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Turkey's Renaissance: From Banking Crisis to Economic Revival

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On the morning of February 19, 2001, Turkish Prime Minister Bülent Ecevit stormed out of a routine meeting of the National Security Council and declared to the news media 'a crisis at the very top of the state.' The Prime Minister's spat with President Ahmet Necdet Sezer at that meeting had nothing to do with economic policy. Nevertheless, it triggered a meltdown in Turkish financial markets. Investors had been on edge since the previous November, when increasing concerns about policy slippages had combined with fears for the creditworthiness of some local banks to spark a run on the crawling-peg exchange rate regime. That mini-crisis was contained, but market confidence remained fragile in the weeks that followed. Consequently, a spike in political tensions – hardly exceptional in the Turkish context – was sufficient to incite a rush for the exits by investors. For three days, the Central Bank (CBT) battled to defend the lira, as overnight interest rates soared to 4,500 percent. But, on February 22, the authorities conceded defeat and the lira was allowed to float, depreciating immediately by some 40 percent. The collapse in confidence, as banks began to default in the market for short-term funds, brought on the worst economic recession in the history of the republic, and required a comprehensive rescue package for the Turkish banking system, at a cost of some $47 billion – one-third of Turkey's national income.

Fast forward to April 2007. President Sezer's term had ended, a new government was in office, and their candidate to replace him was the foreign minister, Abdullah Gül. Secularists, including the military high command, feared that a Gül presidency would herald a rollback in Turkey's strict regulation of religious activity. Late on the night of April 27, the military issued a statement that was interpreted as threatening intervention if needed to protect the secular state. In view of Turkey's history with military coups, a political storm ensued. Although Mr Gül subsequently took office unimpeded, this was, by common consent, a far more serious political shock than Mr Ecevit's outburst six years earlier. Yet the markets took it in their stride. The stock market and the lira dipped briefly the following Monday, but quickly stabilized.

Why did market confidence collapse in 2001 but not in 2007? What had happened in the intervening six years to make the economy, and investor sentiment, so much more robust?

The answer is: a radical and wide-ranging transformation in Turkey's economic policies and institutions. This turnaround was launched by one government, sustained

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and broadened by its successor, and underpinned throughout by extensive IMF support, both financial and technical.

In this chapter, we outline briefly the origins of Turkey's economic weakness in the run-up to the 2001 crisis. We go on to describe the key elements of the post-crisis transformation, with a particular focus on the rescue and rehabilitation of the banking system. The latter was a critical component of the recovery program, and an area where IMF staff provided direct, hands-on support to their Turkish counterparts. We conclude with some observations on why the post-2001 reform effort, more than any of its predecessors, has succeeded and apparently taken root.

The legacy of the 1980s and 1990s

In the decades following World War II, the Turkish economy, like many of its peers in the developing world, was characterized by heavy regulation, protection from foreign competition, and extensive state involvement in commercial activity. Turkey's relatively poor growth performance and high inflation during this period convinced many that a new paradigm was needed, and a comprehensive reform program was launched under the government of Turgut Őzal in the early 1980s.

Growth responded strongly to the liberalization and opening up of the economy. But the impact of the reforms was ultimately undermined by poor financial discipline.[2] The fractious political environment played an important role. During the 1980s and 90s, Turkey had 15 governments, 10 of which were coalitions or minority governments. Agreeing on and sticking with the difficult policy choices that were needed, especially on the budget, proved to be impossible in this setting. The result was chronic budget deficits, financed in part by printing money, leading in turn to inflation in the 30–50 percent range throughout the 1980s, rising to an average of over 75 percent during the 1990s.

At the end of the 1990s, a steep recession and the trauma of the 1998 earthquake appeared to create a political opening for a more serious stabilization effort. Ecevit's coalition government put together a bold program, which the IMF backed under a Stand-By Arrangement approved in December 1999. The government of the day put great emphasis on the corrosive effects of inflation – both on equity and growth. High inflation had deterred long-term investment and stunted the development of Turkey's financial sector. The poor suffered most, especially those on fixed incomes and without access to inflation hedges. Since fiscal profligacy was clearly at the root of the inflation, strong up-front fiscal adjustment was the program's central element. A raft of structural reforms – covering pensions, agricultural subsidies, and privatization – was included to put the budget on a sound footing. To convince financial markets and the public that the value of their liras would no longer be inflated away, the central bank committed to a target path for the exchange rate. This would allow interest rates to come down quickly, which was seen as essential to facilitate the fiscal adjustment and support growth. Banking reforms completed the package: these were slated to reduce borrowing costs

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[2] Ashoka Mody and Martin Schindler, 'Economic Growth in Turkey, 1960–2000,' in *Turkey at the Crossroads: From Crisis Resolution to EU Accession*, Washington DC: International Monetary Fund, 2005.

and revive the economy, and they included plans to establish an independent bank regulator, tighten prudential regulations, and rehabilitate state-owned banks.

The 2000 program had a positive start: interest rates fell sharply and growth took off, exceeding expectations. But the recovery was unbalanced. Though inflation dropped, interest rates fell even faster. Demand surged, sucking in imports. Together with a 60 percent hike in world oil prices, this pushed the current account from near-balance to a deficit of almost 5 percent of GNP in 2000. Rapid credit expansion aggravated risks in the banking system, as short-term funds (some borrowed in foreign currency) were used to lend at longer maturities in lira.

The IMF urged the government to take budget measures to rein in demand, but the government hesitated, not wanting to stall the recovery. This inaction, together with widespread delays in the implementation of the structural reform agenda, growing concerns about bank soundness, and political uncertainties, created a 'perfect storm' that subverted market confidence.[3] With the collapse of the lira peg in February 2001, the economic program had to be recast.

Sowing the Seeds of Recovery: the Design of the 2001 Program

The immediate challenge in the aftermath of the February 2001 crisis was how to restore confidence. The government's first step was to create a new economic team, under Kemal Derviş, a senior World Bank staffer. Its task was to design a new economic program that would repair the wreckage in the banking system, stabilize the budget in the face of the huge costs of those repairs, and provide a new anchor for inflation to replace the exchange rate peg. The key elements were:

- Radical financial and operational restructuring of the state-owned and failed private banks, with capital infusions from the private sector into weak private banks and a further tightening of bank supervision.
- More ambitious budgetary targets, underpinned by new fiscal measures and improvements in the transparency of the budget accounts.
- A revitalized privatization program, covering the telecommunications, electricity, natural gas, sugar, and tobacco sectors.
- Statutory independence for the CBT, with a mandate to move toward formal inflation targeting.
- Incomes policies, including tight control of public sector pay and a more active role for government in influencing private pay settlements.

The program was to be underpinned by a beefed-up financial support package that would combine a restoration of credit lines from international banks with augmented

[3] Caroline Van Rijckeghem and Murat Űçer, *Chronicle of the Turkish Financial Crises of 2000–2001*, Istanbul: Boğaziçi University Press, 2005. Intensifying market worries about problems in the private banks played a particularly important role in the run-up to the November 2000 crisis. The media highlighted lurid stories of corruption and malpractice in several private banks during the fall of 2000. At the same time, analysts and bank creditors became increasingly nervous about banks' foreign currency exposures. Rumors regarding potential funding difficulties for one bank with large debts in the overnight market were regarded by many as the trigger for the market panic on 'Black Wednesday' (November 22).

official financing, notably from the IMF (which increased its $11 billion credit line by $8 billion), so as to begin rebuilding the CBT's depleted reserves.[4]

The reform of the banking system was at the heart of this program and is worth recounting in more depth.

The Outbreak of the Banking Crisis

The week of February 19, 2001 was devastating to Turkey's state banks. During that week, losses in the two largest state banks amounted to a massive $2.5 billion, or about 2 percent of GNP. This was the result of overnight interbank borrowing at stratospheric interest rates as banks sought to avoid default in the daily clearing. Some private banks also incurred losses, while others benefited from the rates the state banks were paying on overnight funds.

How did the state banks end up in this situation? For many years, the politicians had abused these banks, which had been 'allocated' to different political parties to provide subsidized credits to their political constituencies. The banks were not compensated for the losses from such lending but were instead forced to book them as claims on the government, as so called 'duty' losses. These claims generated little income and no cash flow, which meant that the banks had to fund themselves increasingly short term in the interbank market. As the liabilities grew they became more vulnerable to liquidity and interest rate risk. By the end of 2000, the state banks' duty losses had grown to some $19 billion, their short-term liabilities to some $22 billion and their foreign exchange exposure to $18 billion. Even a small shock could have toppled them – the massive shock that hit them in mid-February was truly catastrophic.[5]

Furthermore, the state banks did not have to provide reserves for bad loans, did not have to comply with prudential regulations applicable to private banks, and were not subject to any serious supervision. This allowed massive distortion in the banking system and became the subject of bitter complaints by private banks. Many private banks got their revenge in the crisis, however, as the huge losses of the state banks were mirrored in huge windfall profits for banks with excess liquidity. But such positive effects were not evenly distributed – many private banks were also severely hurt by the shocks of mid-February.

The calamity in the banking system was a rude wake-up call for the government, which realized that current bank practices could no longer continue. There was a need for fundamental financial and operational restructuring of the state banks and a

[4] IMF financing under the 1999–2000 program was initially set at a relatively modest $4 billion over three years. This had been boosted in December 2000 by an additional $7.5 billion in support of the government's efforts to contain the fallout from the November 2000 crisis.

[5] Although the 1999–2000 program included measures to address the duty losses problem, it assumed that the broader vulnerabilities in the banking system (state and private) could be tackled over time by tightening the regulatory framework. This was one of several areas where policy implementation slipped during 2000, and in the event, time was not on Turkey's side. When the crisis hit, the Central Bank of Turkey (CBT) had very limited room to maneuver, as any monetary tightening to limit the fall of the lira was bound to cause the state banks additional losses.

strengthening of the regulatory and supervisory framework under which all banks had operated.

Throughout the 1990s, banking supervision had been light and weak rules on asset valuation allowed banks to overstate their financial positions. Most private banks were owned by families, which used their banks as treasuries to companies owned by them. This was possible as connected lending rules were unusually lax. Most banks borrowed short-term in international markets and invested the funds long-term in loans to related parties or in government securities.[6] This made them extremely vulnerable to liquidity and market risks. By the late 1990s, eight banks had failed and been taken over by the Savings Deposit Insurance Fund (SDIF), which continued to operate them without corrective actions despite growing losses and distortions. There were no bank runs, however, as depositors and bank creditors were fully protected under a blanket state guarantee in effect since 1994.[7]

In mid-1999, a legal amendment called for the establishment of a new independent supervisory authority, the Banking Regulation and Supervision Agency (BRSA). Until then banking supervision had been split between the CBT (off-site) and the Treasury (on-site). The start-up of the new agency was much delayed, however, owing to political disputes over the appointments of the board and Chairman, and it did not become operational until September 2000, following intense pressure from the IMF and World Bank. During this period, banks were without effective supervision and there were no efforts to resolve the 'intervened' banks (that is, banks that had failed and been taken under SDIF stewardship).

IMF Involvement in Turkey's Banking Reforms

Since 1999, there had been several missions from the IMF's Monetary and Exchange Affairs Department (MAE) to provide technical assistance to the authorities on how to deal with the state-owned and intervened banks, and strengthen the regulatory and supervisory framework. In late 2000, market analysts perceived the reform process to be lagging, as BRSA struggled to identify its role and responsibilities.

Most of the issues to be addressed in the banking sector were not new to IMF staff members, who had dealt with a number of banking crises in the late 1990s in Asia and elsewhere. Since the mid-1990s, MAE had systematically built up its knowledge of such crises and their resolution by drawing on banking-crisis experiences in Latin America and the Nordic countries. A number of experienced senior supervisors were hired, and several policy papers on banking crises and bank restructuring were prepared for the IMF Executive Board during this period.[8]

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[6] Connected lending or lending to related parties occurs when a bank lends to its own shareholders or managers, including entities controlled by them or their family members.

[7] Contrary to the IMF-backed program, this guarantee was lifted by the government in June 2000 but was reintroduced in December 2000 after the failure of Demir Bank, when some smaller banks faced liquidity withdrawals.

[8] See, for instance: William E. Alexander, Jeffery M. Davis, Liam P. Ebrill and Carl-Johan Lindgren, *Systemic Bank Restructuring and Macroeconomic Policy*, International Monetary Fund, 1997; David Folkerts-Landau and Carl-Johan Lindgren, *Toward a Framework for Financial Stability*, International

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Prior to the crisis, the Turkish authorities had been reluctant to acknowledge the extent of reforms that were needed. Their policies at this time were also poorly communicated, and with various agencies involved, accountability was unclear. When the new government team took charge after the crisis, the dynamics changed – the restructuring process picked up speed and was implemented with determination and skill.[9]

On February 24, a few days after the crisis had erupted, an MAE mission arrived in Ankara to work closely with the Turkish authorities and IMF European Department colleagues in developing the banking sector reforms that would form part of a new IMF-backed program. The mission stayed in Turkey for almost a month. Their stay coincided with a major religious holiday, and Ankara was more or less closed down for several days, during which the mission members were the sole guests at the Sheraton hotel. The senior Treasury, Central Bank, and BRSA staff stayed at their posts, however, and the work proceeded with a spirit of great cooperation and determination. A central role was played by the new BRSA Chairman, Engin Akçakoca, and his deputy, Teoman Kerman.[10] By late March, agreement was reached on almost all aspects of the banking sector reform program.[11]

The Bank Restructuring Strategy

Restoring confidence in the banking system and credibility to economic management was the top priority. It was clear that financial stability, monetary control and a lowering of interest rates would not be possible unless the banking problems were credibly addressed. The banking sector reforms, therefore, became the central focus of the program. Turkey learned the hard way that macroeconomic stability and economic growth requires a sound banking system. The immediate focus was on the restructuring of state banks, starting the resolution of the intervened banks and putting pressure on private bank owners to recapitalize their banks. Measures to strengthen the legal and regulatory environment were also included. Policies in support of corporate debt restructuring and asset recovery were to be addressed at a later stage.

Monetary Fund 1998; Carl-Johan Lindgren, et al., *Financial Sector Crisis and Restructuring: Lessons from Asia*, IMF Occasional Paper 188, International Monetary Fund, 1999.

[9] In addition to Kemal Derviş as State Minister for Economic Affairs, the team appointed in the aftermath of the crisis comprised Sureyya Serdengeçti as Governor of the Central Bank of Turkey, Faik Öztrak as Secretary of the Treasury and Engin Akçakoca as Chairman of the BRSA.

[10] Before his appointment, Engin Akçakoca had been the General Manager of a medium-sized private bank owned by one of Turkey's most prominent business groups.

[11] The mission had also closely coordinated its work with a financial sector mission from the World Bank.

Reform of the state banks had become the highest priority.[12] A massive recapitalization was called for. The only credible option was to use transferable government securities issued on market terms, so that the banks would not face renewed losses and liquidity problems. In total, the government injected $19 billion in floating rate notes (in lira and foreign currency) thus making it possible for the state banks to fully eliminate their exposures in foreign currency and to repay their overnight money market debt. This meant that the rollover problem was shifted to the CBT, which was in a position to provide liquidity to the banks through more traditional monetary policy instruments. Based on an aggressive valuation of the banks' assets, the government injected an additional $2.9 billion in government securities to raise the capital adequacy ratios of the two large state banks, Ziraat and Halk, above the required minimum of 8 percent. In addition, the state banks became subject to all BRSA regulations applicable to private banks.

In the operational restructuring, the banks' links to line ministers were cut.[13] Instead, an independent and highly professional joint board was appointed for Ziraat and Halk. It would set uniform deposit rates for the state banks, in consultation with the CBT, and these rates were to be kept below market rates for treasury securities to ensure profitability. Moreover, the staffing and organizational structure of Ziraat and Halk were to be streamlined to reduce operating costs. In less than two years, one-third (829) of all branches were closed and the number of employees was reduced by one-half (30,000).

The resolution of intervened banks was tricky, given conditions in the banking market. It was difficult to liquidate good assets, let alone problematic ones. Up to that point, SDIF had taken over 13 banks and the expectation was that three of them could be sold, while the rest would have to be closed and liquidated. The key question was how to build up managerial skills within SDIF to maximize loan recoveries and minimize the fiscal cost.

While the financial condition of some of the larger private banks had strengthened during the crisis, many other private banks had experienced substantial losses from the high interest rates and the depreciation of the lira. With strict application of loan classification and provisioning rules introduced one year earlier, the level of nonperforming loans was expected to increase sharply for all banks. BRSA agreed to hold individual meetings with all banks to discuss their capital positions with the understanding that banks judged to be undercapitalized would be required to present time-bound plans to raise additional capital. All banks had to suspend dividend payments.

In the legal area, the discussion focused on a strengthening of prudential regulations, especially for connected lending and lending to related parties. Agreement was reached on a regulation that would gradually reduce the limits from 70 percent to

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[12] There were four state banks: the large Ziraat and Halk and the smaller Vakif and Emlak. Emlak was merged into Ziraat. Vakif, whose legal owners were various foundations (but *de facto* state-controlled) was supposed to be quickly privatized but as of mid-2008 only 25 percent of its shares have been sold to private investors.

[13] Ziraat, for instance, which was created with a mandate to finance the agricultural sector, had previously been under the authority of the Minister of Agriculture.

the EU-compatible level of 25 percent of own funds by 2006. Accounting standards would be brought in line with international standards from the beginning of 2002 and the legal framework to facilitate corporate restructuring was to be reviewed.

Public Support Scheme

As part of the initial strategy, all undercapitalized banks were required to submit detailed and time-bound plans on how they would raise additional capital by end-2001. The fact that many bank owners had unlimited personal liability under the law for losses in their banks resulting from connected lending was a strong incentive for them to inject needed capital. In total about $1.1 billion was raised. Six banks failed to raise capital and were taken over by SDIF. The persistently high interest rates continued to cause concerns about the financial conditions of banks, however, and there were market rumors that banks still overvalued their assets and would not be able to raise more capital, if faced with additional losses. To remove damaging uncertainties and protect the core banking system, agreement was reached on a support scheme that would make public funds available to help banks that could not raise new capital on their own. This type of scheme had been used successfully in Thailand in 1998.

No effort was spared to make sure that banks' capital needs were assessed correctly. This required a methodology that would spell out in great detail how asset values should be determined and potential losses identified. The assessment had to be fair, equally applied to all banks and transparent. Introduction of the scheme required a special law that took weeks to develop, given its complexity. Considerable effort was made to explain the exercise to the banking industry, public, and politicians. On the advice of the MAE mission, a team of experienced outside consultants, headed by Mark Carawan – partner in a major consulting firm and with experience from Asia and Sweden – was hired to develop the asset valuation methodology in close cooperation with BRSA staff.[14] The team produced a detailed reporting system (some 100 pages long). Banks' external auditors were required to confirm in writing that the data reported by the bank was correct. This was followed up by a second team of independent auditors, who were to confirm that the bank had followed the methodology prescribed by BRSA. Finally, BRSA's examiners were to sign off on the assessment. This process was essential to help BRSA face powerful bankers with close political connections. The exercise was initiated in June 2002 and completed two months later.

Under the scheme, banks that could not raise capital on their own would have access to public funds if several stringent conditions were met, including: (i) such support should be viewed as a last resort; (ii) existing shareholders or new private investors had to match the public contribution; (iii) there would be no bail-out of existing shareholders; (iv) the bank had to have a positive net worth; (v) the government had the right to appoint at least one board member; and (vi) existing shareholders were required to pledge as collateral to the government shares held in the bank equal to the government's contribution. As it turned out no private bank needed capital assistance

[14] Immediate technical assistance was crucial for the success of the scheme. BRSA faced rigid procurement procedures, and so MAE agreed to finance it. Later, a cost sharing formula was worked out with BRSA.

from SDIF.[15] The owners of one large bank, Pamuk, could not raise the $2 billion needed to enter the scheme and that bank was intervened. The incentives built into the scheme for shareholders to invest their own resources rather than to give the SDIF a role in managing their bank had the desired effect.[16] The exercise was a great success and very professionally managed by BRSA.

Confidence in the private banking system was restored and there have been no further bank failures – with one major exception. There was a highly embarrassing bank failure in 2003, when a relatively small family owned bank, Imar, became illiquid owing to massive deposit withdrawals. When BRSA examiners went into the bank they found that most accounting records had disappeared and that deposit liabilities were ten times higher than officially reported due to an elaborate parallel banking operation. For over 10 years, data had been manipulated through a sophisticated computer program. There had been suspicions surrounding the bank – prompting external audits, regular supervisory inspections by the sworn bank auditors,[17] and investigations by the Treasury and even by a parliamentary committee – but no wrongdoing had been found. The episode illustrated how a truly sophisticated fraud can escape detection for years. Once it was discovered, it was felt that depositors had to be paid in full, at an initial cost to SDIF of more than $6 billion. The happy ending to the story is that the SDIF was able to recover the full amount by confiscating and liquidating assets of the bank's owning family.

A Successful Outcome

Following their recapitalization and downsizing under new professional management, the state banks immediately became highly profitable, which allowed them to pay hefty dividends to the Treasury. Ziraat accumulated so much surplus capital that it was able to pay the government a special dividend of $2 billion. The intervened Pamuk was successfully merged into Halk, 25 percent of which was privatized in 2007 for $1.8 billion, indicating a total market value close to $10 billion. Market analysts believe Ziraat's market value to be substantially higher. There is thus a realistic prospect that, once these banks are fully privatized, the government may more than recoup the funds it has had to inject to rehabilitate them. Considering that, in early 2001, the value of these banks was close to zero, this is a measure of the reform's success.

The private banking system's profitability also improved significantly following completion of their restructuring and recapitalization. Further mergers and consolidation followed, including the absorption of some of the banks taken over by SDIF. The passage of a new banking law has brought regulations and supervisory practices fully in line with international best practice. A sign of the confidence shown in the banks is that

[15] Only the foundation-owned Vakif required a $137 million capital injection under the scheme.

[16] A similar scheme had been used in Thailand with the same outcome, that is, shareholders preferred to invest their own money rather than to have the government participating in running their bank.

[17] At the time, the law gave sworn bank auditors exclusive right to conduct on-site inspection of banks. This right was later removed, giving the BRSA more flexibility in the composition of on-site inspection teams.

foreign investors have increased their stake in the Turkish banking system from 6 percent in 2001 to nearly 50 percent today.

The Economic Recovery

The economy turned around remarkably quickly as the program restored confidence. Industrial production began rising in late 2001, and the first half of 2002 saw the recovery in output gathering strength, combined with a 30 percentage point drop in inflation. Business confidence surged into positive territory, and – after a sharp drop in the wake of the September 11 events – the stock market took off.

Six years on, no-one familiar with the history of the preceding decades could fail to be impressed by the fundamental transformation that has been achieved:

The public finances have been put on a sound footing for the long term: The cumulative impact of fiscal profligacy during the 1990s, together with the massive financial costs of the ensuing crisis and the devaluation of the lira, pushed total government debt to over 100 percent of GNP in 2001. Since then, sustained fiscal adjustment has brought the budget into approximate balance and, with some help from an appreciating real exchange rate, has slashed the debt burden by almost half. Turkey's government is justifiably proud that its fiscal position now meets the European Union's Maastricht criteria, a distinction not yet shared by some EU member states. The funding of its debt has also improved: the government can now borrow on longer maturities and lower spreads, and has reduced its reliance on riskier foreign currency debt. As the cost of debt servicing continues to decline in coming years, this will make room for much needed tax cuts and infrastructure investments. The recent passage of social security reform legislation, which was essential to address widening deficits in the health and pension systems, will give additional support to the long-run fiscal consolidation effort.

Inflation has been tamed: In the 20 years leading up to the 2001 crisis, the lira had on average lost half of its US dollar value every nine months. Inflation had been in the double or even triple digits for 35 years. This erosion of the currency stunted the growth of Turkey's financial sector and held back economic development more generally. It also hit hardest the poorest members of society, such as pensioners on fixed incomes and those less able to use foreign currency or other inflation-proof assets to protect their savings. Not surprisingly, therefore, Turks generally acknowledge the success in bringing inflation down – it has been in the single digits since 2004 – as one of the government's foremost achievements.[18] The newly independent central bank was instrumental in delivering this outcome. They quite quickly built a reputation for competence and strong inflation-fighting credentials, meeting every one of their inflation targets from 2002–05. In so doing, they had to stand fast against considerable public pressure, playing an important advocacy role in favor of monetary discipline, and adherence to the stabilization program more broadly. But their efforts would not have paid off without a strongly supportive fiscal policy, and hence they and the government have shared the credit for defeating inflation.

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[18] A telling indicator of this restored confidence has been a marked shift by depositors since 2002 from foreign currency back into lira bank deposits.

The banking system is now helping propel development and broaden access to credit: During the 1980s and 90s, the government's voracious borrowing had absorbed the lion's share of available credit in the economy, leaving little for the private sector. High and unstable inflation, combined with restrictions on making floating rate loans to consumers, also discouraged banks from lending except on very short maturities. This picture has changed dramatically over the past five years. The decline in government borrowing, inflation, and real interest rates, together with wholesale reforms and capital infusions in the banking system, had allowed banks to double their lending to the private sector as a share of (rapidly growing) national income, compared to the 1990s. Lending to households, whose access to credit was almost non-existent in the early 1990s, has expanded at an even faster pace. The stock of housing loans, which stood at a mere 0.2 percent of GNP as recently as 2003, grew by a factor of 20 in real terms in the three years that followed. Such a rapid transformation entails risks that need to be carefully managed, but the changes were long overdue and a necessary step in Turkey's economic development.

The modernization of the economy has accelerated: At the end of the 1980s, almost half Turkey's workforce was still employed in agriculture, while the services sector accounted for less than one-third of total employment. By 2006, these ratios had been reversed. The exodus from the rural economy to the more dynamic industrial and services sectors has gathered pace in the present decade, contributing to a surge in economy-wide productivity. Real per capita incomes increased by more than one third in the five years following the crisis, and continue to grow. The factors driving this structural transformation are many and complex, but the creation of a more market-friendly environment, with stable financial conditions, has undoubtedly played an important part. The declining involvement of the state in commercial activity is another hallmark of a modernizing economy, reflecting the hugely successful privatization program of recent years. These reforms helped draw in more than $50 billion in foreign direct investment during 2004–07, more than double the total inflows of the preceding 20 years.

Notwithstanding the enormous strides that have been made, Turkey still faces significant economic challenges. These will need to be handled adroitly if the economic resurgence is to be sustained. In particular, among emerging market economies, Turkey's exposure to global financial shocks remains relatively high. It relies on foreign investors to finance its large current account deficit, its foreign exchange reserve position is less strong than many of its peers, and its public debt burden is still comparatively large. Fiscal and financial consolidation will therefore need to continue in the years ahead. Persistently high unemployment is another vulnerability, albeit of a different kind. While its causes are unquestionably structural in nature, structural remedies to facilitate faster job creation may prove politically difficult, and governments will need to resist pressures to resort to expansionary fiscal measures as a palliative.

Conclusion

Turkey had launched numerous reform efforts prior to 2001, many of them backed by the IMF, but all eventually foundered. What was different this time that allowed the reforms to be sustained? Two factors, in combination, appear to have been decisive: political determination and a favorable global environment.

The Ecevit government's options were limited in 2001, but the government nevertheless deserves credit for taking courageous decisions, for which it paid a price in the 2002 elections. Those elections then brought to power a new party with a market-friendly philosophy and a pragmatic bent. The AK (or Justice and Development) Party derives part of its core support from the small-business sector in Turkey's heartland and came viscerally predisposed to budget discipline, low inflation, and privatization. The party therefore had little difficulty in embracing and building upon the reforms that were underway. Moreover, it was in a strong position to follow through: it was the first government in more than a decade to rule as a single party, with a strong majority in parliament. Its dominance proved to be less complete than it initially appeared, as the opposition found ways to delay reforms through presidential vetoes and court challenges. But the party's parliamentary majority contributed to greater policy coherence and consistency than Turkey had seen in many years.

Investor confidence received a further boost as the new government declared its intent to push ahead with the long-delayed EU membership process. Though the government's motives were as much political as economic, investors viewed the EU accession process as helping to anchor economic reforms for the medium term – including beyond the life of the IMF-backed program. This not only underpinned the continued inflows of foreign capital that were needed to sustain the recovery but also helped shift the composition of those flows toward longer-term strategic investments.

Positive economic and political changes in Turkey coincided fortuitously with an increasingly favorable global investment climate. Having slumped following the Asian and Russian financial crises, net private capital flows to emerging market and developing countries took off in 2002; by 2005, they were running at almost 2 ½ times the level seen during the 1990s. As a result, borrowing costs dropped for emerging markets in general, including Turkey, and equity markets boomed. The sizeable current account deficits that came along with the growth resurgence, and which might have threatened the sustainability of the recovery, thus proved to be readily financed.

The IMF's contribution to the successful outcome is widely acknowledged in Turkey, and by international investors. Are there lessons we can draw from the experience? We would highlight three main ones.

First, the health of the banking system is vitally important. Transparent recognition of losses is essential, followed up if necessary by substantial fiscal support to restore solvency and confidence. Financial and operational weaknesses in banks have to be addressed up front and quickly: gradualism is very risky. Properly designed reforms minimize economic and financial losses and help restore momentum for economic growth.

Second, while fiscal retrenchment in the midst of a crisis may not be optimal in all cases, if there is a need to restore government solvency, bold measures – far from being contractionary – can actually help speed economic recovery by boosting confidence.

Third, like an increasing number of its peers, Turkey has found that central-bank independence, coupled with explicit inflation targets and a coherent fiscal policy, can be very effective in overcoming entrenched expectations of high inflation.

Important as these technical aspects are, however, good policy design counts for nothing without the strong political will to implement it. In this respect, Turkey has been

fortunate in recent years in having leaders who recognized what needed to be done and who acted accordingly. Thanks to their efforts, the country now faces a brighter economic future than at any previous time in its modern history.

Turkey's Renaissance: From Banking Crisis to Economic Revival
Comment by Süreyya Serdengeçti[19]

This paper describes how an economy finally awakened from a coma that resulted from a chronic illness that lasted 30 years. Given the obvious difficulty of telling the whole story in less than twenty pages, the authors chose to concentrate on the banking reform, while mentioning rather briefly other areas such as fiscal policy, monetary policy, or institutional reforms such as central bank independence. In the following comment, I will look at the story from the perspective of a career central banker.

The year 2001 was the turning point when a financial crisis, the last and the deepest of the many crises that had occurred previously, turned into a big opportunity. The Central Bank of Turkey was given its independence from political influence after 30 years of chronic inflation, and of denial of dismal economic reality or hesitation to confront it on the part of successive Turkish parliaments and governments. This marked the end of a long period in which the political system had tried to finance chronic fiscal imbalances through inflation and, when that was not bad enough, through incurring excessive public debt and misusing public sector banks. Throughout this period, the widespread – if mistaken – belief in Turkish political and business circles was that, however bad inflation might be, it was the reason the economy was able to grow.

Economic instability brought political instability, which led to more economic instability. All elections were held early and the governments that called the elections lost votes, if not the elections. The electorate, given election year promises that were soon forgotten by policymakers or proved unrealistic, was tired of the economic instability and simply responded on every occasion by voting for the opposition.

All the efforts to stop this vicious circle of instability were unsuccessful. I remember the Central Bank's insistence in the early 1990s on the importance of controlling the growth of monetary aggregates in order to reduce inflation, or the warnings by Treasury officials of the growing unsustainability of public debt.

Similarly, in the case of the banking system, numerous mistakes were made and warnings disregarded:

- Turkey had the worst possible model of banking supervision and regulation; the Central Bank's off-site authority and the Treasury's on-site supervisory authority were weakened by the real authority on the banking system, which was the minister in charge of the Treasury. Virtually all decisions, whether they were implemented or not, were politically motivated. One example was the practice of granting licenses to newcomers, which increased the number of banks to more than eighty. This was at a time when many analysts complained that the balance sheets of all these banks combined did not add up to the balance sheet of one large German bank.

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- The efforts to transform this outmoded supervisory and regulatory framework into a modern one went back to 1997. Unfortunately, the establishment of an independent authority had been delayed not only by disagreements over personnel appointments, but more importantly by the lack of political will to delegate authority to an independent professional institution.
- The privatization of public sector banks was constantly delayed. This issue was publicly discussed in the early 1980s. At the time, no country behind the Iron Curtain had considered privatization. Ironically, today almost no public sector banks are left in Eastern European countries, whereas Turkey has yet to privatize its public sector banks.
- The untimely opening up of the capital account and lifting of exchange controls in 1989, despite the opposition of the bureaucracy, led the Turkish banking system to simply borrow from abroad and invest in high-yielding public debt, without adequate regard to exchange and interest rate risks, or to maturity mismatches.
- Last but not least, a 'clever' decision, which had been taken in April 1994 during one of the financial crises, proved to be fatal. The decision was to grant full government guarantees to all bank deposits without upper limit in order to stop a run on bank deposits. The decision was successful in ending a panic, yet it was not sustainable. Unfortunately, in September 1994, the government rejected, it seems, a proposal that deposit guarantees should return to normal and more limited levels, as the maintenance of unlimited guarantees would lead to deepening moral hazard. Not adopting this proposal became a fatal weakness and helped pave the way to the 2001 crisis.

Turning to the economy in general before 2001, an important development took place in 1999. Economic growth was falling due to the negative effects on the Turkish economy from the Russian and Brazilian financial crises, due to political instability after a banking scandal, and due to the effects of the devastating earthquake of August that year.

Politicians were finally persuaded that they had to agree to stabilize the economy. Otherwise they would suffer the consequences not only of even lower growth but also of risking default on the public debt.

This led to the 2000 economic stabilization program supported by the IMF. The program diagnosed price and financial instabilities and fiscal imbalances as the three main issues. It attempted to address them through an exchange-rate-based stabilization approach that would enable two developments. First, incentives for capital inflows and a low-interest-rate environment would be created, which would be crucial for improving the sustainability of public debt ; and, second, disinflation would be encouraged, given the strong exchange rate passthrough effect and inflation inertia that had become the primary determinants of inflation in Turkey in the 1990s.

At the start, foreign capital flew in and interest rates came down to levels that had not been seen for almost 15 years. By the end of August 2000, however, a variety of problems developed and intensified. Interest rates, no longer under the control of the Central Bank – itself under the 'quasi currency board' rule – started to increase, albeit slowly. Much publicized debates on structural reforms between the IMF and the government took place in September concerning the reform of public sector banks and incomes policy and created uncertainty. The government was reluctant to tighten fiscal policy despite a deteriorating external current account and the

increasingly cloudy environment in international capital markets as Argentina seemed to be heading towards a financial crisis. Many banks were overleveraged and had large open positions in foreign exchange, while the newly independent supervisory authority, after years of delay, had only just become operational. These developments coincided with a political crisis and led to two rounds of speculative attacks on the currency and on weaker banks, in November 2000 and February 2001.

The stabilization program failed, and the currency was devalued and left to float.

As the country found itself in its worst economic crisis, the opportunity for an independent central bank finally emerged. In a floating exchange rate environment, the Central Bank immediately declared that there was nowhere else to go but to adopt a monetary policy of inflation targeting, which would be effective in time as conditions allowed. The Central Bank also adopted a very transparent communications policy to honestly show its determination to fight inflation and affect inflationary expectations, as the only way to reduce inflation.

The new stabilization program – the 2001 program – was announced in May 2001, together with the independence of the Central Bank that had been granted by the parliament. The aims of the 2001 program again were price stability, financial stability, and the restoration of fiscal balances so as to ensure debt sustainability.

The tremendous efforts to revitalize and reform the banking system have been explained in detail in the paper. But two important points must be highlighted, since they mark the beginning of the painful process of banking reform:

- First, the operations of the public sector banks, under which the Treasury issued government debt securities to cover the public banks' losses and also intervened in the banks' negative capital balances, were followed by the Central Bank making an outright purchase of the debt securities issued by the Treasury, amounting to 14 billion New Turkish Liras (TRY). Moreover, the Central Bank provided these banks with a TRY 7 billion repo facility with short maturities. So, the amount of liquidity provided to these banks by the Central Bank reached TRY 21 billion which is roughly the equivalent of $18.5 billion at April 2001 exchange rates. The Central Bank avoided hyperinflation by mopping up a substantial amount of liquidity from this bank restructuring operation in a record time.
- Second, the debt-swap operations of the Treasury, which were aimed at reducing the rollover risk of government debt and facilitate a decline in interest rates on the one hand, and helping banks close their large open foreign exchange position on the other. This operation involved the exchange of TRY 9.3 billion worth of domestic T-bills and longer-dated fixed and floating rate T-bonds for a package of US dollar-indexed bonds and shorter T-bonds. The swap reduced the banks' foreign-exchange open position significantly.

From the very beginning, the 2001 program was under constant fire from some political and business circles and also from the media. Those in charge of it, from the Minister for Economic Affairs, Kemal Derviş, to institutions like the Central Bank and the Treasury, as well as the IMF and the World Bank, were under growing political and market pressure as it became evident that this time the stabilization program was determined to reach its aims. In fact, the program started to deliver positive results as early as 2002 and in the years that followed went on to become a most successful one.

Inflation came down to single digits in 2004 after 34 years of high inflation. Inflation targets were reached for four consecutive years; the public debt to GDP ratio was more than halved between 2001 and 2007; and expected real interest rates, as high as 30 percent in early 2002, came down to 8 percent by early 2006. A currency reform – dropping six zeros off currency denominations – was successfully carried out in 2004 and 2005.

Despite the appreciation of the lira, Turkey improved its international competitiveness and the share of the country's exports in total world exports rose sharply. Meanwhile, the deterioration of trade and current account balances was accompanied by a change in the composition of the capital inflows, from one dominated by hot money inflows from 1989 to 2004, to one dominated by medium- and long-term inflows and foreign direct investment inflows thereafter.

As for the banking system, capital adequacy improved considerably, while the number of banks diminished to about half of their number in 2001. An injection of foreign capital was instrumental in the system's improving health.

The program's biggest success has been in the area of economic growth. From a 4 percent annual average growth rate during the chronic inflation period of 1970–2001, a level lower than in many other emerging market countries, the growth rate rose to an annual average of 7.2 percent from 2002 to 2006.

It's no wonder, as the paper's authors say, that adverse political developments in 2007 didn't have the same devastating effect on the economy as was the case in 2001.

I wish to conclude my comment by saying that the IMF played a vital role in the recovery of the Turkish economy by collaborating with and supporting the stabilization efforts of successive governments, the Treasury, the Central Bank, and other institutions. This collaboration and support came not only from teams in charge of the stabilization program, but also from special teams that worked with the authorities in diverse areas such as helping to implement the inflation-targeting policy of the Central Bank and the currency reform.