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Economic Development in Turkey Stabilizes – Banking Sector Reforms Make Progress

Alfred Steinherr and Joachim Volz

The year 2004 saw Turkey take a big step forward to the European Union, as international investors also believe, and in December last year the European Council opened up real prospects of entry for Turkey for the first time. Agreement was also reached with the International Monetary Fund (IMF) on further support, chiefly to secure the servicing of public debt in the next few years. The consequences of the serious financial crisis in 2001 now seem to be largely overcome, although the inflation rate is still too high – currently at around 9%. However, it is believed that Turkey may well fulfil the Maastricht criteria for public budgets in the next two years. According to the latest figures economic growth was around 9% last year, and strong growth is expected this year as well.

This analysis takes a closer look at some of the important aspects of Turkey's economic development in recent years and the state of the reforms already carried out, particularly in the banking sector.¹ It shows that the Turkish economy is developing very satisfactorily – compared with the development in the most recent new EU member states as well, so at least in the economic perspective Turkey's aim of coming close to EU membership in the medium term does not appear to be unrealistic.

The macroeconomic background

Faced with permanent problems in foreign trade and payments the Turkish Government endeavoured as early as the 1970s and 1980s to liberalize foreign trade and make the country more competitive in order to initiate more export-oriented growth. However, despite the rapid reduction in trade restrictions (customs duties, import quotas) and the introduction of convertibility the inflow of foreign capital remained low. High deficits in the public budgets, inflexibility in the economy under the powerful influence of the

¹ The information on the Turkish banking system is chiefly based on a study by Alfred Steinherr, Ali Tukel and Muret Ucer: 'The Turkish Banking Sector', *EU-Turkey Working Papers*, no. 4, Centre for European Policy Studies, Brussels, August 2004.

Table 1

Key Data on the Economic Development in Turkey 1995 to 2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross domestic product (year-on-year change in %)	7.2	6.9	7.5	3.1	-4.7	7.4	-7.5	7.9	5.8	9.8	6.4
Private consumption	4.8	8.5	8.4	0.6	-2.6	6.2	-9.2	2.0	6.7	9.2	4.5
Public consumption	7.2	8.1	5.0	7.1	6.7	7.3	-8.7	5.3	-2.0	2.2	2.8
Fixed-asset investment	8.9	14.2	14.7	-3.7	-15.7	16.8	-31.5	-1.3	10.2	39.9	10.2
Exports	8.0	22.1	19.2	12.0	-7.1	19.1	7.4	11.2	16.0	14.5	13.9
Imports	29.4	20.8	22.3	2.3	-3.6	25.3	-24.8	16.0	26.8	27.0	12.1
Balance on current account (in % of nominal GDP)	-1.6	-1.3	-1.3	1.2	-1.0	-4.9	2.5	-0.8	-2.9	-5.2	-4.5
State revenue balance (as % of GDP)	-4.1	-8.4	-8.2	-7.9	-10.1	-10.3	-15.7	-14.4	-11.4	-7.6	-5.9
State indebtedness (as % of nominal GDP)	40.8	49.7	48.0	48.2	49.5	93.7	85.8	82.8	74.8	70.4	76.8
Unemployment rate (%)	7.5	6.5	6.7	6.7	7.5	6.3	8.2	10.1	10.3	9.5	10.0
Consumer prices (year-on-year change in %)	89.1	80.4	85.7	84.6	64.9	54.9	54.4	45.0	25.3	10.7	8.6
Short-term interest rates (%)	-	-	-	-	-	38.9	92.4	59.5	38.5	22.5	14.7
Long-term interest rates (%)	-	-	-	-	-	37.7	99.6	63.5	44.1	24.2	16.5
Exchange rate (lira to US dollar)	45 738	81 281	151 595	260 473	418 984	624 325	1 228 269	1 512 342	1 502 542	1 437 340	1 526 498

Sources: OECD; Deutsche Bank Research.

public sector, rising unemployment and persistently high inflation, with consumer prices rising by around 70%, characterized the economic situation in Turkey towards the end of the 1990s.

So from spring 1999 the Government endeavoured, with financial support from the IMF, to reduce the inflation rate quickly, restructure the public enterprise sector and reorganize the public budgets. But the reform measures were only half-hearted and they were not generally accepted, so distrust of the Turkish currency rose again rapidly, and despite exorbitant increases in interest rates the exchange rate had to be floated in February 2001.

The ensuing second round of reforms proved more successful. First the current account showed a favorable development, then the reforms in the public sector made rapid progress and the establishment of an independent central bank strengthened confidence in the seriousness and durability of the economic policy efforts. A contributing factor was the aim to reach social consensus to tie prices and wage policy more strongly into the macroeconomic development. One difficulty was the inability to achieve a current account surplus over a continuous period – mainly owing to the persistent high deficits on

trade in goods. The central and eastern European countries became more interesting to foreign direct investors than Turkey, as their attraction grew with the extensive economic reforms after their political change, and with their prospects of soon joining the EU. Turkey's relatively poor performance was probably due to both the hesitant privatization and its confusing and unreliable bureaucracy.²

From crisis to effective reforms

The economic situation in Turkey has now stabilized and normalized (cf. table 1). It proved possible to bring the inflation rate back into single figures in the course of last year – to 9.3%, the lowest for nearly thirty years. The price formation mechanisms have become more

² On the economic development in Turkey up to the early 1990s see also the studies by Siegfried Schultz: 'Türkei: Stärkung der aussenwirtschaftlichen Flanke erforderlich', in: *Wochenbericht des DIW Berlin*, no. 5/2002, and 'Turkey's Accession to the EU: Economic Criteria Still Out of Reach', in: *DIW Berlin Economic Bulletin*, vol. 40, no. 7, July 2003.

flexible, although high subsidies are still being paid for social reasons, on energy prices, for example. Major areas, especially agriculture, telecommunications and energy, have already been clearly deregulated, and this has brought considerable savings in state expenditure, which in turn has improved the balances on the public budgets.

The problems for regional policy, which are manifest chiefly in the big economic gap to the east and southeast of the country, have not yet been solved. The EU is giving financial assistance to the amount of several hundred million euros a year, but Turkey still lacks the corresponding development concepts, nor can it make the national contributions that are necessary.

The state of banking reform

A banking system that was inefficient and risk-prone was the reason why the first stabilization programme had to be terminated at the end of 1999 with new impositions by the IMF. Both the difficulties of stabilizing the currency and the mismatch of maturities, particularly for the liquidity of the banking system, made the Turkish economy more vulnerable to crises, especially as international financial flows were reoriented worldwide after the boom of 2000 and the ensuing period of weakness and crises. The central bank's efforts at inflation targeting were bound to fail in view of the problems in the banking sector. However, it was hardly possible to develop a sound banking system with the high level of public debt and inflation.

So getting the inflation rate down was also essential to reform and stabilize the banking system. What is the present state of reform?

The situation in the late 1990s was characterized mainly by soft budget restrictions – an attitude of 'live and let live'. The Treasury was the biggest borrower and the banks were the main lenders. With a chronic lack of equity capital they funded chiefly abroad. The share of domestic private bonds in relation to the gross national product actually declined further in the second half of the 1990s, falling to less than 20% in 2001 and 2002.

The IMF programme of 1999 was therefore also designed to strengthen the banks' equity capital base. An ambitious programme to restructure the Turkish banking system was launched, with the aim of increasing yields and utilizing these to improve the banks' capital. To secure the reforms externally not only were IMF loans granted, the currency was also to be stabilized flexibly, with possible shocks cushioned. So for up to 18 months a wider fluctuation margin was allowed. The

Table 2

Costs of the Crisis in the Turkish Banking System

	In billion US dollars	As % of GDP
Costs to the Treasury	43.7	29.5
Restructuring the state banks	21.9	14.8
Costs of including private banks in the Savings and Deposits Insurance Fund	21.8	14.7
Costs to the private sector	9.5	6.4
Costs borne by the Savings and Deposits Insurance Fund	6.7	4.5
Supplementary equity paid by shareholders	2.8	1.9
Total	53.2	35.9

Sources: BRSA: Efforts to Strengthen the TBS after the IMAR Bank Episode, Report by Ercan Turckan, Ankara, October 2003, quoted from Alfred Steinherr et al., loc. cit., p. 5.

main item in the reforms themselves was the creation of an independent agency to regulate and supervise the banks.

However, owing to the poor development in the economy as a whole this first set of reforms did not prove successful. On the contrary, a massive injection of public funds, amounting to around 35% of the 2001 GDP, had to be given to consolidate the banking system (cf. table 2). The Turkish banking crisis was thus one of the most expensive in recent history. But it did result in consolidation of the banking sector, which emerged from the crisis with modern structures that meet international standards.

The chief measures were to restructure the state banks and sell numerous private banks (the alternative of allowing them to become insolvent was avoided as far as possible, although this made the process more protracted). The remaining private banks were to have more equity capital (cf. table 3) and better funding structures³ The regulatory and supervisory framework for the banking sector was also to be improved.

The number of private commercial banks had fallen to 18 by January 2004 and the remaining banks could be regarded as largely stabilized, although some of them,

³ Under the Istanbul Agreement non-performing loans or bonds not being serviced by private banks were to be taken out of the banks' balance sheets and replaced by funding assistance from international institutions. But this only proved possible in part. Instead, in many cases repayment terms were simply extended, so shifting the problems into the future.

Table 3

Risk Indicators for the Turkish Banking System

	Non-performing loans			Risk provision in % of non-performing loans		
	December 2001	December 2002	December 2003	December 2001	December 2002	December 2003
State banks	37.3	37.4	26.2	62.7	73.9	97.6
Private banks	27.6	8.9	6.5	31.5	53.0	80.0
Foreign banks	5.5	4.9	4.3	75.6	77.7	78.5
Investment banks	10.7	4.0	3.5	82.3	64.2	90.3
Banks controlled by the SDIF ¹	67.3	69.4	53.8	55.9	60.5	75.4
Total	29.3	17.6	11.5	47.1	64.2	88.5

1 Savings and Deposits Insurance Fund

Source: BRSA Annual Report 2003, quoted from Alfred Steinherr et al., loc. cit. p. 16.

like the IMAR bank, still faced problems. However, the loan risks that still remain in the banking system may be taken to amount to at most 5% of GDP, and so they are relatively low compared with the overall cost of the consolidation as stated above. But compared with the five CEE countries that joined the EU last year, the Czech Republic, Poland, Slovakia, Slovenia and Hungary, the Turkish banking system is still under-developed. Both the number of banks and the level of bank assets in relation to GDP (around 60%) are relatively low, while the share of banks owned by the state is relatively high at around one third. The high share of public bonds in the banks' portfolios is also striking, at around 44% in 2003 and as much as 80% for the state Halkbank.

Some success in restructuring the Turkish banking system

The real level of interest rates rose to 32% in 2002 following the crisis but it has now normalized as the economy has stabilized. In mid-2004 it was 12% and may now be assumed to have fallen to less than 10%.

At the same time the composition of bank assets changed and improved. The share of private consumer loans rose strongly, while the share of public bonds fell. Although there are no longer any official unconditional guarantees for deposits in the state banking sector, the impression among the general public is still widespread that they do de facto still exist, and this disadvantages the private banks to that extent. However, the state banks have other disadvantages – in the service area, for

example, and in innovation, so there are many demands for the state banking sector to be reduced and limited to core areas like support for the agricultural sector and granting special loans for small and mid-size enterprises. However, the state banks would first have to prove that they can withstand competition. Their monopoly in granting loans to state enterprises and foundations must be questioned. Their creditworthiness must also be appraised in future, for many of their loans were politically motivated and would hardly have been given with a normal rating.⁴

Another problem the banking sector has to solve is the heavy burden of taxes and charges, which in individual cases can increase the costs of a loan in Turkish currency by more than 50%.⁵ This is greatly hampering the expansion of the volume of lending. It has also cost the Turkish banks large amounts of deposits and loans, which have gone to banks and financial institutions abroad. In some cases this has also led to the establishment of subsidiaries abroad by Turkish banks. At the end of 2002 around 40% of bank loans, most of which went to Turkish firms, had been obtained through foreign subsidiaries or foreign financial institutions.

In the private banking sector at least efficiency and productivity now appear to be entirely comparable with the EU standard. In 2003 the cost-yield relation of the four largest banks was between 30% and 70% (EU average around 61%). And productivity, measured for instance by the relation of deposits to the number

⁴ Cf. Rauf Gönenc, Willi Leibfritz and Erdal Yilmaz: 'Reforming Turkey's public expenditure management', *OECD Economics Department Working Papers*, no. 418, Paris 2005.

⁵ Alfred Steinherr et al., loc cit. p. 20.

employed, has also risen strongly in recent years, although it is still clearly below the level of western banking systems (about 42% of the productivity of the US banking system, for example). Many financial market services are still insufficiently developed, so that big Turkish companies particularly prefer to use the services of foreign banks.

In regard to future EU membership a comparison of the activities of foreign banks in Turkey with their activities in the new 5 CEE member states is of great interest. Although access to the Turkish banking sector has been largely liberalized in the last 25 years, foreign banks only account for around 5% of the activities of the banking sector as a whole. That is about the same as the activities of foreign banks in Germany, but it is low compared with the activities of foreign banks in the new accession countries. However, the private banking sector had to be built up from scratch in the new accession countries, and it was evident that foreign banks would play a part as strategic investors right from the start.

The need for future reforms

The main requirements for the Turkish banking sector to develop further are

- Reducing the costs of banking transactions (lower reserve requirements, harmonization of taxes and charges with EU practices)
- Greater transparency (consolidated balance sheets, also on account of the numerous subsidiaries of Turkish banks abroad)
- A stronger capital market (the decision to transfer supervision of the capital market from the Treasury to the Banking Regulatory and Supervisory Agency on 1 January 2005 is the right step towards making the state more neutral)
- Encouraging foreign investors to participate in the process of further consolidating the banking system
- Increasing lending to small and mid-size enterprises, while developing appropriate supervisory functions, and
- Countering the impression that the state still has too great an influence. It would certainly be disadvantageous, for example, if in the privatization of Türk Telekom, which is now being planned, the choice fell on, of all possible candidates, the armed forces pension fund. It is under the Defence Ministry and would hardly be able to guarantee independence of the state.

Finally it must be asked whether the Turkish banking system will be able to fulfil the requirements of Basel II by 2007. Higher equity capital requirements

pose similar problems for the Turkish banks as for banks in other countries. One advantage, however, would be that higher equity capital would make it easier for the private banks to obtain a higher rating, where up to now they have generally been at a disadvantage against the state banks.

Turkey's macroeconomic performance is good at present, and this should strengthen confidence in the economy and ultimately also bring higher deposits into the banks. Economic growth continues strong at around 9% a year, and the budget deficit is at its lowest since 2001. Only the development of the current account is giving cause for concern, with the deficit almost doubling last year from 2003 to reach more than 15 billion US dollars.

Conclusion

If the state of reforms in Turkey, and particularly in the banking system, is compared with that in the 5 CEE countries ten years ago – which is roughly the time horizon for EU entry for Turkey, in the present view – the result is certainly positive. Most important is to reduce the influence of the state further and ensure macroeconomic stability, particularly in regard to foreign trade and payments.

Above all the development since mid-2003 gives grounds to hope that a new dynamic has entered foreign direct investment in Turkey. The share index has almost tripled and the exchange rate has been oscillating around the 0.70 US dollar mark per new Turkish lira since 2001.⁶ Turkey's international rating has improved,⁷ although at mostly BB it is still not satisfactory, and long-term interest rates have nearly halved in the last four years. Real interest rates are now about 8%, after up to 40% in 2001. Turkey's central bank law is largely accepted by the European central bank. If the positive development of the reforms continues, and if the desired soft landing for economy succeeds,⁸ little should stand in the way of the planned commencement of negotiations on EU entry as planned on 3 October 2005.

⁶ On 1 January 2005 the Turkish currency was converted from old to new lira in the ratio of 1 000 000:1.

⁷ Cf. 'Türkei lockt internationales Kapital an', *Handelsblatt*, 18/19 February 2005, p. 33.

⁸ The most recent surveys appear to confirm that, e.g. *Nachrichten für den Außenhandel* of 10 March 2005: 'Industrie plant umfassende Investitionen.'