vacuum. This political vacuum was filled by the WP and the WP emerged as the only viable alternative in Turkish politics, “with its wild promises to those long ignored by the political parties of the center” (Çınar, 1997, para.3). It presented itself with a missionary zeal to cure the long-lasting problems of Turkey, which were inflation, corruption, and income distribution.

However, the WP failed to live up to its promises. The Refahyol Government did not attempt to cure the long-standing economic problems of Turkey decisively. More importantly, the government’s policies and discourses created suspicions among the public, certain political parties and civil and military bureaucratic institutions about the future of secularism in Turkey. According to certain segments of the public, rise of radical Islam, under the auspices of the Refahyol Government challenged the foundations of the Republic. The WP failed to establish itself as a centre-right party and to gain popularity among the secular middle classes of Turkey. The credibility problem

of Turkish politics was exacerbated since the secular regime of Turkey was threatened by the Refahyol Government.

On February 28, 1997, National Security Council (NSC) issued the Refahyol Government with a list of measures designed to reverse the supposed Islamization of Turkey and strengthen the secular system. NSC put pressure on the Refahyol government with the help of civilian sectors of the society and ultimately led to the collapse of the Refahyol Government in June 1997. This period, which began with the notorious NSC decisions on February 28, 1997, was called the ‘28 February Process’ (28 *Şubat Süreci*).

‘28 February Process’ was one of the factors that further exacerbated the credibility problem in Turkish politics. Political parties began to engage in state-centered discourses and lost their touch with their social bases. According to Cizre and Çınar (2002): “Turkish political parties have retreated from a constituency-serving position to a state-supporting one.” The Process involved reconfiguring of Turkish politics along republic’s radical secularism. According to Cizre and Çınar (2002): “Foremost in their [military] minds was a structural redesign to strengthen Turkey’s political center so as to minimize the importance of what they considered the “non-centric” forces of political Islam and establish a center-party majority rule” (p.316). This vision led to the closure of public debate on key issues. The only debate around was about ‘who’ will implement the policies. The political discourse gravitated towards state-centered arguments. As a result, civilian politics was weakened. Resolution of crucial problems was delegated to civil-military bureaucracy. In short, credibility problem in Turkish politics was exacerbated.

Although the '28 February Process' exacerbated the credibility problem in Turkish politics, it also created, if not injected, an awareness of the graveness of the economic problems of Turkey in the political parties. Turkish political scene was in a state of alarm. Since culprits were the inflation rate and populist governments who wasted public resources and engendered high public deficits for the rise of political Islam, fiscal austerity and reform in the regulatory structure of the Turkish state were the main items in the to-do-list of Yılmaz and Ecevit Governments. They continuously reiterated the urgent need of disciplining the fiscal balances of Turkey in order to reduce the inflation (Cizre-Sakallıoğlu & Yeldan, 2000). In June 1997, the 3rd Yılmaz Government, which was called ANASOL-D under the premiership of Mesut Yılmaz from the MP, took office. Coalition partners were centre-left Democratic Left Party (DLP), centre-right Democratic Turkey Party (DTP)²⁰ and independent parliamentarians. Yılmaz stated that "if the fight against inflation fails and distributional justice continues, conservation of the regime will turn into a grave problem" (Cizre-Sakallıoğlu & Yeldan, 2000, p.482). As a result, reducing public deficits and inflation rate were introduced as a matter of life-and-death for the survival of the Turkish Republic thanks to the '28 February Process'.

In this environment, where economic and political stability was the buzzword, Yılmaz and Ecevit Governments applied for the help of the IMF in order to achieve their economic and social goals, thus to maintain political power and to preserve the support of the military and civil bureaucracy, which engineered the '28 February Process'. IMF advocated the establishment of the BRSA as a part of the economic reform agenda. The

²⁰ DTP was founded in January 1997, by ex-TPP members who opposed the decision of Çiller to establish coalition government with the WP.

main justification was to limit the implementation problems in the regulatory regime by creating an autonomous regulatory agency. Political interferences in the regulatory regime would be removed and the banking sector would be monitored and regulated more effectively, since Turkish politics had credibility problems. Separation of the banking sector regulation from politics was the solution to the implementation problems in the regulatory regime.

Bank Failures

Failures of three banks between November 1997 and January 1999 provided a further impetus for the establishment of the BRSA. These bank failures exposed the implementation problems in the regulatory regime. These banks had been able to circumvent regulatory rules because of their close connections with politicians. Thus, it was understood that close relationship between politicians and the banking community engendered the implementation problems and thus contributed to bankruptcies in the banking sector. Moreover, bank failures proved that regulatory agencies responsible for bank supervision and monitoring should be composed of experts and thus be technically effective in assessing the growing risks and complex strategies of fraud in the balance sheets of banks.

Three banks collapsed in this period because of illegal transfer of banks' assets. On November 6, 1997, Türk Ticaret Bank was transferred to the SDIF according to the Banks Act No.3182, Article 64. It was the first bank under the control of the SDIF; however, it signaled the upcoming bankruptcies. Banking sector began to go down after the bankruptcy of the Türk Ticaret Bank. Türk Ticaret Bank's loss was \$US777 million

and credits used in favour of dominant partners was \$US 56 million. After 4 years of administration by the SDIF, in July 2001, Türk Ticaret Bank lost its banking license. Between 1997 and 2001, two auctions were made in order to sell the bank. In the mid-1998 auction, Korkmaz Yiğit bought the bank. But in October 1998, Fikri Sağlar declared that Çakıcı threatened the other bidders in the auction as a result of the order given by Yiğit. Moreover, it turned out that Korkmaz Yiğit had certain connections with the MP politicians. These events engendered the fall of the Yılmaz Government in November 1998. The Yılmaz Government lost a vote of confidence over accusations of rigging the sale of Türkbank.

On December 12, 1998, Bank Ekspres (2nd bank taken over by the SDIF), whose owner was Korkmaz Yiğit, was transferred to the SDIF by the Banks Act No.3182. Its loss was \$US 435 million. Korkmaz Yiğit used \$US 311 million. Depositors pulled out \$US 220 million from Bank Ekspres immediately because of the news in the press about telephone records between Korkmaz Yiğit and Alaettin Çakıcı about the Türkbank auction (Tartan, 2003).

Failure of Bank Ekspres proved that lack of technical expertise in assessing the divergent risks emerging in the balance sheets of banks was an important problem in the regulatory framework. Güneş Taner, minister of state responsible for economic affairs at the time, claimed that: “the bank was officially robbed”. The methods of robbing were unknown to the regulatory agencies; therefore, Sworn Board of Auditors failed to prevent the collapse of the bank (TBMM Tutanak Dergisi, June 17, 1999). Existing regulatory agencies, namely the CBRT and the Treasury, responsible for bank supervision were not flexible enough in adopting the state-of-the-art regulatory rules.

On January 7, 1999, Interbank (3rd bank taken over by the SDIF), whose owner was Cavit Çağlar, was transferred to the SDIF by the Banking Act No.3182, Article 64/2. Banking license was cancelled and total assets of the bank were transferred to the SDIF. The bankruptcy story of this bank once again clearly demonstrated the close relationship between politics and the banking sector. Cavit Çağlar bought Interbank in March 1996, during the 3rd Çiller Government. Cavit Çağlar was a close friend of the President Demirel. However, at the time when Çağlar bought the bank, financial situation of the bank was already weak. The reason was that Interbank had given high amounts of credit to the Çukurova Group, which was the previous owner of the bank. Moreover, the Board of Sworn Auditors reported this development to political authorities. However, governments did not intervene in the bank and permitted the sale of the bank to Çağlar although the financial situation of the bank was already weak. One of the reasons might be the close connection between politicians and the bank. During Çağlar's ownership of the bank, there were TPP members in the Executive Board of the bank, namely: Hayri Kozakçıoğlu, Necdet Menziri, Mehmet Sağlam and Erman Yerdelen. As a result, governments failed to prevent the connected lending in the bank. At the time of the takeover, Interbank's loss was \$US 1.269 billion and Cavit Çağlar's firms used \$US 1.17 billion amount of loans. In short, connected lending was the biggest problem in the balance sheet of the bank (Tartan, 2003).

These bank failures proved that implementation of prudential regulations was at the core of the problem in the regulatory framework. Illegal activities and fraud increased in the banking sector. In addition, connected lending was another major problem that threatened the solvency of the banks. Bank owners, who were political supporters of the governments, gained bank licenses easily. Then these new bank

owners, who had no prior experience in the banking sector, gave credits to affiliated firms. As a result, most of the loans were not paid back by the affiliated firms. Thus connected lending endangered the financial situation of the banks. In summary, these failures showed that regulatory agencies failed to contain these developments before the bank became financially insolvent. In these 3 takeovers, the SDIF spent 657 trillion TL (Tartan, 2003, p.215).

After these takeovers, minority coalition government led by Ecevit reiterated the existence of the full deposit insurance scheme in order to soothe the markets and to restore the confidence in the banking sector. Moreover, banking sector problems were publicly discussed for the first time. Political parties began to understand the graveness of the situation. As a result, minority coalition government led by Ecevit declared the necessity of a new Banks Act and promised that he would pass the Bill, prepared during the 3rd Yılmaz Government, if he became prime minister after the April 1999 elections. He kept his promise and passed a new banks act in 1999, which envisaged the establishment of an independent regulatory agency

International Environment

As it was explicated in the Chapter 2, governance through autonomous agencies was the hallmark of American-style regulation (Majone, 1996). However, in the 1990s, major European, East Asian and developing countries established independent regulatory agencies. Politicians were increasingly willing to delegate authority to regulatory agencies which enjoyed considerable autonomy in the formulation and implementation

of regulatory policies. This diffusion of IRAs was also an important factor contributing to the establishment of the BRSA in Turkey.

In Latin America especially after 1992, number of IRAs increased dramatically according to the findings of Jordana and Levi-Faur (2005). They studied nineteen Latin American countries and twelve economic and social sectors. They stated (2005) that: “From a meager 43 regulatory authorities created before 1979 (mostly in the financial sector), the overall number had grown threefold to 138 by 2002” (p.103).

Role of the IMF Programs

Between June 1998 and May 2001, Turkey implemented one Staff-Monitored Program and one disinflation program supported by the IMF.

Regulatory Change under the Staff-Monitored Program between June 1998 and December 1999

From the inception of the government, Prime Minister Yılmaz announced his commitment to combatting inflation and reducing public deficits. Moreover, his government tried to ensure IMF that his government would pursue pro-market policies in the economy. Güneş Taner (September 23-25, 1997), the minister of state responsible for economic affairs, stated on the occasion of the IMF-IBRD annual meeting in Hong Kong:

The new government is fully committed to the principles of market economy and will try to ensure, both domestically and internationally, that state intervention in

the markets will stay at a minimum level and will permit free market forces to determine the course of action (p.3).

In June 1997, the Yılmaz government adopted a three-year program and started the negotiations with the IMF. During the negotiations, which were finalized a year later in the signing of a staff-monitored program, he rejected the one-year shock therapy, including strict fiscal discipline advised by the IMF. He feared loss of public support because of tough, anti-inflationary measures (Cizre-Sakallıoğlu & Yeldan, 2000, p.505). He claimed that he did not want to be another Shimon Perez, who lost the election after successfully reducing the inflation rate in Israel (Özkök, Hürriyet, November 26, 1997). However, in order to appease the IMF, in the government program, the Yılmaz government introduced several reform measures for the banking sector. The major goal of the reforms was to deepen the financial market. More importantly, regulatory structure of the financial sector was going to be changed. Public banks were going to be privatized.

Starting from the 1998, the Yılmaz government embarked upon its economic program more ambitiously, and since in January 1998, the annual inflation rate rose to 101 percent. In June 1998, the Yılmaz government sent a memorandum on economic policies to the IMF. In this memorandum, the government delineated its three-year economic program to combat inflation under Turkey's Staff-Monitored Program²¹ with the IMF. The major goal of the program was to decrease the inflation rate. WPI target for 1998 was 50 percent. For the following 18 months, IMF was going to monitor the

²¹ "A members's staff-monitored program is an informal and flexible instrument for dialogue between the IMF staff and a member on its economic policies. A staff-monitored program is not supported by the use of the Fund's financial resources; nor is it subject to the endorsement of the Executive Board of the IMF."(Memorandum on Economic Policies, June 26, 1998). Government did not request financial assistance but only guidance of the IMF.

program results quarterly. The government acknowledged the fact that large budget deficits lay at the heart of the inflation process. The program had three main areas of economic actions, namely fiscal policy, monetary policy and structural policy.

In the fiscal policy area, primary balance would be strengthened and primary fiscal surplus would be achieved. Privatization was also on the agenda. Moreover, on February 6, 1998, the Yılmaz government had announced its new tax reform as “Milad of Turkish Public Finance” (Cizre-Sakallıoğlu & Yeldan, 2000, p.490). The goal was to expand the tax base by lowering tax rates. Withholding tax on interest income was also introduced. In the monetary policy area, CBRT would implement a tight monetary policy. Net domestic assets of the CBRT would be controlled in order to limit the expansion of the monetary base.

In the structural policy area, the Yılmaz Government declared that it would secure the passage of ‘The Draft Law for Regulation and Supervision of the Financial Markets’ (Memorandum of economic policies, June 26, 1998). Moreover, regulatory framework for the banking sector changed frequently, and rather irregularly. The major goal of the changes in the regulatory standards was to limit the off-balance sheet activities of banks in order to contain the fragilities emerging from off-balance sheet activities. Moreover, like its predecessors, the government manipulated tax provisions in order to control the banking sector fragilities. In addition, Güneş Taner stated that Ziraat Bank would gain autonomy.

Regarding the financial sector, the government implemented certain measures to contain the increasing fragilities of the banking sector. Prof. Steve Hanke warned Turkish authorities about the danger of high open positions of the Turkish banking sector in the Euromoney conference. According to him, the situation of the banking

sector resembled the picture prior to 1994 financial crisis (Hürriyet, June 4, 1998). In August 1998, the government reduced the ceiling on banks' net open foreign exchange positions by the notification issued by the Treasury. Net open foreign exchange position to capital ratios (*Net genel pozisyon/sermaye tabanı*) was reduced to 30 percent from 50 percent by end-December 1998, and to 20 percent by end-September 1999.

A new measure regarding net open foreign exchange positions (*Yabancı para net vadeli işlem pozisyonu/ sermaye tabanı standart rasyosu*) was introduced. This new ratio could not exceed 15 percent. The new ratio aimed at limiting the forward contracts and swap arrangements in order to limit off-balance sheet activities of banks. However, at the end of August, this limit was abolished by another notification of the Treasury. Banking sector opposed this limit since banking sector was making high profits by engaging in these off-balance sheet activities. Treasury was not able to resist the pressure from the banking sector and annulled the notification. Once again, the importance of independent regulatory bodies was proven.

The government declared that from then, the Treasury would enforce more stringently the capital adequacy requirements. In June 1998, the Treasury issued a notification which stated that capital adequacy ratio (*Sermaye Tabanı / Risk Ağırlıklı Varlıklar, Gayrinakdi Krediler ve Yükümlülükler*) was established to be maximum 8 percent.

The Yılmaz government, like its predecessors, continued to strengthen prudential regulations by introducing new taxes. The government put a 12 percent withholding tax on the transactions in the interbank market, which was becoming a major source of liquidity for banks. In order to limit the off-balance sheet activities of banks, the government put 6 percent withholding tax on purchases of repo and declared its

intention to subject repos to the same reserve requirements as bank deposits. The danger in these repo transactions was that banks were increasingly engaged in repos in order to finance GDIs; therefore, maturity mismatch increased in this period. The government aimed to contain this risk. The banking community opposed these decisions, and claimed that these taxes would put pressure on the domestic financial market and interest rates would rise.

In this period, the Yılmaz government failed to change the regulatory framework for the banking sector decisively. Namely, it failed to establish the BRSA. Moreover, changes in the regulatory framework were cosmetic and irregular. However, it succeeded in tightening the prudential regulations.

The major problem regarding the changes in the regulatory framework was its irregularity. The government encouraged open positions by reducing the tax (*Kaynak Kullanımı Destekleme Fonu*) imposed on the foreign credits borrowed by domestic commercial banks. This was a paradoxical development regarding the earlier notification declaring the new limits on the open positions. In addition, the government implemented new tax rates for the banking sector in order to increase consumer credits. KKDF rates on consumer credits and on credits borrowed abroad were reduced. KKDF on consumer credits was reduced to 3 percent at the end of 1999 from 10 percent. Moreover, KKDF rate on foreign credits was reduced to zero (Bankalarımız, 2000).

In addition, the government failed to pass the Draft Law for Regulation and Supervision of the Financial Markets. Zekeriya Temizel, the Finance Minister from the DTP, was responsible for the preparation of the new banks act. It was interesting that although the economy and the banking sector were under the governance of ministers from the MP, preparation of this law was delegated to Temizel from DTP who was

famous for his honesty. Güneş Taner was not included in this process. The Draft Law for Regulation and Supervision of the Financial Markets²² was introduced to the Cabinet in June 1998. However, the government failed to pass this law. The Finance Minister Temizel declared the urgency of this law in November 1998. But the law was debated for a long time in the parliamentary commissions. When finally the law could be passed through the commissions and brought down to the parliament, the Yılmaz government lost a vote of confidence and resigned (Hürriyet, December 26, 1998).

Although, the Yılmaz Government strengthened the regulatory framework for the banking sector, it failed to address the root causes of the problems in the regulatory framework for the banking sector. On July 9, 1997, the IMF Executive Board concluded the 1997 Article IV consultation with Turkey. In the press information notice number 97/17, IMF analyzed the problems in the Turkish banking sector and recommended certain measures. According to the IMF, the major problem was directed lending in public banks. Directed lending at subsidized rates were engendering losses, liquidity problems and inadequate liquidation. Regarding the private banks, although they strengthened their balance sheets in recent years, they were still exposed to a significant maturity mismatch and a substantial open net foreign exchange position. As a result, Executive Directors (IMF concludes Article IV consultation with Turkey, August 5, 1997):

urged the authorities to strengthen banking sector supervision and accounting standards, and to end the preferential lending of state banks to favored sectors, a

²² “The aims of the draft law are: (i) to bring the regulation and supervision of banks, insurance and re-insurance companies, and other financial institutions under a single set of rules and a single law; (ii) to strengthen the financial structure of financial institutions; (iii) to strengthen and increase the efficiency of the supervision and oversight authority; and (iv) to keep supervision standards in line with international norms. The draft law was prepared taking due account of the laws and regulations of the European Union and other accepted international practice. The government intends to secure passage of the draft law as soon as possible”(Memorandum of Economic Policies, June 26, 1998).

practice that introduces distortions and undermines the stability of the banking sector as a whole. Eliminating the quasi-fiscal activities of state banks would also permit their eventual privatization, a goal that should be pursued as an essential element of banking sector reform (para.14).

In the government program, it was stated that major goals of the government were to save the country from the regime and state depression and to prevent moral corruption. However, ironically, corruption charges against Güneş Taner and Mesut Yılmaz about the sale of Türkbank engendered the fall of the Yılmaz cabinet.

Dissemination of banking licenses was in the domain of the government. During 1st Yılmaz Government in 1991, banking licenses were easily disseminated just 10 days before the general elections. During the 3rd Yılmaz Government again new foreign and domestic banks were formed²³. Güneş Taner²⁴ stated in June 1998 that whoever offered enough money could establish banks. The necessary money to establish commercial banks was \$US50 million, while it was \$US25 million for investment banks. Accordingly, money would enter the “system” (Hürriyet, June 4, 1998). As a result, Taner clearly challenged the Treasury notification published on June 6, 1995, which stated the official requirements of establishing banks. Taner’s statement showed that it was very easy to establish banks in Turkey.

The banking community reacted to the establishment of an independent regulatory body, namely the BRSA. They claimed that enforcement was at the core of

²³ During the 3rd Yılmaz government, 3 foreign banks were allowed to open branches in Turkey and 7 investment banks were established²³. The three foreign banks were: Rabobank Nederland, Credit Suisse First Boston and Morgan Guaranty of New York. 7 investment banks were: Okan Investment Bank, Nuro Investment Bank, GSD Investment Bank, Toprak Investment Bank, Diler Investment Bank, Atlas Investment Bank and Çalık Investment Bank. Couple of years later, banking licenses of three of these investment banks were cancelled. These were Okan Investment Bank, Toprak Investment Bank and Atlas Investment Bank. Council of State reversed the annulment of Okan Investment Bank’s banking license.

²⁴ Taner stated in February 1998 that there were 12 banks surveilled by the Treasury under Article 64 of the Banking Act. He did not state the names of the banks. This information must have been kept confidential since it might have created runs on these banks. However, he claimed that he did this statement for the sake of transparency in the banking sector (Sağlam, Hürriyet, 1998, June 2).

the banking sector problems rather than the regulatory structure itself. Moreover, the banking community was ambivalent about the success of the new institution.

Directors of major banks, namely, Akbank, Garanti Bank and Egebank, claimed that the establishment of the BRSA would have complicated the regulatory structure. Moreover, BRSA would not be independent from political interferences. Especially, Sakıp Sabancı, advised the government to establish the CBRT as the sole regulatory body (Hürriyet, December 6, 1998). The problem according to the general director of Garanti Bank, Akın Öngör, was not in the monitoring process but in the implementation of the decisions taken by the bureaucrats of CBRT and the Treasury about banks. Political authority did not act according to the reports of the CBRT and the Treasury. As a result, the banking community emphasized the importance of the implementation of the decisions of the regulatory bodies.

Another point of malcontent in the banking community was the appointment procedure of the Board of Sworn Auditors. In the draft law, it was stated that BRSA would have appointed the Board of Sworn Auditors. Banking community opposed this provision since they were content with the existing appointment procedure of the Board of Sworn Auditors. It was appointed by the governmental decree, which is called “*3’lü kararname*” in Turkish, thus signatures of the prime minister and the president were necessary. Since they believed that BRSA would not act independently from politics, appointment of the members of the Board of Sworn Auditors should not be delegated to the BRSA. (Toker, Hürriyet, December 2, 1998).

Regulatory Change under the Disinflation Program in the Period of December 1999-
May 2001

During the 5th Ecevit government regulatory framework for the banking sector changed drastically. The major accomplishment of Ecevit government was the establishment of an independent regulatory agency, namely the BRSA, for the banking sector. Mode of regulation was now statutory regulation implemented by an IRA. However, in this period, not only the mode of regulation was changed, but also rehabilitation of public banks and sale of banks under the control of the SDIF were on the agenda of the government. Hence, in this part, ‘banking sector reform’, which includes not only the establishment of the BRSA, but also rehabilitation and privatization of public banks and sale of banks under the control of the SDIF, instead of the ‘transformation in the mode of regulation’ was used and analyzed.

The major actor contributing to banking sector reform was the IMF. In order to secure a stand-by arrangement, the Ecevit Government established the BRSA and strengthened the regulatory framework as advocated by the IMF. Moreover, during the implementation of the disinflation program, the government continued to reform the banking sector as advocated by the IMF.

As it is explained above, in early 1998, Turkey adopted a disinflation program which was centered on fiscal adjustment, structural adjustment and tight incomes policy. However, the Russian crisis in the mid-1998, political uncertainties and fiscal laxity prior to the elections prevented the government from reaching the program targets. Thus,

the 5th Ecevit government formed in May 1999²⁵ declared from the outset its intentions to set the disinflation program on a more solid basis and to reverse the previous policy slippages. The government aimed to prepare the ground for a more ambitious disinflation strategy which was supposed to be launched at the end of 1999.

From its inception, the Ecevit Government reiterated the country's need for further IMF assistance. Economic policies were still monitored by the IMF under the Staff-Monitored Program (SMP) signed in the mid-1998. However, on August 17, 1999, a major earthquake happened in İzmit, which was the industrial heartland of Turkey (LoI, September 29, 1999, IMF). As a result, importance of further IMF assistance increased.

The Ecevit Government stated that public deficits lay at the core of the economic problems in Turkey. Moreover, in the government's program, it was stated that the most primary economic problem of Turkey was the short maturity of domestic debt and high interest rates.

In order to secure a Stand-by arrangement with the IMF, the Ecevit Government made major changes in the regulatory framework for the banking sector (See Appendix C). In June 1999, Banks Act. No.4389 was approved by the Parliament. The law acted in conjunction with the Basle Committee's principles for bank supervision. It required all banks to comply with a risk-weighted capital adequacy ratio derived from the Bank of International Settlements (BIS) model (Değirmen, 2002, p.29). Prior to the disinflation program adopted in December 1999, it was amended by the law No. 4491. The amendment in the banks act was included as *prior actions* in the December 9, LoI. In

²⁵On May 28, 1999, 5th Ecevit Government was established. MP and DTP had also been together in the 3rd Yılmaz Government. This time NAP was also included in the coalition government. As a result, there was continuity in the governments in the post-28 February process.

other words, the amendment was a necessary condition for the Stand-By arrangement. Moreover, in September 1999, the limit on the banks' net open foreign exchange position has been lowered from 30 percent to 20 percent.

Banks Act No. 4389 (June 24, 1999- December 12, 1999) and amendment No. 4491 was very important regarding the regulation of the banking sector. The most important accomplishment of the law was the creation of an independent regulatory agency: the BRSA. The establishment of the BRSA was an important milestone in the regulation of the banking sector. BRSA centralized the regulatory regime and ended the split between the CBRT and the Treasury. Moreover, the law acted in conjunction with the Basel Committee's principles for bank supervision (Değirmen, 2002, p.29). It required all banks to comply with a risk-weighted capital adequacy ratio derived from the Bank of International Settlements (BIS) model.

The main task and responsibility of the BRSA was to protect depositors' interests; to prevent actions that may endanger the economy and the safe workings of banks; to ensure the efficiency of the credit system (Banks Act No. 4389, Article No.3/1). The BRSA had administrative and financial autonomy; thus political interferences in the banking sector regulation were minimized. It was the sole authority to issue and withdraw licenses and to make decisions regarding the takeover of failing banks by the SDIF. Previously, issuing bank permits had been a political decision by the Council of Ministers. The Amendments also abolished the distinction between private and public banks. Same regulatory rules would be applied to all banks.

Since the goal was to minimize political interference with the regulation and the supervision of the banking sector, time-line for each committee member was six years.

Moreover, the minister was not able to discharge any board member based on random reasons, unless certain conditions were met.

Six months later, on December 19, 1999, the Banks Act was amended by Act. 4491. The main goal of this amendment was “to increase transparency and independence in the operation of the Agency, strengthen key prudential regulations, and to provide all of the tools needed for the improved resolution of problem banks” (December 9, LoI).

The major accomplishment of this amendment was that BRSA was made fully autonomous by removing the involvement of the Council of Minister from all decisions, other than the appointment of the members of the Board. Moreover, the three-year period during which a Board member was prohibited from employment as a senior executive in the banking sector was eliminated in order to find active professionals to take Board positions.

One of the goals of this amendment was to strengthen the prudential standards for bank lending to owners and to single or related parties. Banks could not extend their credits to a person or private firm in excess of 25 percent of its equity capital. Total credits could not exceed eight-fold of its equity capital. New requirements would be met in five years. More importantly, it became easier to take over troubled bank and the SDIF was not anymore permitted to lend or provide liquidity support to banks other than those under its full control.

The appointment of the board members was a structural performance criterion. The Board of the BRSA had to be named by end-March 2000. Therefore, the IMF considered this appointment very important. However, politics was still able to interfere with the workings of the BRSA through the selection of the first board members. Moreover, the IMF was directly involved in the dismissal of the board members after the

February 2001 crisis. This intervention of the IMF challenged the independency of the BRSA.

Understanding the Legal Change in the Regulatory Framework:

The Banks Act No. 4672 (The Amendment)

After the financial crisis in February 2001, regulatory framework for the banking sector was strengthened again. High unemployment in the banking sector²⁶ and failures of private banks necessitated the change in the regulatory framework. Moreover, the IMF supported the new law.

However, before delving into the amendment, the financial crisis in February 2001 and the role of the banking sector in the financial crisis should be addressed. The establishment of the BRSA, strengthening the regulatory framework for the banking sector and especially rehabilitation of public banks was not a smooth process. Several banks collapsed in this period. Moreover, Turkey experienced a major financial crisis, in which banking sector vulnerabilities were the primary culprits.

Role of the Banking Sector in the Twin Crisis

Turkey experienced a liquidity crisis in November 2000 and a major financial crisis in February 2001, while it was in the middle of the 1999 Disinflation Program. These crises were referred to as ‘The Twin Crises’. GNP contracted by 9.4 percent in real

²⁶ In 2001, more than 32,000 banking sector employees, which were mostly well-educated and well-paid, became unemployed (Kibritçioğlu, 2005, p.3).

terms in 2001, while per capita income dropped from \$2986 to \$2110. 1 million people, including skilled and highly educated employees became unemployed.

There were multiple factors contributing to the Twin Crises. Major factors were: flaws in the program design, and failure of the IMF to assess the idiosyncrasies of the Turkish economy; lack of commitment to the Program on the part of the government; accumulated weaknesses in the banking sector; and external factors like the rise in international oil prices.

Major problem regarding the role of the banking sector in the Twin Crises was that the Program provided a fertile ground for private banks to accumulate grave fragilities in their balance sheets. Because of the CBRT's non-sterilization policy and liquidity generation mechanism, financial sector vulnerabilities increased. These financial fragilities emerged in the banking sector triggered the financial crisis in 2001.

Private Banks

Sak and Özatay (2002) claimed that although the government had a stabilization plan, accumulated weaknesses in the macroeconomic fundamentals generated fragility in the banking sector. Regarding commercial banks, especially, the way the government financed its high PSBR was problematic. GDIs increased in the balance sheets of banks and they exceeded commercial loans. Banks financed GDIs by borrowing short-term loans in foreign exchange or in TL from the inter-bank market or by REPOs.²⁷ In other

²⁷ Alper (2001) also claims that this “aggressive positioning” of banks engendered the rapid decline of interest rates since these banks bought high amounts of GDIs and thus decreased the interest rates. Then currency mismatch in balance sheets created vulnerability:

words, commercial banks borrowed short-term loans in order to make profits by giving longer-term loans to the government. Maturity mismatches emerged in the balance sheets of banks. Therefore, they became vulnerable to the exchange rate and interest rate risks, hence sudden capital reversals threatened the banking sector.²⁸ They implied that the under-regulated financial institutions were the major actor in the crises.

Public Banks

In order to understand the role of the banking sector in the financial crisis, public banks should also be examined and the term ‘duty losses’ should be understood²⁹. For long years, public banks had given cheap credit to farmers and to small-scale enterprises by the order of politicians since politicians wanted to maintain political power by securing votes of farmers and of small-scale enterprises. As a result, their ‘duties’ were to lose money in exchange of political support for politicians. The problem was that the governments did not compensate the losses of public banks; the Treasury did not take full responsibility for duty losses. In other words, they did not cover the losses of public banks by diverting funds from the central budget to public banks. In addition to duty losses, public banks also had losses called enterprise losses (*işletme zararları*). In 1999, it was 2.9 percent of the national income. Before the financial crisis in 2001, duty losses

However a bank purchasing government securities and engaging repo funding for short-term financing needs, bears the maturity mismatch risk since 99% of the volume of transactions in the repo market consist of repos with maturity 1 day whereas the underlying government securities’ average maturity is approximately 15 months (Alper, 2001, p.7).

²⁸ High ratio of non-performing loans to total loans, high open positions of the banks and maturity mismatches were important fragilities in the banking sector.

²⁹ There is difference between state banks and private banks. State banks were more vulnerable to interest rate risk since the ratio of TL denominated liabilities to assets in foreign exchange was much higher. However, since foreign currency liabilities of private banks were more severe, they were more vulnerable to exchange rate risk.

were around 17.9 quadrillion. During the financial crisis, because of the hike in interest rates, TL7.4 quadrillion was added to the total duty losses. In summary, these losses were extra-budgetary expenditures of governments.

Duty losses created pressure on financial markets. Public banks strived to cover their losses through different ways. They offered high interest rates to deposits in order to collect funds. They used to finance their day-to-day liquidity needs from the inter-bank market. As a result, public banks began to seek desperately for funds. This situation of banks created pressure on financial markets. They became vulnerable to sudden stops of capital inflow or worse, capital outflows.

The governments pushed public banks to take duty losses. Between 1984 and 2001, there were 97 governmental decrees that ordered public banks to take duty losses. 90 percent of these governmental decrees were issued after 1990. According to Öniş (p.19), rent distribution was undertaken by public authorities by recourse to public banks since the stabilization program of 1994. For instance, the Yılmaz government issued 26 governmental decrees during his term of office. In this context, public banks played a fatal role in the financial crisis of 2001.

Story of the Twin Crises

First of all, Turkey failed to bring down inflation to target levels from the start. There are several reasons. First, state, in order to generate revenue, increased some of the prices of the products of State Owned Enterprises (SOEs). Second, wage increases in the public sector often exceeded the targets because of collective agreements that were done before the stand-by agreement. Third, house rents increased more than the target CPI

level. This failure to bring down the inflation eventually caused appreciation of the exchange rate since the Turkish government followed the schedule of exchange rate depreciation strictly (Akyüz & Boratav, 2002).

From the inception of the Program, net foreign capital inflows increased due to the elimination of the exchange rate risk and initial optimism generated by the EU candidacy. In the first three quarters of 2000, while capital inflows lowered the interest rates because of non-sterilization policy of the CBRT, the real interest rates were still higher than the US and European rates. Moreover, the difference between domestic interest rates and international interest rates was higher than rate of depreciation of the currency. This situation created arbitrage opportunities for foreign investors. This inflow of foreign capital caused an expansion of the monetary base and increase in international reserves since the current account deficit was much smaller than the capital account surplus. This increase in domestic liquidity helped to lower interest rates and thereby contributed to the rise in aggregate demand. Rise in aggregate demand contributed to rise in imports and hence current account deficit, i.e. overheating of the economy.

Strong support for the stabilization program and IMF bail-out guarantee in case of a trouble further contributed to the inflow of foreign capital. However, the nature of private capital flows is very important. According to Akyüz and Boratav (2002)

Over 90 per cent of net capital inflows by non-residents were debt-creating, with FDI and portfolio inflows adding no more than \$1.5 billion out of \$15.2 billion of net private capital inflows. Three items constituted more than 80 per cent of total net capital inflows; international bond issues by the public sector (\$5.7 billion), short-term bank credits from abroad (\$3.6 billion), and long-term bank credits (\$3.2 billion)” (p.14).

This situation created currency risks for the borrowers, i.e. commercial banks. Short-term external debt of the banking sector reached US\$ 16.9 billion, while total short-term

external debt of the country was US\$ 28.9 billion (Tuncer, 2001). The government put upper limits to the ratio of forex positions (liabilities in foreign currency) to equity, i.e. open positions in order to eliminate excessive currency risks. However, it did not succeed in implementing it.

A huge increase in aggregate demand, thanks to capital inflow, currency appreciation³⁰ and low interest rates created a 7 percent growth in GDP in 2000. The current account deficit increased also because of the rise in the oil prices and in the consumption of durable imported goods³¹. Therefore, the current account deficit reached 5 percent of GDP, while exceeding the target (2 percent). However, everything seemed fine until the rapid exit of capital in November 2000³².

There were several reasons behind this capital flight³³. The important point was that the banking system proved to be very vulnerable to such a capital flight. As a result, banks began to sell TL in order to buy foreign exchange and cover their open positions. This created a liquidity crunch because the CBRT could not provide sufficient liquidity because of upper limits on its net domestic assets. As a result, banks sold their GDIs to

³⁰ Alper (2001) claims that main reason for the rise in the current account deficit was *not* currency appreciation but the sudden fall in interest rates which caused delayed consumption of traded goods to rise immediately.

³¹ Imports increased by 35 percent while export growth was only 7 percent (Akyüz & Boratav, 2002).

³² The amount of capital flight was US\$ 5.2 billion.

³³ According to Akyüz and Boratav (2002):

The events that eventually led to a rapid exit of capital in November included disappointing inflation results for October, unexpectedly high monthly trade deficits, political difficulties encountered in privatization, worsening relations with the EU, the economic situation in Argentina, and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the SDIF (p.16).

According to Alper (2001):

The onset of liquidity crisis seemed to stem from the seasonal factors of 'fleeing capital' as well as rumors of 'bankruptcy' of some banks that were positioned aggressively under the assumption of ever-falling interest rates (...) During the last quarter of each year, some amount of foreign capital outflow occurs from emerging markets due to incentives to U.S. investors to sell stocks before the end of the year, in order to reduce their tax liability (p.11).

buy TL. While the value of GDIs fell, interest rates took a hike³⁴. At the beginning of December, Turkey signed a new agreement with the IMF, which gave US\$ 7.5 billion from Supplemental Reserve Facility. But this credit had to be used in a three year span; therefore, the liquidity squeeze and high interest rates prevailed. The exchange rate was defended at the cost of bankruptcies, capital flight and high interest rates. The government's firm commitment generated confidence. However, underlying fragilities remained. In the aftermath of the political crisis between the President and the Prime Minister in February 2001, there was another speculative attack on TL. This time CBRT could not sustain the currency by raising interest rates; therefore, TL was devalued. Even the devaluation of the domestic currency did not stop the demand on the foreign exchange³⁵.

Bank Failures

On October 27, 2000, prior to the Liquidity Crisis, EtiBank and Bank Kapital were transferred to the SDIF on the Banks Act No.4389, Article 14/3 and Article 14/4. Connected lending was the biggest problem in these banks. Ceylan Group owned the Bank Kapital, which was founded in July 1995. Its loss was \$US 392 million, while the amount of connected lending was \$US 250 million. Etibank's loss was \$US 698 million while the amount of connected lending was \$US 588 million. Sworn Board of Auditors

³⁴ Eichengreen (2001) summarized the events : "Initially, interest rates shot up to 100-200 per cent, and the Central Bank of Turkey (CBT) allowed net domestic assets to increase in excess of targeted rates. This led to the rapid loss of foreign reserves, and on 30 November the CBT announced that it would stop providing liquidity to the market. Rates then skyrocketed to more than 1,000 per cent. At this point the government requested access to the Fund's Supplemental Reserve Facility" (p.5).

³⁵ Between February 2001-September 2001, US\$ 6 billion fled out of the country. Regarding the volatility of capital flows between November 2000-September 2001, swing of net capital flows was US\$ 28 billion (Akyüz and Boratav, 2002).

had warned the Treasury for two years prior to the takeover and reported that high amounts of loans had been given to Bilgin's companies.

Etibank's privatization process was also problematic. Etibank had been sold to Cavit Çağlar and Dinç Bilgin in 1997. Yalım Erez, minister of state at the time, had objected to the sell and had claimed that if they let Etibank be sold to Cavit Çağlar, they would have been prosecuted by the High Court (*Yüce Divan*). The reason behind Erez's objection was that at the time, Cavit Çağlar owned Interbank and Interbank was not able to perform banking duties effectively. Moreover, Interbank was under the surveillance of the Treasury. However, Güneş Taner had advocated in favour of the privatization. Later in January 1998, Dinç Bilgin bought Çağlar's shares and became the sole owner of the bank (Tartan, 2003). Dinç Bilgin stated that he bought the bank since private banks were making high profits by investing their funds in GDIs. Moreover, he wanted to invest the profits, which his media corporation made, in his own bank instead of other banks (Tartan, 2003, p.253).

On December 6, 2000 Demirbank was transferred to the SDIF on the Banks Act No. 4389, Article 14/3. Its loss was \$US 648 million, while the amount of lending to dominant partners was only \$US 58 million. However, there was a difference between Demirbank and Etibank since connected lending was not the problem in Demirbank. Main problem of Demirbank, was that it excessively invested in GDIs. Demirbank owned 18 percent of the total GDIs. Moreover, it financed GDIs by engaging in REPO operations. It performed 80 percent of the total REPO operations in the İstanbul Stock Exchange. Hence, CBRT stated that Demirbank had been one of the market makers, prior to the takeover. Its excessive reliance on GDIs brought out the collapse. CBRT stopped financing Demirbank through market operations and it forbided it to make

transactions. State Auditing Institution (*Devlet Denetleme Kurumu*) published a report about the collapse of Demirbank and in this report it was stated that Demirbank could have been saved by the CBRT if it continued to inject liquidity to Demirbank.

Çingilioğlu Group, who was owner of the bank, blamed the government and stated that Demirbank trusted the government and its economic program but his bank was left alone in the financial chaos (Tartan, 2003). In any case, failure of Demirbank illuminated the real situation of the banking sector and delivered ominous signs regarding the future of the banking sector.

In summary, most of the bankrupt banks were founded by businessman close to the governments. They excessively invested their funds in GDIs and also gave high amounts of credits to the affiliated firms. In return, they supported respective governments' policies either through their media corporations or other more indirect methods.

Banks Act No. 4672

On May 12, 2001, Banks Act No.4389 was changed in the midst of the economic crisis by the Banks Act No.4672. According to Canevi and Çetinkaya (2001):

The Amendment aims principally to: (i) reduce losses of the banks taken over by the SDIF by granting the SDIF extraordinary powers; (ii) further conform the Banks Act to banking legislation of the EU by incorporating critical provisions previously ignored; and (iii) establish a private financial institutions union (para.8).

Moreover, the amendment was promised in the LOI given to the IMF on May 3, 2001.

Article 16 of the LOI states that,

The Banking Law will be amended in several respects to facilitate the resolution process and support the upgrading of the regulatory framework, including: (a) establishing special commercial courts and giving SDIF special debt recovery powers; (b) strengthening the protection of staff and management of the BRSA and SDIF against law suits arising from carrying out their official duties; (c) defining the concept of "own funds" to permit the application of new connected lending limits on a consolidated basis; (d) broadening the definition of credit exposure to include derivatives (...)

Parliamentary approval of these amendments will be a condition for the completion of the sixth and seventh reviews.

In summary, the BRSA's and the SDIF's powers and autonomies increased significantly with the amendment and the IMF was one of the major actors that pushed for the amendment.

The BRSA's ability to influence lending limits and capital adequacy ratios increased, since it was able to define its 'own funds' under the discretion of the Amendment. The definition of 'own funds' was crucial in calculating a bank's capital adequacy. As a result, the BRSA gained the ability to influence lending limits through its discretion on the definition of 'own funds'. Moreover, the new definition of 'own funds' conformed to the definition in the EU.

The SDIF's powers increased dramatically. The reason was that the SDIF took over 13 banks since 1997. In 2001, the SDIF was controlling seven banks. Therefore,

resolution of these banks became a high priority. According to Canevi and Çetinkaya (2001),

The SDIF is now entitled to take over all shareholder rights (except for the right to dividend payments) and management of (i) the subsidiaries of a bank taken over by the SDIF; (ii) entities which have direct or indirect control over such a bank; and (iii) companies over which the shareholders of such a bank have direct or indirect control” (para.25).

More importantly, these amendments were retroactive. Banks which were taken over by the SDIF prior to the Amendment for reasons such as misuse of funds, and their shareholders and directors are also subject to the new regulatory rules. Moreover, the SDIF was exempt from any penalty stated in the Turkish Code of Execution and Bankruptcy for creditors pursuing a debtor.

Regarding public banks, on July 3, 2001, an important law was passed by the parliament. By this law, further emergence of duty losses was prevented. The governments were obliged to prove the existence of necessary funds and display them in the budget balance sheet before they could inject these funds to public banks. The two largest state banks, Ziraat Bank and Halk Bank, were rehabilitated. Their autonomy from political interferences increased. In summary, Canevi and Çetinkaya (2001) stated the ‘reactionary’ characteristic of the Amendment, “in general the Amendment appears to be a reactionary piece of legislation, setting the new standards in the banking industry based on the past "bad" behaviour of various banks.”

Conclusion

In this chapter, changes in the mode of banking sector regulation, namely, establishment of the BRSA and strengthening prudential regulations are examined in the period of 1996 and 2001. The major engine behind this tremendous change was the IMF. Two IMF programs promoted and encouraged the banking sector reforms, including the establishment of the BRSA. However, there were also other factors contributing to change in the regulatory framework. The political environment after the fall of the Refahyol government engendered a fertile ground for the change in the regulatory framework. Moreover, several bank failures directed the attention to the implementation problems in the regulatory framework for the banking sector. Finally, because of the financial crisis in February 2001, regulatory framework for the banking sector was strengthened and the BRSA's autonomy increased.

CHAPTER 6

CONCLUSION

In this thesis, I aim to analyze the change in the mode of banking sector regulation in Turkey between 1980 and 2001. The mode of banking sector regulation changed toward statutory regulation implemented by IRAs. I analyze this change in the mode of banking sector regulation. Major factors that contributed to the change in the mode of banking sector regulation were international institutions and international environment; domestic political environment; and financial crises which included bank failures. As a result, general argument of the thesis has two layers. The first layer is about the changing mode of banking sector regulation according to the categorizations of Gual (1999). The second is about the reasons which have contributed to this change.

Regarding the first layer of the argument, a brief history of banking sector regulation has been introduced. After World War II, regulation implied state administration of the economy in Continental Europe and in developing countries. The banking sector was regulated through the dominance of public banks in the banking sector and through a large body of rules that limited competition. However, after the worldwide economic crisis in the 1970s, mode of regulation began to change through privatizations of public banks and abolition of restrictions on competition. Entry to the banking sector became easier and banks began to engage in interest rate competition. In other words, deregulation of the banking sector constituted the core of this new mode of banking sector regulation. However, regulatory rules, which aimed to contain the

emerging risks in the balance sheets of banks, were also strengthened. Thus, change in the mode of banking sector regulation involved deregulation and re-regulation at the same time. In the 1990s, statutory regulation implemented by IRAs was the motto of the day. IRAs were introduced as ideal regulatory agents since they were flexible, effective and more importantly free from political interferences. As a result, the state has delegated its authority considerably to regulate and to supervise to independent regulatory agencies.

Regulatory change in Turkey followed the pattern of regulatory change in the world. Mode of banking sector regulation in Turkey between 1980 and 2001 evolved from regulation through public ownership to statutory regulation implemented by independent regulatory agencies (See Appendix A). Prior to 1980, the state regulated the banking sector through heavy involvement of public banks, restrictions on interest rate competition and foreign currency transactions, and limited entry into the banking sector. Private banks were marginal in the banking sector and competition between private banks were limited. Private banks were merely a part of large conglomerates called 'the Groups'. So the financial market was shallow.

However, at the end of 2001, the state delegated its regulatory role to an independent bureaucratic agency, which enforces regulatory laws, namely the BRSA. Thus, the mode of banking sector regulation has become statutory regulation implemented by an independent regulatory agency. In these two decades, ceilings on interest rates have been abolished, capital account has been liberalized and competition between private banks has increased significantly. Prudential regulations have been introduced and legal framework for the banking sector has been changed a couple of times in order to contain emerging risks in the balance sheets of banks. More

importantly, in 1999, an independent regulatory agency, namely the BRSA, was established in order to effectively monitor banks and enforce prudential regulations strictly since the role of the banking sector in engendering a financial crisis increased tremendously at the end of 1990s. In short, mode of banking sector regulation changed tremendously in this time period.

Regarding the second layer of the general argument, namely, the analysis of the change in the mode of banking sector regulation, the research question is which political and economic factors including domestic and international facilitated this evolution. This analysis constitutes the essence of this thesis. Several variables are systematically analyzed for each time period. I analyze the roles of international institutions, domestic political environment, and roles of financial crises, including bank failures in influencing the change in the mode of banking sector regulation. Moreover, while analyzing the contributing factors to regulatory change, Turkish economic and political environment surrounding the regulatory regime are addressed.

Vertical diffusion perspective and sociological institutionalism apply in the analysis of change, since role of international institutions, namely the World Bank and the IMF and developments in the international environment were important in understanding the regulatory change especially in the period between 1980 and 1987. Vertical diffusion perspective claims that international institutions became increasingly instrumental in engendering regulatory change within nation-states. Moreover, sociological institutionalism claims that governments might imitate other governments in certain conditions. However, the theory of economic regulation fails to adequately address the regulatory change in the Turkey. The major reason is that this theory is developed from the experiences of developed countries, which have well-established

democracies. However, in Turkey, communication channels between the banking community and the state were not effective. Also, public interest theory of regulation helps in understanding the re-regulation episodes in the aftermath of economic crises. In Turkey, public authorities usually reversed some of the earlier policies of regulation in order to correct market failure in the aftermath of economic crises.

The influence of international institutions on affecting the mode of banking sector regulation has changed in each time period. The IMF and the World Bank were extremely influential in changing the mode of banking sector regulation, between 1980 and 1987. The World Bank extended five Structural Adjustment Loans between 1980 and 1984 and promoted major reforms in the banking sector, namely, deregulation of interest rates, reducing the tax burden on banks and Banks Act No. 3182 in 1985. However, the role of international institutions in shaping banking sector regulation diminished toward the end of the decade. Only, in 1989, the Treasury issued a notification about the new capital adequacy standards in line with the Capital Accord, designed by the Basel Committee. In the aftermath of the Refahyol Government, role of international institutions, namely the IMF in shaping Turkish economy and the regulatory regime of the banking sector increased tremendously. Establishing an independent regulatory agency for banking sector regulation was on the agenda of domestic policy-makers, thanks to the conditionality attached to the IMF Program in December 1999.

The influence of international institutions in shaping the Turkish regulatory regime for the banking sector depended upon the domestic political environment. Domestic political considerations of policy-makers intermingled with the role of international institutions in shaping Turkish regulatory regime. In the first half of the

1980s, Turkish political regime was a limited democracy and Turkish policy-makers had embarked upon a major economic transformation project in which they desperately needed the guidance and financial support of international institutions. As a result, in the first half of the 1980s, Turkish regulatory regime for the banking sector has changed according to the policy advice of international institutions.

Toward the end of the decade, the domestic political environment changed. Turkish political regime became more democratic and thus populist pressures on the policy-makers increased significantly. The MP Government has lost popularity. According to Way (2005), diminishing popularity and rising political insecurity of governments are important factors in engendering capital account liberalization. His theory is applied in the analysis of Turkish capital account liberalization. Turkish capital account was liberalized and domestic financial market liberalization, which was initiated in 1984, was completed in 1989. The major reason was that the “politically insecure” MP Government aimed to regain its popularity among the public and maintain its political power by revitalizing economic growth through capital account liberalization.

Domestic political environment was also crucial in understanding the establishment of the BRSA. Throughout the 1990s, Turkish political parties have gradually lost credibility for their policies. After the fall of the Refahyol Government and with the '28 February Process', the credibility problem of Turkish politics came to the fore. The problem was that the public lost their belief in the capability of Turkish political parties in solving the major economic and social problems of Turkey. Populist governments were blamed by the public for the severe economic problems of Turkey and thus indirectly for the rise of radical Islam and the WP. As a result, an extensive economic reform including the banking sector reform was on the agenda of governments

established between 1997 and 2001. The establishment of the BRSA was one of the components of the banking sector reform, which Yılmaz and Ecevit Governments adopted in order to re-establish credibility and trust in Turkish politics. In this context, the 3rd Yılmaz government, which took office in June 1997, prepared a disinflation program and a draft law for the regulation of the banking sector, which envisaged an establishment of an independent regulatory agency. The Ecevit Government, which followed the Yılmaz Government, prepared a more ambitious disinflation program and established the BRSA solidly. In short, Turkish politicians strived to re-establish credibility for their policies by delegating their powers to an IRA, namely the BRSA.

Economic crises and frequent bank failures were also important in engendering changes in the mode of banking sector regulation. Turkish policy-makers responded to crises and bank failures in rather awkward manner. They frequently reversed earlier policies and changed the legal framework in order to prevent the emergence of further risks in the balance sheets of banks and thus further collapse in the banks. After the Brokerage Houses Crisis in 1982, the interest rate competition among banks was terminated and ceilings on interest rates were re-introduced. Moreover, in 1985, a new legal framework for the banking sector was introduced in order to prevent further crises in the financial sector. In 1994, Turkey experienced a major economic crisis and three banks were taken over by the SDIF. The government responded by strengthening the legal framework and introduced new standards regarding capital adequacy ratios and net open foreign exchange position of banks. Full deposit insurance scheme was introduced in order to re-establish confidence in the private commercial banks. Finally, in 1998 and 2001, Turkey experienced severe economic crises and 8 banks were taken over by the SDIF between 1997 and 2001. Because of these bank failures, and severe economic

crises, in which the banking sector played a crucial role, an independent regulatory agency, namely the BRSA, was established in order to correct the implementation problems of the regulatory regime and to remove political interferences from the regulatory regime.

This thesis, namely the study of the Turkish history of banking sector regulation illuminates different areas of research, regarding the relationship between domestic interest groups and politicians; and pattern of Turkish politics in the post-1980 period, which needs to be covered by other studies. As it is shown in the thesis the international institutions have increasingly been involved in the national policy-making processes and affected Turkish politics significantly, especially toward the end of the 1990s. Although that does not mean that domestic factors did not account for the regulatory changes, in the two decades of regulatory change, domestic banking community was not as effective as the IMF in influencing the mode of banking sector regulation. Communication channels between politicians and domestic interest groups did not work effectively in the post-1980. The reasons of this miscommunication between banking community and state may further enlighten the history of banking sector regulation in the post-1980 period.

The huge role of international institutions in engendering regulatory changes introduces important hindsight and brings out further research questions regarding Turkish politics in the post-1980 period. Especially after the mid-1990s, Turkish political parties faced credibility problems because of growing economic problems and political turmoil created by the rise of radical Islam and the '28 February Process'. In this environment, Turkish political parties resorted to the IMF in order to re-establish credibility for their policies. In this way, politicians began to delegate their powers, albeit gradually, to independent regulatory agencies. Elected policy-makers devolved

their powers to IRAs and the international institutions in order to revitalize the trust of the public in politicians. This development was paradoxical since external actors-the international institutions and autonomous bureaucratic agencies-independent regulatory agencies, which are not accountable to domestic constituencies, have become the source of legitimation for Turkish politicians. The public seemed to want politicians with less discretionary powers and less control over economic and social matters.

In conclusion, Turkish history of banking sector regulation in the post-1980 period is examined around two central questions, how and why the mode of banking sector regulation changed between 1980 and 2001. However, it also involves several other important questions regarding the relationship between state and economic interest groups; democratic accountability of institutions; and finally the role of international institutions in developing countries. Therefore, analysis of the change in the mode of banking sector regulation sheds light on the major issues of Turkish political economy in the post-1980 period.

APPENDICES

APPENDIX A

CHANGE IN THE MODE OF BANKING SECTOR REGULATION

TIME PERIODS	ELEMENTS OF CHANGE	MODE OF REGULATION
Chapter 3: 1980 – 1987	<ul style="list-style-type: none"> • Interest rate deregulation • Liberalization of foreign currency transactions • Banks Act No.3182 	The first and second category of regulations, which soften domestic competition and which limit the scope and scale of banks have gradually been eliminated; while the third category of regulations, which alters the external competitive position of banks, gradually introduced.
Chapter 4: 1987 – 1994	<ul style="list-style-type: none"> • Capital account liberalization • Notification of the Treasury No.6; introduction of a new capital adequacy ratio • Governmental Decree No.538 • Full deposit insurance scheme 	The first and second category of regulations, which soften domestic competition and which limit the scope and scale of banks were gradually eliminated; while the third category of regulations, namely prudential regulations regarding capital adequacy have gradually been introduced.
Chapter 5: 1997 – 2001	<ul style="list-style-type: none"> • Several notifications of the Treasury regarding open positions and capital adequacy ratios • Staff-Monitored Program with the IMF • Establishment of the BRSA • Disinflation Program with the IMF • Banks Act No.4672 	Mode of banking sector regulation has changed toward statutory regulation implemented by independent regulatory agencies.

APPENDIX B

TABLE OF IMPORTANT EVENTS IN THE HISTORY OF BANKING SECTOR REGULATION IN TURKEY

January 1980 – Economic Stabilisation Program was introduced by the government.
July 1980 – Interest rates were deregulated: One of the first category of regulations was abolished.
June 1982 – Turkey experienced the Brokerage Houses Crisis.
January 1983 – The government re-introduced the interest rate controls: One of the first category of regulations was re-introduced.
July 1983 – The government changed the Banks Act. No7129 by the Governmental Decree No. 70: Prudential regulations were strengthened.
1984 – Commercial banks were allowed to engage in foreign currency operations: One of the second category of regulations was abolished.
May 1985 – Banks Act No. 7129 is replaced by the Banks Act No. 3182: Prudential regulations were strengthened.
August 1989 – The government liberalized the capital account regime: One of the second category of regulations is abolished.
October 1989 – The Treasury issued the Notification No.6, which introduced a new capital adequacy ratio in line with international standards: Prudential regulations were strengthened.

May 1994 – The government introduced full deposit insurance scheme. Mode of banking sector regulation changed toward third category of regulations.

June 1994 – The government changed the Banks Act No.3182 by the Governmental Decree No.538. Prudential regulations were strengthened while establishing banks became easier.

February 1995 – The Treasury issued a notification No.12 which set the capital adequacy ratio for banks at maximum 8 percent: Prudential regulations were strengthened.

March 1995 – The Treasury issued a notification and limited the net open foreign exchange position of banks to capital ratio to 50 percent: Prudential regulations were strengthened.

June 1998 – The government signed a Staff-Monitored Program with the IMF. The Draft Law for Regulation and Supervision of the Financial Markets was introduced to the Cabinet. This law envisaged the establishment of the BRSA.

August 1998 – The Treasury issued a notification on the ratio of net open foreign exchange position of banks to capital to 30 percent: Prudential regulations were strengthened.

June 1999 – The Banking Regulation and Supervision Agency (BRSA) was established by the Banks Act No.4389.

December 1999 – Turkey signed a three-year stand-by arrangement with the IMF and initiated the exchange-rate based disinflation program. Operationalization of the BRSA was one of the structural performance criterions. Banks Act No.4389 was

amended by the Banks Act No. 4491. The BRSA's autonomy was increased by this amendment.

November 2000 – Turkey experienced a liquidity crisis.

February 2001 – Turkey experienced a major financial crisis and established a floating exchange rate regime after a massive devaluation of the domestic currency.

May 2001 – Banks Act No.4389 was amended by the Banks Act No.4672. The SDIF's power to take over banks and the BRSA's autonomy was increased.

APPENDIX C

COMPONENTS OF THE BANKING SECTOR REFORM IN 1999

Banking sector reform had two major goals. The first goal was to strengthen the banking sector. The second goal was to strengthen the banking regulation. Below are given major components of the banking sector reform:

A. Establishment of a fully autonomous IRA, appointment of members of the Board of the BRSA

B. Strengthening prudential regulations

i. Strengthening prudential standards for bank lending to owners, and to single or related parties

ii. Application of stringent loan loss provisioning regulations in line with international standards

iii. Modify the capital adequacy and foreign exchange exposure limit regulations to apply on a consolidated basis.

C. Insolvent banks are going to be taken over by the SDIF immediately and the SDIF will no longer be permitted to lend or otherwise provide liquidity support to banks other than those under its full control. Banks Act was going to be amended in line with the stated objectives in A, B and C. Moreover, all of the above measures were prior actions for the discussion of the stand-by arrangement request by the IMF Board. The goal of these measures was to increase public confidence in the banking sector.

D. Rehabilitation of public banks

- i. Strengthening oversight of the public banks
- ii. Beginning of the commercialization of Ziraat Bank and Halk Bank with an eventual privatization goal
- iii. Imposition of financial discipline on public banks.

E. Effective communication of the above policies to the public

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