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Banking in Turkey: history and evolution

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Editorial

The South-Eastern European Monetary History Network (SEEMHN) is a community of financial historians, economists and statisticians, established in April 2006 at the initiation of the Bulgarian National Bank and the Bank of Greece. Its objective is to spread knowledge on the economic history of the region in the context of European experience with a specific focus on financial, monetary and banking history. The First and the Second Annual Conferences were held in Sofia (BNB) in 2006 and in Vienna (OeNB) in 2007. Additionally, the SEEMHN Data Collection Task Force aims at establishing a historical data base with 19th and 20th century financial and monetary data for countries in the region. A set of data has already been published as an annex to the 2007 conference proceedings, released by the OeNB (2008, Workshops, no 13).

On 13-14 March 2008, the Third Annual Conference was held in Athens, hosted by the Bank of Greece. The conference was dedicated to *Banking and Finance in South-Eastern Europe: Lessons of Historical Experience*. It was attended by representatives of the Albanian, Austrian, Belgian, Bulgarian, German, Greek, Romanian, Russian, Serbian and Turkish central banks, as well as participants from a number of universities and research institutions. Professor Michael Bordo delivered the key note speech on *Growing up to Financial Stability*. The participants presented, reviewed and assessed the experience of SE Europe with financial development, banking and central banking from a comparative and historical perspective.

The 4th Annual SEEMHN Conference will be hosted by the National Serbian Bank on 27th March 2009 in Belgrade. The topic of the Conference will be *Economic and Financial Stability in SE Europe in a Historical and Comparative Perspective*.

The papers presented at the 2008 SEEMHN Conference are being made available to a wider audience in the Working Paper Series of the Bank of Greece. Here we present the tenth of these papers, by Yüksel Görmez.

July, 2008

Sophia Lazaretou
SEEMHN Coordinator
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BANKING IN TURKEY: HISTORY AND EVOLUTION

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ABSTRACT

The early stages of banking and finance in Turkey were one of its brightest periods, even though it was the toughest because of lack of capital and unfavourable initial conditions. The finance and banking conception was quite rational and potential crises were eliminated through careful choices. In the following years, boom and bust conditions dominated financial services provision with a crisis in every decade under different economic policy frameworks. Since 2001, European convergence has been leading the way and one may argue that Turkish banking and finance is ready for the challenges of the 21st century, supported by fast-increasing foreign participation that has increased capital adequacy ratios.

*Keywords***:** Money; Banking and finance; Turkey.
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1. Introduction

The aim of this paper is to analyse the history and evolution of banking in Turkey. It may not be a strong assumption that banking is an activity purely based on trust and reliance on the goodwill of deposit custodians or credit repayment. It requires proper regulation and supervision under the social rule of law with proper societal and habitual records. Scottish banking is historically well perceived in these accounts. The Ottoman Empire never had such a track record in banking and finance. We may argue that one reason for the extremely underdeveloped banking services in the Ottoman Empire was the strong reaction to an important part of personal wealth creation: *interest.* It was religiously unacceptable to take interest payments for borrowing activities among the Muslim citizens of the Empire and financial services relied heavily on non-Muslims, mostly Christians and Jews. As nationalism became a destroying trend for the Ottoman Empire and many different groups of the Empire preferred to declare independence, Turkish banking and financial development began to take its first steps as secularism was one of the main components of the new Republic: *interest was therefore allowed to be a part of personal wealth creation.* It was in Asia Minor that money had been invented; however, the same track record is not evident in the case of banking and finance for one reason or another.

This paper first provides an historical analysis of the emergence of banking and finance by addressing religious temples as the safest banks during early history (Section 2) while Section 3 is devoted to a summary of banking in the Ottoman Empire. Section 4 analyses the emergence of banking and finance in the new Turkish Republic in depth, including the reasons why public money was invested in the early years and why banking was without a national central bank in the first decade. The impact of both 1929 US financial crisis and the Second World War is also covered. Moreover, the emergence of private banking is investigated. A plan-based development strategy and its impact on banking and finance is covered with special emphasis given to why Turkish banking and finance paid a high price for misjudging the paradigm shift during the first and second oil crises in the 1970s. In particular, it provides an analysis of how banking and finance progressed after the export-led growth strategy had been introduced during 1980s and how the banking crises absorbed an important amount of already scarce capital. The "lost years" of the 1990s are also examined by addressing the banking crisis of 1994 and the financial crisis of 2001. Finally, Section 5 explores the re-structuring and re-capitalisation of banks after the destructive financial crises at the beginning of the 21st century. The paper concludes with an assessment of the future prospects for banking and finance in Turkey under the assumption that European convergence will continue.

2. Banking and Finance in general

It may not be surprising to assume that only temples would have served as wealth custodians in the pre-historic periods as they represented trust and reliance. In the 18th century BC, first examples of lending activity were observed in Babylon, where loans were recorded officially and Hammurabi's Code provided the first legal base for primitive banking activity.

During 700 BC, the Lydians became the first in the Western world to make coins. Asia Minor led early developments in banking with this invention. In 1100 AD, as Christianity expanded in Europe, banking innovations in Genoa and around the Mediterranean region where intensified international trade was observed, as well as Papal Banking were building up. In 1800 AD, Venice took over with a better security structure with its unique geographical location. In that century, the gold standard was invented and representative money appeared in countries such as Sweden and England, where central banks were established in parallel to national banks, both public and private. Central banks emerged not only as a consequence of the endless financial deficits of war-making kings and sultans, but also from a need to establish a clearing house that would support the banking system during the times of heightened stress in order to prevent bank runs. Scottish banking during the Free Banking era (White, 1995) successfully managed to decrease the inevitability of central banks when there is an inclusive clearing bank for all banks, which had been owned by all banks to support systemic trust. However, in many other countries, central banks were assigned with the responsibility of being a lender of last resort in order to eliminate systemic risk.

It has been from 1900 to the present that financial deepening and innovation have been increasing their dominance in the world of banking and finance. As central banks were nationalised almost in all parts of the world and the gold standard relaxed from time to time under well-capitalised private financial structures, lending and borrowing activity increased continually. After the collapse of mono-bank systems in the 1980s, the system of collecting deposits from the savers and distributing them to investors has become a "small" part of the whole extremely complex nature of huge financial conglomerates, with the help of ever increasing globalisation.

It may be argued that the evolution of banking and finance will not end in the near future. Because of continuously increasing computing power and decreasing communication costs, more paradigm shifts can be expected in terms of globalisation of the payment systems including electronic money through emerging currency areas other than the Eurozone, heightened mergers and acquisitions among banks and financial service providers to increase competitiveness, increased recoupling and decoupling of activities and ever more "organised interventions" by cooperating central banks. At the end, it may only be one world, one money and a banking and financial system for all. Under these circumstances, the road for Turkish banking and finance would be to adapt itself to ever increasing challenges of the global banking and finance by all means, including membership of the European Union.

3. Banking and Finance in the Ottoman Empire

The Ottoman Empire has generally been blamed as having missed the opportunities of industrial revolution. It may be true to argue that, although the Ottoman Empire was among the major empires playing a global role in those times, it failed to create a strong capital base in order to stimulate sustainable development and increase welfare within its borders. The reasons are many and varied, ranging from the continuous loss of land as a result of strong pressure from the nationalist movements within the Empire, to tired and unmotivated citizens because of the corruption and mismanagement within the Istanbul Palaces. However, one should also pay a special emphasis on the misjudgement of the importance of banking and finance in producing sustainable welfare gains in the long run. Kazgan (1997) gives a perfect example of the unlawful financial practices in the Empire of taking over the wealth from the rich whenever there was a deficit in public accounts, sometimes by taking lives of the rich with 'made-up' accusations.

One of the signs of this mistake is the fact that commercial banking development within the Empire was limited to a couple of bankers settled in a particular district in Istanbul called Galata[1]. Even though street banking triggered the start of banking and finance, the strict rules of Sultans Treasury management prevented private banking from emerging. As the Empire missed the industrial revolution, there was no chance for private wealth accumulation and the Sultans' wealth was kept mostly in gold, hidden in the Castles, to be used for war finance and the construction of more and more beautiful palaces, instead of for productivity-enhancing investment.

It may be argued that Ottoman Sultans were too late to understand the dynamics of banking and finance. Missing the industrial revolution, the economy was losing its already limited comparative advantages to challenge competing kingdoms all around. Moreover, endless wars imposed a huge financial cost and leading bankers were licensed simply to decrease the cost of borrowing from other countries. There was an incentive for local wealth holders to lend to the Sultans and this that brought the Galata bankers as the early experiments in banking and finance.

Banking licences had been distributed in order to ease the burden of borrowing more from European capitals. Ongoing wars in many parts of the Empire put huge pressure on public finance and created a destructive borrowing requirement. Bank licences were mostly given to foreigners. Some of the banks were named as follows with the year of establishment[2]:

- 1845: Banque de Constantinople; it was the first Bank of the Ottoman Empire
- 1856: Bank-ı Osmani
- 1859: İttihadi Mali
- 1860: Türkiye Bankası

[1] Galata derives an additional interest; remember that the British banking evolved in Lombard Street! The history of banking has a sort of "street-brotherhood" sense to it.
[2] Akguc (1989) provides an in-depth analysis of banking in the Ottoman Empire.

- 1863: Bank-ı Osman-i Şahane; it was licensed as the Central Bank of the Ottoman Empire. It emerged from Bank-ı Osmani that was founded by a British and French joint venture. Later, a new approach in favour of national banks was brought in and in 1863 Ziraat Bank was established[3] with state capital.
- 1868: İstanbul Emniyet Sandığı; it was followed the tradition but foreign banks created joint ventures with local capital as well.
- 1869: Austria-Ottoman Bank
- 1872: the Austria-Turkish Bank.

Coincidently, in 1881 Duyun-u Umumiye was established as a declaration of the bankruptcy of the Ottoman Treasury and external control over public finances was introduced. It was the end of banking and finance in the Ottoman Empire even though Istanbul Bankası was not to be established until 1911. It may be worth underlining the fact that there was never a banking act in the Empire, but only some financial regulations such as Murabaha convention in 1887.

In summary, banking licences were distributed in the Ottoman Empire just to secure easier and cheaper government borrowing. Even though incentives for national banks were used and some banking activity in Anatolian cities such as Konya and Aydın appeared, endless wars rose barriers to capital formation and financial services were never a priority. Unsustainable public spending, mostly military, led to crowding out and loss of land and human capital could not support financial development. The late Ottoman history failed to create a suitable economic environment for financial development because as both the land and human capital of the Empire decreased, so confidence in the future of the Empire fell. Local, national and international conflicts prevented potential growth from being realised. The political agenda gave priority to survival. It might be argued that the Independence War was financed with the Asia Minor Capital hidden from the central authority.

[3] Ziraat Bank has managed to survive in the new Turkish Republic and still in 2008, it is one of the biggest commercial banks in Turkey. Its privatisation is planned in the following years.

4. Banking and Finance in Turkey

The fall of the Ottoman Empire did not only mark the end of a multi-cultural state in the previous lands of the Eastern Roman Empire, but also it threw a huge burden on the new Turkish Republic that gained independence in the final stages of the Empire. With little in the way of inherited human capital and a very heavy external debt burden transferred from the Empire, the early years of the young Turkish State were characterised by a lack of potential for capital formation. And, of course, without capital, those early years were full of challenges to create additional resources to pay the inherited debt. It was not until the 1950s that the final instalment of the Ottoman debt was paid.

4.1 The First Decade

One of the most effective financial decisions was to bargain with the Central Bank of the Ottoman Empire to provide sound money for the young Republic. As money at those times was mostly backed by gold, at least to a certain extent, any additional financial stress was eliminated by allowing the central banking license to survive and create a capital base for the new State. It was a key decision that proved itself by preventing financial crises in the early years. Perhaps the potentially most difficult time for banking in Turkey was managed most successfully compared to later decades when crises and stress followed each other in almost every decade.

Financial underdevelopment was one of the main characteristics of the late years in the Ottoman Empire. A lack of monetisation led to the dominance of a non-money base in trade and transactions, effectively implying the existence of a barter economy. Just after the declaration of independence of the Turkish Republic, hunger prevention and poverty reduction was inevitably prioritised. As an almost closed economy with agriculture dominant, no inheritance of physical or human capital from the Ottomans but rather only debt, the lack of a national central bank and with credit channelled mainly by foreign banks with strong capital bases and credit powers built up over a long period, there was no chance for private banks to emerge. The banking sphere was characterised at this time mostly by foreign banks with foreign capital and a couple of local banks with single branches. The priority of designing the democratic institutions was not a barrier for the public sector to lead banking and finance because of a lack of private capital. Public money injection was inevitable if a financial system, a prerequisite for welfare enhancement, was to be created.

Until the creation of a national central bank in 1930, there were around 22 small domestic and 13 large foreign banks with 419 branches.[4] In the first decade of the young Republic, the incentive to pursue a policy of nationalisation was high in the light of the strong negative reaction to foreign capital. Foreign banks, however, were not closed, as they were capable of providing cheaper and long-term finance from a strong capital base. There was no problem in understanding the importance of finance for growth and trade, and local banks were empowered for regional development. Learning banking in the early years of the Republic, escaping from financial crisis and even resisting the effects of the United State's Great Depression of 1929 with almost perfect fiscal discipline allowed the emergence of a mixed private-public banking system that eased the burden of financial re-development and re-structuring. Between 1923 and 1932, more than 20 local banks went bust mostly because of the Great Depression.

In order to support national capital accumulation, Turkiye Is Bankası was licenced as a private bank capitalised with certain incentives in 1924. Additionally, the re-structuring of Ziraat Bank for agricultural support was completed. These two banks are still active and are leading banks in their areas. In order to support manufacturing, the Industrial Bank of Turkey (Sınai ve Maadin) was established in 1925. Another sectoral bank was created for construction in 1927 as Emlak ve Eytam Bankası. A National Central Bank came after ten years from the first meeting of the General Assembly. Between 1923 and 1932, more than five foreign banks opened branches as an indication of the liberal approach to international capital. In 1932, there were around 45 national banks in Turkey.

4.2 The Second Decade: the Banking System Matures

At the beginning of the second decade of the Young Republic, the basic financial architecture was almost complete with the creation of a central bank and the emergence of private banks. Public banks were inserted to the financial system in order to further support capital formation. A public and private co-operation to empower the young Republic was considered to be the road to welfare growth. Additionally, sectoral banks were created in order to give incentives for prioritised areas of development. For example, Sumerbank was formed in 1933 to encourage the development of the textiles sector. Moreover, there was the Municipal Bank for regional development, Etibank for natural resources including iron and steel, Denizbank for sea lines and maritime development and Halk Bankası for small- and medium-sized enterprise credits. In the second decade, no short-term advance from the central bank was allowed and credits were given to support sustainable welfare gains without triggering inflation.

Banking sector modernisation increased with the approval of the Deposit Insurance Law in 1933, followed by the Banking Law in 1936. However, the strong effects of the Great Depression caused a reduction in the number of operating banks and branches with chronic bankruptcies of the single branch domestic banks. Towards the end of the second decade, the young Republic lost its founder, Mustafa Kemal Atatürk, at a time when the Second World War began in Europe. Expectations sunk to their lowest level because of both the internal and global turmoil and attempts to meet basic needs and increase defence expenditures took over from the priorities of banking and finance. In general, this period is viewed as exhibiting almost the lowest level of financial development with conservative credit expansion. The public sector supported industrial development but, until the end of the war, banking and finance lost its impetus.

4.3 Damage Control and post-war Gains

Although Turkey did not take a part in the Second World War, already scarce resources were directed to defence and, thus, banking and financial development was delayed during wartime. Public resources were used for basic needs and the private sector's aim was to control the damage and limit the impact of the war in Europe on the Turkish economy.

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[4] Akgüç (1989).

Capital controls, interest rate controls and a fixed exchange rate regime were the main pillars of the economic policies pursued during the 1940s. Real interest rates stayed positive. A substantial devaluation of 113% in 1946 under the fixed exchange rate regime and a licence for foreign exchange fixing were announced with the establishment of the International Monetary Fund (IMF) and the World Bank. The intention was to achieve a competitive foreign exchange rate before certain rules were imposed under Bretton Woods.

Selective credits and credit expansion were heavily regulated through different means such as investment licences with publicly-sponsored credits. A lack of financial deepening led the deposit base and monetisation by the Central Bank of Turkey (TCMB) to be the main sources of credit. Prioritisation of investment banking was intended to help banks to merge but, with a young population with a high average propensity to consume, it was quite impossible to increase the saving ratio.

During the second half of the 1940s, small banks with low capital bases disappeared fast. A newly emerging trend was the fast growing private banks which reached 30 in number. For example, in 1946 Yapı Kredi and Garanti, in 1948 Akbank, in 1953 Demirbank, in 1954 Sekerbank and Vakıfbank were formed. An explosion in branch numbers and increased non-price competition occurred because of interest rate controls. In 1958, the banks came together to establish Turkish Bankers Association.

During the first half of the 1950s, there was a sharp change in economic policies for development: from nationalisation to privatisation and a liberal approach to development became the priority. This change jump-started growth after the global political turmoil during wartime. The welfare gains were lost quickly, however, in the second half of the decade when an erosion of fiscal discipline led to inflation and extreme central banking experiments such as the distribution of reserve requirements as credits to finance government deficits with short-term advances of up to 15% of the budget, became common practice. Additionally, the governments tried to create development by following a strategy of selecting priority sectors, printing money and giving it as credit. However, the ultimate effect was inflation and an explosion of central bank credits.

Thereafter, a banking crisis with devaluation came in 1958. More than 10 banks went bust and enforced mergers were conducted to delay solutions to public banking problems. Banking Law was also revised in this year. In 1960, the Banking Solvency Fund was put forward by the central bank in order to manage bad debts accumulated by the fall of liberal economic policies of the 1950s.

4.4 Back to the Planned Economy: Can Banking and Finance be Planned as well?

As the cold war heightened political stress all around the world, Turkey also experienced a period of uncertainty that led to the military coup in 1960. The new order put an end to liberal development strategies and imposed a heavily regulated import-substitution growth strategy. Import license deposits at the TCMB were a typical example of how strong the reaction was against imports. Financing State Economic Enterprises and creating a public company for almost all products including consumer goods such as milk brought governance to a joint system, which was neither fully liberal nor socialist. Banking became simply the practice of funding the "Five-Year Plans", of which the first was implemented between 1963 and 1967. Until 1983, more than 4 plans were designed, but not all were successful, as the implementation of even the best designed plans always had the problem of financing, which was continuously scarce.

Heavy planning was framed within the five-year development plans. In the first half of the 1960s, the new economic order created sustainable development with high growth rates and low inflation levels. Selective central bank credits to planned investment projects with preferential rates and credit preference to the public sector, especially heavy agri-credits supported strong growth in the early years. With controlled interest and foreign exchange rates, branch banking became a norm without any pressure of competition and "holding banking"[5] dominated the decade encouraged by tax incentives. Industrial conglomerates had no choice but to try to have a bank in order to finance their potential investments as most of the deposit base of the financial system was strictly channelled to "planned" investments. Limitations surrounding new banking licences increased the value of operating banks but public banks such as the

[5] The term refers to priorising irrationally a group (holding) company in credit allocation.

State Investment Bank and the State Tourism Bank had no difficulty in beginning their operations with the hope that all such banks would create strong sectoral development in their area. Surprisingly, the first foreign bank of the Republic was established in this decade when the American-Turkish Foreign Trade Bank was created. Foreigners were allowed to open foreign exchange accounts whereas the savings gap was filled by workers' remittances.

At the beginning of the 1970s, a lack of financial innovation, the conflict between liberalism and state planning, interest and foreign exchange rate controls characterised by heavy-handed planning and creative central banking increased pressure on sustainable growth. Creative solutions such as "convertible accounts", which gave a right to create an indexed asset on hard currencies and nationalised foreign exchange risks added to the cost of payment system crises through contingent liabilities. The two oil crises wiped out almost all the gains of the planned development strategy based on import-substitution. Balance of payment crises and central bank competition for hard currency deposits including indexed or convertible bonds did not help to create a suitable environment for banking even though the Banking Law was more than four times revised and the number of banks decreased from 59 to 44. Financial crises and continual devaluation pressures on the currency increased the need for a re-structuring of finance and banking.

4.5 Banking under Openness and Export Led Growth

The 1970s were one of the worst decades for the economic prospects of Turkey. The global oil price shocks were mismanaged and adaptation to the new order was slow and inadequate without increased savings and accomplished structural reforms. There were queues for basic consumption goods on the streets and dollarisation increased sharply due to un-ending foreign exchange rate risks arising from a lack of hard currency reserves. "In need of 70 cents" became a popular saying to explain the difficulties of those times. At this difficult conjuncture and with the involvement of the IMF, there was a Paris Club agreement to re-structure external debts and a new economic policy package was announced in January 1980; at that time there were 44 banks in Turkey.

The basic aim of the new economic package for banking and finance was to lift the heavily-regulated banking practices and jump-start a competitive and open banking system based on the quality of financial services. In July 1980, the setting of interest rates was left to the market as liberalisation intensified. The exchange rate regime was moved towards a flexible managed float instead of a fixed rate regime and foreign exchange rates were announced daily from May 1981 in order to put an end to the periodically unexpected devaluations.

During the early 1980s, the TCMB was determining deposit rates but interest rates on loans were set freely even though high and volatile inflation rates eroded the capital adequacy ratios of banks. Financial liberalisation opened the doors for competitors and bankers armed with certificate of deposits began to challenge the dominance of banks in the financial system. However, a lack of adequate supervision and regulation coupled with ponzi style games created a systemic risk and there was a Bankers' crisis and a loss of confidence in 1983. Learning how to compete was not risk free and banks such as Istanbul Bank, Ortadogu Iktisat Bank, Hisarbank and Workers Credit Bank that relied on those bankers all went bust. Bagbank followed them in 1984. The lesson from the bank failures was that without proper regulation and supervision to support a strong capital base, financial consolidation and incentives for capital inflows can lead to catastrophic results opposed to financial deepening. Consequently, the Banking Law was revised once again in 1985 in order to rectify the deficiencies that led to the 1983 crisis.

The second half of the 1980s witnessed another critical decision for banking and finance in Turkey: the TCMB was licensed to conduct open market operations. It was a critical decision because, most of the time, the interest and the exchange rate were set by dictate and credit allocation committees were involved in certain central banking decisions. It was far from central bank independence but still an important step towards the market economy that allowed a base for marketisation to be defined. Not only were the required decisions for the emergence of money markets were taken, but also the Capital Markets Board (in 1982) and the Istanbul Stock Exchange (in 1986) were formed as well. The TCMB designed the money market infrastructure and a strategic borrowing mechanism for Treasury bonds and bills was developed, which was followed by interbank money markets, foreign exchange and banknote markets and even a gold market to put an end to unregistered gold imports and unofficial gold trade. In 1986, the framework of monetary policy might best be described as implicit monetary targeting, which was a turning point for the TCMB.

The main pillars of the 1980s were the end of import substitution, the emergence of export-led growth, financial liberalisation, marketisation, the support of entrepreneurship and private ownership along with incentives for privatisation. However, good-will and an encouraging road-map were not enough for prosperity with sustainable growth and low inflation. In the second half of the 1980s, economic and financial stability was again lost, and Tobank in 1987 and Caybank and Anadolu Bank in 1988 went bust. Advances to the Treasury of 15% of the annual budget, almost daily devaluations and foreign exchange deposits allowed not only for workers abroad but also for local residents, increased the speed of dollarisation. The Turkish lira was struggling to compete against hard international currencies such as the US dollar and the Deutsche Mark.

4.6 The 1990s Banking and Financial Crisis

The marketisation incentives of the 1980s generated a serious gap for high quality financial regulation and supervision. Transition from heavy state involvement in relative price adjustment to market-determined pricing resulted in financial discipline being deficient. Capital account liberalization in 1990 further obscured the picture and led to an accrual of open foreign exchange positions in the financial system just as soon as Turkey became a small open economy. Postponing the elimination of worker’s deposits at the TCMB, securitisation and incentives for external borrowing complicated the management of risks. A whole series of factors added to the Treasury’s borrowing requirements: managing financial liberalisation whilst ignoring current account deficits; signing a customs union agreement with the EU without convergence aids; absence of structural reforms; misuse of public banks; a lack of fiscal discipline; increasing political tensions with periodically early elections; failed privatisations, a lack of social security reforms in a system which gave the chance for early retirement at 38; and investment in public infrastructure.

Although the banking sector was opened to external competition, a high level of financial volatility kept the participation ratio of foreigners in the banking system below 10%. The IMF became involved in many stand-by agreements, most left incomplete. Rating Agencies came onto the scene with an external evaluation of the national economic situation. Interestingly, the first rating level given still remains the highest ever. Extremely high real interest rates of more than 20% resulted from chronic mismanagement of inflation expectations and increased hot money pressures. Worse than that, strictly controlled bank licensing lost its strength and easy licenses were given with simple transfers of bank ownership.

At this time, the TCMB was fighting for financial stability. New instruments for monetary policy implementation were introduced, including open market operations, liquidity controls and discount window. Compulsory hard currency transfers from banks supported a flexible exchange rate regime. The domestic borrowing scheme created transparency for debt management. An increasing need for external borrowing and a growing level of reserves caused an active reserve management strategy with forced interventions in the foreign exchange markets. Explicit monetary targeting in 1990 proved quite successful in terms of achieving the targets, but failed to control inflation and thus gain credibility. In the first half of the 1990s, the banking system desperately needed a nominal anchor around which inflation expectations could form.

The lack of a credible stabilisation programme and the mismanagement of the public debt as well as interventions in TCMB operations with implicit and explicit tools during 1993 caused financial stress to cumulate and in 1994 a destructive banking crisis returned once again. At this time there were 67 banks operating in Turkey. Again, many, such as TYT Bank, Impexbank, Netbank, and Marbank, failed.[6] Financial deepening and development once again paused with real interest rates at levels of more than 50%. Coincidently, money and capital markets gained importance and special emphasis has been laid on "markets" ever since. This may not be surprising under the circumstances since although the debt to national income ratio did not indicate a risk, the duration of the debt was less than six months. There was a huge burden on rolling over the debt which occurred at the expense of financial system

[6] The easing of the licensing rules in 1987 may take some of the blame for the high cost of the banking crisis of 1994.

stability. A new economic stabilisation programme was announced with the support of the IMF in April 1994. The TCMB Law was also changed and there was a road map to diminish the rate of advances to the Treasury from 15% to 3% after 1998. One critical mistake was to give a 100 per cent blanket guarantee for deposit holders in May 1994.

The 1990s might also be marked as another "lost decade" for the country's banking and financial development prospects. Even though there were many national policy mistakes, global financial conditions were not favourable either. The invasion of Kuwait and the first Iraq War, global turmoil associated with the Tekila, south-east Asian and Russian crises and the collapse of the European Exchange Rate Mechanism hindered the ability of domestic policies to break out of the vicious circle of financial stress. Even nature pitched in with the 1998 earthquake, which caused a negative growth rate. Banking was trying hard to survive and most of the structural reforms that would give a boost to ease the burden of these difficult times were delayed because of a lack of political commitment. Even if it became clear that there was no easy way out, applications such as extra budgets just to take more advances from the TCMB and Workers' Super foreign exchange accounts with import incentives to collect more deposits at the TCMB were not helping to increase credibility.

Day-to-day management of the economy came to an end in 1999 when an exchange rate based stabilisation programme with the IMF involvement was announced. Actually, it was an almost perfectly designed programme that anchored inflation expectations and decreased borrowing costs for the Treasury for a while. Unfortunately, it failed because of incomplete promises, especially in the areas of privatisation and public sector re-structuring.

1999 witnessed rapid credit growth for the first rime in Turkish banking history. There was a full commitment to price stability and a pre-announced exchange rate horizon was kept for six quarters with an exit strategy. However, various components of the programme were broken with a lack of full commitment to privatisation (of, for example, Turk Telecom). Non-ending delays on the promised structural reforms sharply increased foreign exchange risk and with the first accumulated stress signal in November 2000, a couple of banks went bust. An additional package from the IMF was not enough to prevent a terribly destructive financial crisis in February 2001 with a sudden collapse of the 1999 programme. Bank runs caused by the systemic risk and inevitable devaluation cost more than 4% of GNP, due to a 100 per cent blanket guarantee. More than 10 banks went bankrupt, overnight interest rates rose to above 15000% (which may be a European history record) and the debt to income ratio more than doubled to a level beyond that enshrined in the Maastricht Treaty. The collapse of the programme resulted from inadequate IMF funding, the lack of a contingency funding facility and a short-run vision with respect to debt sustainability. Implementation failures such as delays in banking re-capitalisation and privatisation of public banks and the endless discussions on the ownership of the programme only caused deeper wounds.

There are many reasons why banking and finance development have failed to outperform countries in transition that began their liberalisation at least ten years later then Turkey[7]:

1. Central bank independence was never prioritised or well-respected. Advances to the Treasury had been misused in almost all cases where the annual budget got into difficulties with the "extra budgets" structured to siphon more advances from the TCMB.
2. Funds were siphoned regularly by the Treasury from public banks in order to hide unbearable levels of borrowing requirements and irregular redistributions of wealth. The privatisation of these banks was delayed for almost two decades.
3. High and volatile borrowing requirements crowded out both the households and the corporate sector and significantly reduced the potential for financial deepening. Treasury bonds and bills had invaded banks' balance sheets. Consequently, banks dominated the financial system and blocked the emergence of insurance and other financial services.
4. Because of crowding out, creative credit channelling became common practice. In particular, back-to-back credits or holding banking, referring to selecting group companies - even when there were more rational and profitable investment opportunities from unconnected firms - were common practice from the 1970s onwards.

5. Irreversible mistakes in the area of regulation and supervision increased the cost of risk management. Even creating an umbrella institution such as the Banking Regulation and Supervision Agency (the Turkish FSA), it had taken very complicated discussions and extensive delays occurred. Capital market supervision is still under a different institution, i.e. the Capital Markets Board. Deficiencies in capital adequacy have been accumulated through frequent changes to the banking law, in almost every decade. There were also unexcused delays in enhancing the institutional framework and missed opportunities to put in place a rational set of tool kits for risk control. Practices such as blanket guarantees for all deposits and a lack of a proper solvency law for banks have not helped to create better prospects for banking sector development.

6. Institutional quality failed to catch up European standards. Good governance has never been a priority.

7. A lack of appetite for reform has been accompanied by failed attempts to create an economic environment for sustainable growth and price stability. Macroeconomic problems covered up most of the deficiencies and inefficiencies in the national economy, hiding the microeconomic problems as well. Short-sightened policies became common practice with chronic political instabilities followed by un-ending cycles of early elections. There was almost no chance for a fully-committed medium or long-term stability programme to be implemented.

8. Misjudgements occurred over the choice of foreign exchange regime, especially after the two oil crisis. Because of inadequate savings, there was a continual requirement for balance of payment financing. Managed float hid foreign exchange risk and, most of the time, private losses resulting from foreign exchange risk were nationalised. Even the TCMB balance sheet carried an open position annually because of the foreign exchange deposits of workers abroad.

9. Mismanagement of the liberalisation of capital flows in 1989 by not ensuring *a priori* a proper regulation and supervision framework and going into the customs union with Europe in 1996 without receiving the counterpart aid packages, resulted in the build-up of a large degree of fragility.

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[7] For an extended analysis see, Saraç (2002).

Lessons from the 1990s financial crisis could be endless. However, the question of risk measurement and management, the institutional framework and good governance as well as the coordination of economic policies are among the most important. Fiscal dominance increased the cost of recovery and the IMF was called in once again. The significance of supervision and regulation was, this time, understood but at a high cost. Taxpayer's money had to be injected to re-capitalize the banking sector. The 2001 financial crisis can be characterised as the end of an era with all the ensuing uncertainties and ever accumulating risks.

4.7 Banking in the 21st Century: the Road to the European Union

The last crisis terminated the country's long lasting experience with some form of managed exchange rates and free floating became inevitable. Foreign exchange risk was at last left to the markets, putting in place incentives for responsible investment decisions that would prevent excessive risk taking. The new economic programme aimed at prudent fiscal and monetary policies along with structural reforms including the foundations of an economy that would be well-placed on the track of sustained low-inflationary growth. The ultimate goal would be to make the economy more resilient to adverse shocks, less vulnerable to crises, more equitable in income distribution, more conducive to foreign and domestic investment, and as a consequence, to be better positioned to integrate into European structures.[8]

The agenda of the new order was full of reforms, including the jump-starting of privatisation. Credible actions were taken to approve laws for real transformation and the transition to a free market economy. The extensive re-capitalization of banks as well as re-structuring of state-owned banks were both parts of the new programme. Fiscal management reform, public resource management and enhancing the role of private sector had been given priority as well. A decision was taken to expel state involvement from production and manufacturing and to open the field for the private sector. The goal of price stability had been legally underlined with a change in the TCMB Law[9] forbidding advances to the Treasury and the buying of Treasury debt

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[8] Monetary Policy Framework announcement in September 2002.

[9] Price stability as the overriding objective; the central bank and the government jointly determine the inflation target and instrumental independence was legalized.

instruments on the primary market. Raising credibility with single digit inflation targets in the medium term and strong growth to enjoy a window of opportunity provided by favourable demographics, were the main pillars of the programme. Banking based on sound risk management with transparency, credibility and accountability had been a prerequisite for successful implementation of the programme.

The new road map for the economic stabilisation programme placed heavy burdens on banking and finance in the early stages. Almost all the banks lost confidence in each other and preferred to deal with the TCMB directly, a phenomenon recently observed in the US as well. After more than 15 failures, a new commitment to complete an IMF agreement fully opened the way to ease the burden of crowding out on banks' capital bases. Primary surplus targets to end fiscal dominance had also helped.

Banking in the 21st century began with a terrible crisis but subsequently was given an opportunity to concentrate on microeconomic problems. The increasing pressure of competition and the need to develop an extensive set of risk controls became welcome problems for banks following the macroeconomic problems of the past decades. Managing EU convergence, sustaining profitability under heightened global volatility, managing foreign exchange risk carefully when private sector was heavily indebted in foreign currencies under a floating exchange rate regime, expanding at least locally in order to compete globally were among the challenges for banks.

When early signs of the success of the stabilisation programme began to emerge, foreign investors started to search for potential bank acquisitions in Turkey. With an improved capital base and offering good opportunities (and in particular good demographics) compared to other transition economies, the Turkish financial markets attracted increasing attention from Greek, British, German, French and American banks. Increasing mergers and acquisitions caused the foreign participation rate to rise above 30% within a couple of years. The lack of financial deepening implies that Turkey offers a huge potential for growth in the following decades. Looking back at a later date it might be the case that the first decade of the 21st century will be seen as the end of national banking in Turkey, particularly if state-owned banks are also sold to foreign investors.

In the first half of the first decade of the 21st century, the Monetary Policy Committee of the TCMB was formed to help institutionalise the monetary policy framework and, indeed, implicit inflation targeting proved successful, bringing inflation down to single digits. Given the full commitment to price stability under floating rates with the TCMB instrument independence, the Monetary Policy Committee began to target inflation explicitly with strong transparency, credibility, and accountability. As a result, inflation was brought down to less than 8% in 2005. There is a full awareness that even such a historically low level of inflation is not equivalent to price stability as defined, for example, by EU institutions. Consequently, the medium and long term inflation target is to bring inflation to 4% and keep it at that level until EU convergence is achieved.

Banking experienced further rapid credit growth and the customer base of banks was enlarged. Financial deepening has now occurred and fiscal dominance has been overturned with high primary surpluses being achieved. Increased competition and the impact of globalisation under the floating exchange rate regime exposed banks to currency risk. The TCMB managed capital inflows during convergence with regular foreign exchange buying auctions and rare interventions to buy domestic currency. Recent challenges for banks in Turkey have included adapting to a low inflation environment after all the years of high and volatile inflation, developing new financial instruments to meet the hedging demands of their customers and investing in new generation technologies, especially in payment systems, so as to sustain a strong customer base.

4.8 Lessons Learned

88 years of learning how to bank since the Turkish Grand National Assembly was opened in Ankara have inevitably brought many important lessons. The price of learning was high with the crises of 1958, 1979, 1983, 1994 and 2001 and global shocks such the 1929 depression, competitive devaluations in Europe, World War II, Bretton Woods, the Cold War, Marshall Aid, the collapse of Bretton Woods, the oil

price shocks of the 1970s, global inflations through to the end of the 1970s, the 1980s Latin American Debt crises, Glasnost and Perestroika, transition in Eastern Europe, the South-East Asian, Tekila and Russian financial crises, the German unification and the ERM crises, the birth of the euro and, lately, the energy and food price shocks. Surprisingly, banking related crises were concentrated in the recent past, as opposed to priors that might have led to expectations of crises during the early years since initial conditions were more prone to stress and there were many understandable deficiencies and fragilities. This might lead to the conclusion that there was no structural problem with the institutional design of the early Turkish banking framework but mistakes were made often as finance matured.

The first lesson is a very common truth that banking is unique in its ability to generate risks of contagion. When one bank is in trouble, other banks may get into difficulties with potentially large output losses being a consequence. This side of banking puts pressure on the authorities to promote safe and sound supervision and regulation. One may argue that the institutional framework of banking in Turkey after 1940 permanently required further improvements especially during the various shifts in orders - the Second World War, the collapse of Bretton Woods, the first and second oil crises, liberalisation and marketisation in the 1980s, the elimination of capital controls and the opening up of competition in 1990 and finally, the promotion of EU convergence. The fact that the Banking Law changed at least twice in each decade might be an indicator of the incomplete nature of rules, law and order in domestic banking and finance. The recent reforms to the institutional framework might be judged successful and globally competitive if the steady rise in foreign participation ratio over the five years is an indication.

When dealing with banking and finance, special emphasis should be placed on its systemic nature since losses can easily affect public finances. Recent turmoil in the US and the UK has once again reminded us of the fact that financial sector losses are usually nationalised because of their impact on economic activity as a whole. If the credits channel fails, low growth and high inflation usually follows. Turkey nationalised bank losses many times with the blanket guarantee granted in 1994, being the most extreme example, which had a huge cost in 2001.

The second lesson from the history of Turkish banking includes the importance of a well-balanced balance sheet. Excessive risk taking may grant high returns from time to time, but on average it leads to a loss of capital because of fire sales. At the same time, off-balance sheet activities should stay under control not to threaten unbearable losses through loss of confidence arising from transparency hesitations. Calculating and managing risk extremely carefully and being aware of fiscal and global imbalances are vital if a profitable balance sheet is to be sustained. Ignoring the basics of banking services may cause profits to be foregone during financial deepening periods but may save large losses during credit crunches. It may be ironic to observe that the same logic holds not only for Turkish banks but also for the US, British and Swiss banks as well, as their sub-prime mortgage losses have already reached hundreds of billions of US dollars.

The third lesson is to keep capital adequacy as strong as possible. Stakeholders should remember that strong capital bases allow banks to absorb losses and that, unless there is a systemic risk, the monetary authorities will not come to save the bank and the financial service provider during the difficult times.

The fourth lesson is to stay away from actions that may lead to systemic risks. One may assume that under such cases, rescue will be inevitable. However, shareholders are usually forced into bankruptcy and the bank is saved only institutionally with new owners and sometimes under a different brand name.

The fifth lesson is not to rely on unlimited deposit guarantee schemes. This lesson has parallels with the fourth because it is with unlimited deposit guarantee schemes; it is the deposit holder that is saved following financial collapses, not the shareholders.

The sixth lesson is to allow the market room to mould the banking system and to avoid excessive regulation and supervision. In the long run, the prices are best set according to the market power of supply and demand. Once intervention becomes draconian, it may not be sustainable in the long run with excessive social costs of trying to defend the strict rules. A floating exchange rate regime may contribute significantly in this area, as it internalises the foreign exchange risks and enhances the appetite for risk management.

The seventh lesson is to invest in advanced technologies, especially in the payment and custody systems as basics of banking and finance. Comparative advantages in these areas create a sustainable non-interest income base through commissions and increases resilience during turbulent times.

The final lesson which emerged only recently is to increase awareness of global opportunities rather than concentrating solely on the domestic market. It becomes quite challenging to survive as a bank with only a local focus, because of the prevalence of global hunters. Unless synergies are exploited through mergers and acquisitions, survival as an independent financial service provider seems quite unsustainable in the long run, especially once eventual membership of the European Union becomes a goal.

It is not surprising to observe that these lessons have many common characteristics with global banking and finance experiences. As the nature of this sector is essentially the same globally, one lesson in a particular country often holds for many others. In the next section, the current stance of Turkish banking will be analysed to see whether all these lessons have been learnt or not.

5. Banking and Finance in Turkey: Recent Developments

According to data from the Banks' Association of Turkey (BAT)[10], recently there are 50 banks operating in the country. Four of them are participation banks. Table 1 compares the figures of the last two years.

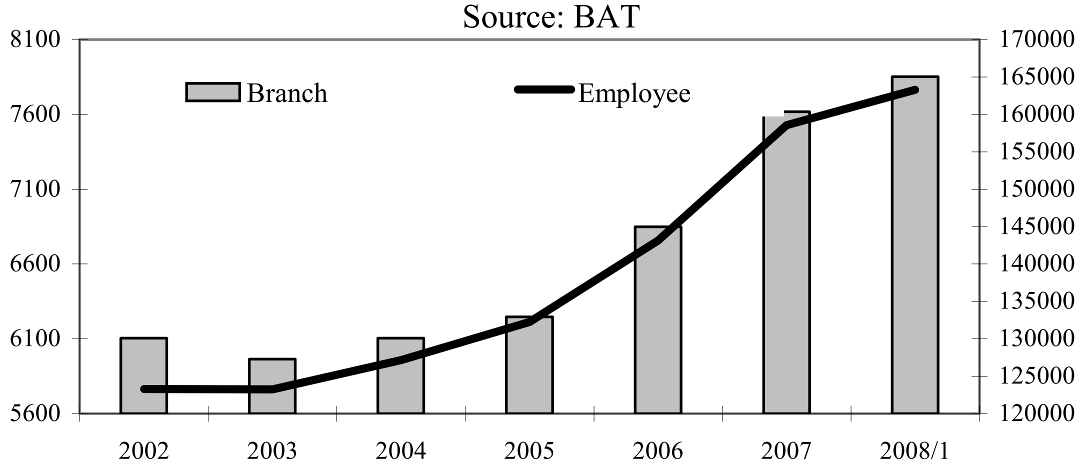
Table 1: Banks in Turkey

	March 2007		March 2008		March 2008
	Bank	**Branch**	**Bank**	**Branch**	**Employee**
Deposit Banks	**33**	**6928**	**33**	**7801**	**157938**
State-owned	3	2150	3	2246	41393
Private	12	3636	11	3759	77648
Deposit Fund Bank	1	1	1	1	288
Foreign	17	1141	18	1795	38609
Investment and Development	**13**	**46**	**13**	**51**	**5357**
Total	**46**	**6974**	**46**	**7852**	**163295**

Recovering from the crisis of 2001, the banking sector increased its contribution to growth. As Figure 1 suggests, the number of branches and employees has been increasing.

Figure 1: Number of Branches and Employees

Source: BAT



Most of the banking data goes back to the 1960s and Table 2 displays the historical data from the balance sheet for the sector as a whole provided by the BAT.

Table 2: Banking Sector Balance Sheet (USD million)

ASSETS	**1960**	**1970**	**1980**	**1990**	**2000**
Liquid Assets	502	1.274	5.812	19.094	49.825
Loans	1.088	3.267	10.011	27.342	50.919
Permanent Assets	276	576	896	4.626	22.920
Other Assets	287	966	1.913	7.109	31.283
Total Assets	2.153	6.083	18.631	58.171	154.947
LIABILITIES					
Deposits	874	2.564	9.132	32.564	101.884
TL	-	1	14	24.864	54.953
FX	-	-	-	7.700	46.931
Non-Deposit Funds	53	695	1.155	11.760	29.435
Other Liabilities	899	2.292	7.316	7.944	12.909
Shareholders' Equity	295	502	762	4.535	7.514
Total Income	32	30	266	1.368	3.205
Total Liabilities	2.153	6.083	18.631	58.171	154.947

[10] The publication is available on the web: http://www.tbb.org.tr/english/40.htm, and covers most of the BAT data that will be used in this section.

Table 2 records the dollarisation trend of the last two decades clearly and exhibits the relatively low levels of credit to deposit ratios. In Table 3, the BAT data summarises historical indicators of the banking sector.

Table 3: Comparative Macroeconomic Variables

		1960	**1970**	**1980**	**1990**	**2000**
Wholesale Price Index	1968=100	73	117	2,063	71,234	13,361,552
USD/TL Exchange Rate		9	15	89	2,927	671,765
GNP	TL Billion	47	208	5,303	393,060	125,970,544
M2	TL Billion	10	44	882	71,570	31,912,095
M2Y	TL Billion				87,482	56,849,061
RATIOS (%)						
Total Assets						
Total Assets/GNP		41.5	43.5	31.4	43.3	82.6
Total Assets/M2		192.9	203.9	188.6	237.9	326.2
Total Assets/M2Y					194.6	183.1
Deposits						
Deposits/GNP		16.9	18.3	15.4	24.3	54.3
Deposits/M2		78.3	86.0	92.4	133.2	214.5
Deposits/M2Y					109.0	120.4
Loans						
Loans/GNP		21.0	23.3	16.8	20.4	27.2
Loans/M2		97.5	109.5	101.3	111.8	107.2
Loans/M2Y					91.5	60.2
Capital Adequacy						
(Shareholders' Equity + Total Income) / T. Assets		15,2	8.7	5.5	10.1	6.9
(S.ers' Equity + T. Income)/(Deposits+Non-d. Funds)		35.3	16.3	10.0	13.3	8.2
Net Working Capital / T. Assets		2.4	-0.7	0.7	2.2	-1.7
Asset Quality						
Total Loans / Total Assets		50.5	53.7	53.7	47.0	32.9
Permanent Assets / Total Assets		12.8	9.5	4.8	8.0	14.8
FX Assets / FX Liabilities		-	-	-	88.1	75.9
Liquidity						
Liquid Assets / Total Assets		23.3	20.9	31.2	32.8	32.2
Liquid Assets / (Deposits + Non-deposit Funds)		54.2	39.1	56.5	43.1	37.9
Profitability						
Net Income / Average Total Assets		1.7	0.2	1.7	2.8	-3.6
Net Income / Average Total Shareholders' Equity		12.8	2.4	40.2	36.0	-89.8
Net Income / Average Share Capital		15.9	2.8	40.1	62.3	-71.9
Income - Expenditure Structure						
Net Interest Income / Average Total Assets		2.5	2.5	5.4	6.4	3.5
Interest Income / Interest Expenses		190.5	183.7	181.8	135.5	127.7
Non-interest Income / Non-interest Expenses		86.4	48.2	55.8	57.7	19.8
Total Income / Total Expenses		120.0	102.7	111.1	112.2	95.8

The impact of chronic fiscal dominance is clear in the above table as the loan to GNP ratio increased from 21% to only 27% in 40 years. Another problem for the Turkish financial system is the dominance of banks: Table 4 (from the second Financial Stability Report of 2007 (FSR, 2007)) shows that almost 87% of the financial sector is dominated by banks. These are two faces of the same coin. On one hand, the figure indicates the underdeveloped nature of financial services. On the other hand, it underlines the potential financial deepening gap for the following years, especially in the context of European convergence.

Table 4: Banks Dominate the Turkish Financial System

(Billion TRL)	2002	2003	2004	2005	2006	June07	Assets/GDP (%,June07)
Banks	216,7	255,0	313,8	406,9	499,5	533,7	87,2
Leasing Companies	3,8	5,0	6,7	6,1	10,0	11,4	1,9
Factoring Companies	2,1	2,9	4,1	5,3	6,3	6,6	1,1
Consumer Fin. Companies	0,5	0,8	1,5	2,5	3,4	3,4	0,6
Insurence Companies	5,4	7,6	9,8	14,4	17,4	18,5	3,0
Pension Companies	-	3,3	4,2	5,7	7,2	7,2	1,2
Securities Stock Broker(2)	1,0	1,3	1,0	2,6	2,7	3,4	0,6
Securities Investment Partn.	0,1	0,2	0,3	0,5	0,5	0,5	0,1
Securities Investment Funds	9,3	19,9	24,4	29,4	22,0	24,6	4,0
Real Estate Investment Partn.	1,1	1,2	1,4	2,2	2,5	2,7	0,4
Total	314,1	370,4	437,7	560	668,6	713,9	116,6
Central Bank	74,1	76,5	74,7	90,1	104,4	109,2	17,8

The FSR (2007)[11] also provides a set of analytical data to make comparisons between the Turkish financial system and the European countries (see Table 5).

[11] For a detailed analysis, please refer to: http://www.tcmb.gov.tr/yeni/evds/yayin/finist/finist5.php

Table 5: Total Assets of Credit Institutions*

(billion Euros)	2002	2003	2004	2005	2006
Germany	6,370	6,393	6,584	6,826	7,123
France	3,831	3,998	4,419	5,073	5,728
U.Kingdom	5,855	6,171	6,931	8,318	9,651
Greece	202	213	230	281	315
Czech Republic	79	78	87	101	115
Hungary	44	55	68	78	94
Bulgaria	8	9	13	17	22
Romania	13	15	23	35	51
Turkey	131	155	192	248	305

*Banks, Leasing Companies, Factoring Companies and Consumer Financial Companies are included in CIs.

With its population of almost 72 million, mostly under 30, the potential for growth in the financial sector in Turkey is substantial and most probably this is the main motive for increased foreign participation in the sector. The impact of long-lasting fiscal dominance limited the credit expansion to the private sector and Turkey may well be the only European country with a net un-indebted household sector. Table 6, taken from the FSR, compares consumer credit stocks in different countries.

Table 6: Consumer Credit

(billion Euros)	2002	2003	2004	2005	2006
Germany	225.2	174.9	174.4	171.0	167.6
France	121.1	128.4	134.1	142.0	148.7
United Kingdom	259.6	256.5	281.0	307.1	315.3
Greece	9.8	12.4	17.0	20.8	25.5
Czech Republic	1.4	1.7	2.2	3.1	4.0
Hungary	1.2	2.1	3.0	4.8	6.9
Bulgaria	n.a.	n.a.	1.5	2.2	2.5
Romania	n.a.	n.a.	2.1	4.4	9.2
Turkey*	n.a.	n.a.	n.a.	n.a.	24.8

*Data are available after June 2005 due to changes in the calculation of consumer credits.

The picture is quite similar regarding the corporate sector (see Table 7).

Table 7: Loans to non-financial Corporations*

(billion Euros)	**2002**	**2003**	**2004**	**2005**	**2006**
Germany	841	814	787	774	800
France	549	535	567	611	670
United Kingdom	440	408	427	540	631
Greece	52	58	63	69	74
Czech Republic	14	14	15	19	24
Hungary	15	18	21	23	26
Bulgaria	n.a.	n.a.	5	6	7
Romania	n.a.	n.a.	7	10	15
Turkey	9	13	20	33	38

*Corporate sector intermediation

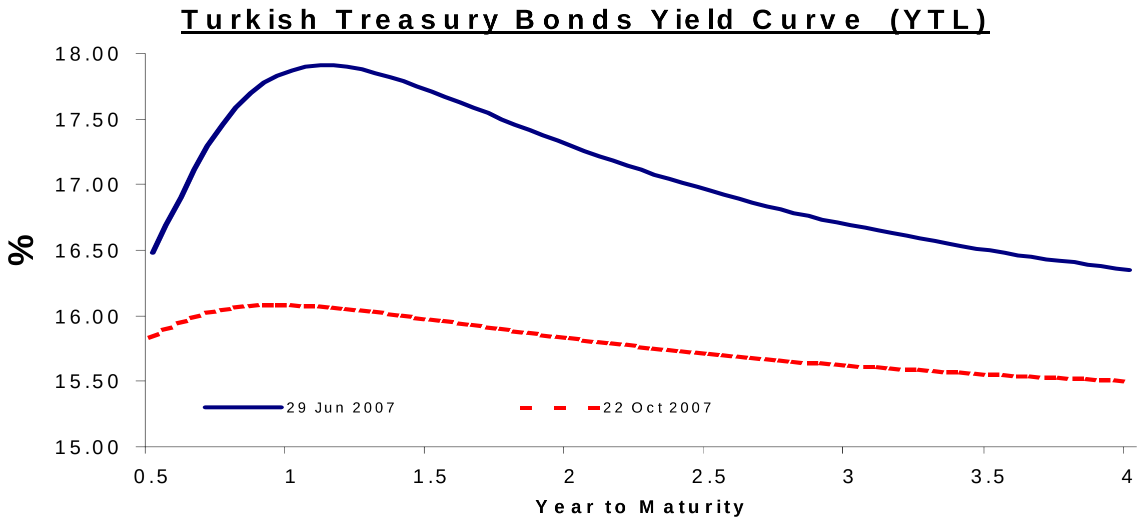
With all these indicators suggesting future potential, there appears not to be a structural concentration problem for the Turkish banking sector and indeed indicators from the FSR (2007) show that the situation is quite similar to many European countries, as seen in Table 8.

Table 8: Market Share of the 5 Largest Credit Institutions

(% of total assets)	**2002**	**2003**	**2004**	**2005**	**2006**
Germany	21	22	22	22	22
France	45	47	49	52	52
United Kingdom	30	33	35	36	36
Greece	67	67	65	66	66
Czech Republic	66	66	64	66	64
Hungary	55	52	53	53	54
Bulgaria	n.a.	n.a.	52	51	50
Romania	n.a.	55	60	59	60
Turkey	57	59	58	61	61

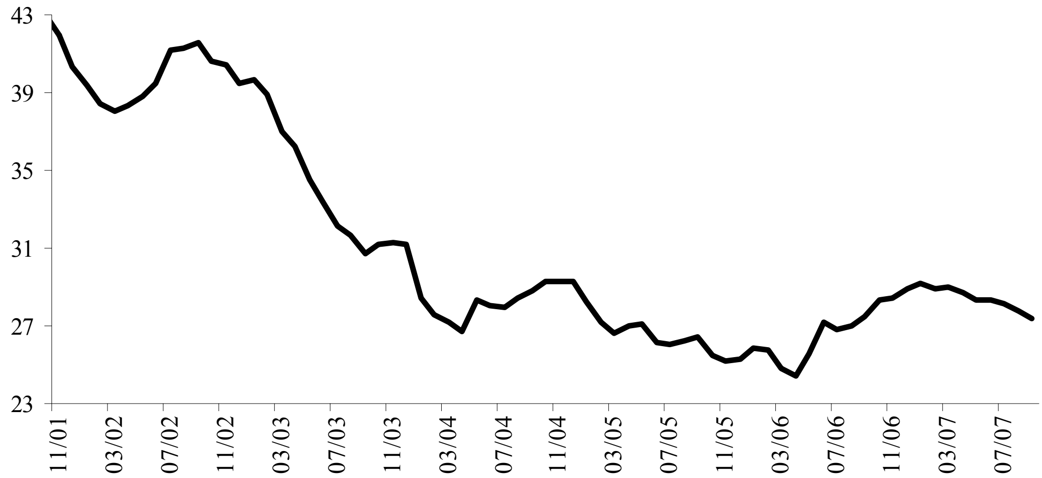
The above analysis probably underestimates the structural problems of Turkish banking by focusing only on the potential. It may be better to underline the fact that short-termism is one of the most difficult challanges the sector faces for the future. The average maturity of the deposit base is less than three months. While many European countries have a government bond yield curves for nearly 30 years, Figure 2 shows a current yield curve calculated by the TCMB. The longest end of the yield curve is only four years and worse than that between 2 to 4 years, there are a limited number of bonds and bills; most of the maturities lie between 6 months to two years.

Figure 2



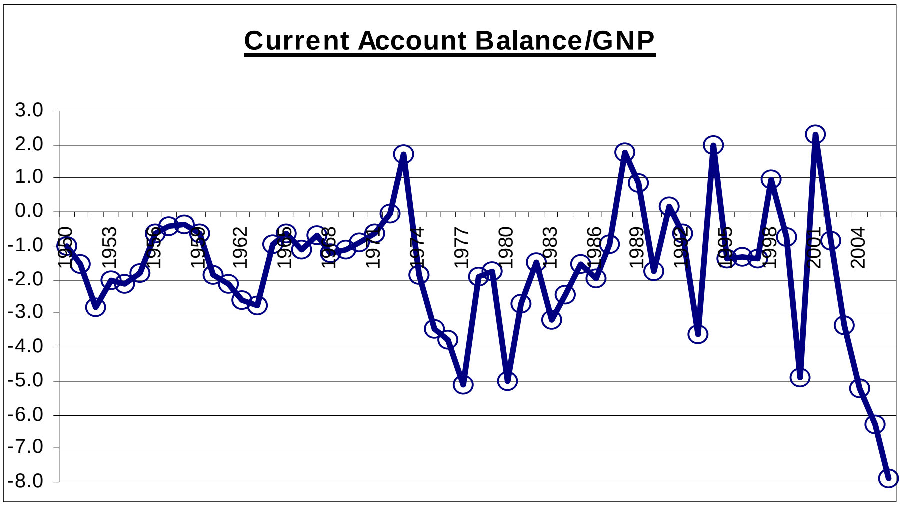
Dollarisation is another structural macro problem for the Turkish financial system. Because of the history of persistent high and volatile inflation and unexpected currecy's devalutions, there is a strong inertia with dollarisation even if there has been some limited success to de-dolarise certain assets. Figure 3 exhibits the recent phase of dollarisation. As seen in Figure 4, the outlook for the future of dollarisation depends mostly on the financing of current account deficits, data for which is provided by the TCMB.

Figure 3: Asset dollarisation



After the 2001 crises, strong primary surpluses have helped to ease the burden of fiscal dominance. As the Treasury decreased the supply of bonds and bills, household and corporate sector credits expanded rapidly. Most of the discusions have surrounded the financial account of the balance of payment. Another way of looking at a current account deficit problem is to increase the savings ratio in order to close the gap between savings and investment, which is equalised by external inflows. In inceasing the savings ratio, banking and finance could play a critical role and with the help of single digit inflation levels, Turkish banking and finance seems now ready for the future challanges. European convergence can only help the way forward and increase the awareness of the importance of monetary and financial stability as two prerequisities for the future potential of banking and finance in Turkey.

Figure 4



*Source:*TCMB

6. Conclusion and Recommendations

The final years of the Ottoman Empire take much of the blame for the destruction of all capital formation channels in Asia Minor. When the collapse came to a close in 1920 with the formation of an independent Assembly in Ankara, all that was inherited was a huge debt burden with no hope for the emergence of a strong financial system. Struggling with poor initial conditions, a scarcity of basic consumption goods and a production structure dominated by agriculture delayed the formation of private banks. Even capital controls were inevitable under the heavy burden of the Ottoman Debt instalments that lasted until the 1950s.

Looking back to this time, however, one might argue that it was the most successful period of Turkish banking and finance. While initial conditions were poor and the institutional framework was limited, perceptions of finance and good governance were at their highest. A lack of capital accumulation and human capital created quite difficult times in the early years and global conflicts coupled with 1929 US depression only increased the cost of survival for the emerging capital base. The reaction was to inject public money to create at least semi-private banks. However, heightened conflicts in Europe and the beginning of the Second World War delayed early success stories in banking and finance and, until the end of the 1940s, the aim was to prevent financial crises through heavy regulation at a time when even bread distribution had to be licensed. Public money was used to support the financial system extensively until the Marshall Aid Programme.

From the 1950s, a jump-start for capital accumulation within the framework of a market economy went into force and private banks were established. Without the U-turn in the 1960s in favour of a "plan based", centralised development strategy based on import substitution, there might have been no demand for "creative" central bank financing for the country's economic development and thus inflation was the ultimate result.

The semi-socialist approach to economic governance might be considered for the mismanagement of the twin oil crises of the 1970s. After the collapse of Bretton Woods, the Turkish economy failed to adapt to the new order. As a result, a lack of structural reforms, ever-increasing dollarisation inertia and a lack of fiscal discipline coupled with central bank financing of public deficits through short-term advances created an unfriendly environment for banking. Additionally, a lack of adequate supervision and regulation gave rise to Ponzi games and a Bankers' crisis took away already scarce capital base of private banks.

The management of change requires strong attention to be given to a well-designed institutional framework. It was the early 1980s when Turkey started to implement an export-led growth strategy, supported by liberal economic governance to break-up boom and bust cycles. The central bank and the public banks were gradually removed, to a certain extent, from direct competition with private banks. The aim was to remove intervention and heavily-regulated public sector involvement in the production and distribution channels and encourage private entrepreneurs to be the leading innovators so as to encourage future productivity that would further increase wealth accumulation. This was before Glasnost and Perestroika, when strong incentives for privatisation were also evident. Unfortunately, in the following decades, countries in transition managed to implement similar re-structuring policies much more successfully than Turkey. Consequently, 1990s can be considered "lost years" for banking and finance in Turkey. Many mistakes were made, including the opening up of the capital account without having in place a strong supervisory and regulatory framework and joining to the European customs union without a financial support package. The outcome was chronic financial stress, the 1994 crisis and accumulated pressures on structural reforms that were never given enough attention.

On the eve of the 21st century, the Turkish financial markets and banking system paid a huge price for all these problems and the 2001 crisis wiped out more than 4% of national income. At that time, a challenging reform agenda including both microeconomic and macroeconomic policies was put in place and, because of the cost of past financial turmoil, there was social consensus backing reforms. Central bank independence was one of the most important reforms to limit the monetisation of public deficits. Banking re-structuring and re-capitalisation have been implemented successfully and a new road map for eventual European Union membership has been reflected in a decrease in the risk premium, a phenomenon also supported by a rare successful IMF stand-by programme.

The fruits of the success came sooner rather than later and Turkish banking and finance has attracted increasing interest from the global financial service providers through mergers and acquisitions. The heightened interest of global financial conglomerates in Turkish banks has taken the share of foreign participation to above 30% and the capital adequacy ratio to above 15%. Recently, the foreign participation rate has been increasing further and, as state-owned banks are being privatised as planned, the ratio is expected to increase to over 50%. Since 1920, there have been quite difficult times. However, with the current window of opportunity with favourable demographics arising from the young population structure, Turkish banking and finance seem ready for the future challenges of managing current account deficit financing, reversing the impact of dollarisation, breaking out of the trap of concentration on the domestic market under the increasing pressures of globalisation and bringing Turkey into the European Union.

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