

1 CHAPTER 8
3 GOVERNANCE BY
5 SUPRANATIONAL
7 INTERDEPENDENCE: DOMESTIC
9 POLICY CHANGE IN THE TURKISH
11 FINANCIAL SERVICES INDUSTRY
13

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19 1. INTRODUCTION

21 The 17 December 2004 was a turning point in both Turkish and European
23 history: The European Council followed the European Commission’s rec-
25 ommendation and approved the opening of accession negotiations with
27 Turkey, which commenced on 3 October 2005. The goal of accession to the
29 European Union (EU) has become one of the main driving forces for
31 broadly defined legal, political, economic, and financial reforms in Turkey.²

27 This chapter argues that the current policy outcomes of the Turkish fi-
29 nancial system are largely the products of “governance by supranational
31 interdependence”. The policy outcomes can be understood in terms of the
33 pressures emanating from the international political economy and from ef-
35 forts to harmonize national monetary governance and financial governance
arrangements.³ Specifically, the EU, with the accession process, the Inter-
national Monetary Fund (IMF) and the World Bank with their financial

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1 support and the technical assistance for reforms, serve as the external anchors for institutionalization and harmonization of the Turkish financial
3 regulatory regime.⁴ Specifically, both the National Economic Convergence
5 Program with the EU *Acquis* adopted following the EU Summit of Helsinki
7 in 1999 and the IMF stand-by agreements made between Turkey and the
9 IMF since 1999 required major regulatory and legal changes in monetary
11 and financial governance. Most of the microeconomic and macroeconomic
13 reforms needed for convergence in Turkey towards EU standards were already embedded in the IMF/World Bank – supervised economic and financial reforms. In evaluating the responses to external pressures, the paper focuses mainly on financial policy outcomes (e.g., rules, regulations, and policy decisions enforced by state) and degree to which they conform to the norms promoted by transnational actors.

This chapter has two main parts. The first part overviews the key features of the governance arrangements in the financial services. It argues that recent policy decisions were effectively domestic responses to external pressures. The Commission of the European Communities (CEC) notes that “sustainable integration of Turkey’s financial sector will to a large extent depend on achieving macroeconomic stability, as well as on strengthening the legal and supervisory framework in this sector” (CEC, 2004a, p. 17). Accordingly, the second part of the chapter outlines the main features of the pre-accession economic program (PEP), current capital market structure, the role of the financial system in allocating resources, and its normative properties.

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29 **2. GOVERNANCE ARRANGEMENTS IN THE** 31 **TURKISH FINANCIAL SERVICES**

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2.1. Governance by State Control: The Period Prior to the 1980s

John Zysman (1983) offered a typology of financial systems in his analysis of how national economies responded to the common external shocks of the 1970s. He found “state-directed, price-administered” financial systems in France and Japan; a “private bank organized credit market” in Germany; and “capital market-based” financial systems in the UK and the USA.⁵ Today, his work still serves as a useful starting point in the comparative political economy of financial systems.

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1 With regards to European banking, Pagoulatos (1999, p. 68) argues that
2 “five competing and mutually complementary modes of governance define
3 European banking policy and policy making: governance by state control;
4 governance by the market; governance by regulation; governance by sect-
5 oral co-ordination; and governance by supranational interdependence.”⁶
6 Governance by state control has dominated the EU banking systems, from
7 the embedded liberalism of postwar monetary order established after Bret-
8 ton Woods negotiations in 1944 to the worldwide market liberalization and
9 European integration of the 1980s (Pagoulatos, 1999, pp. 69–72). This
10 “model [was] identified with the banking systems of France and Southern
11 Europe (Italy, Spain, Portugal and Greece)” (Pagoulatos, 1999, p. 69).

12 Following Pagoulatos (1999) Turkish banking before the 1980s fits into
13 this “governance by state control” or what Zysman would label a “bank-
14 based” financial system.⁷ Initially, state banks were established to promote
15 state-led industrialization in Turkey, from the 1920s onwards until the de-
16 regulatory 1980s.⁸ State intervention in banking was part of the protec-
17 tionist import substitution policy which was maintained until 1980. The
18 regulatory interventionism and direct government control over banking
19 ownership and management were main features of state control over the
20 banking sector during this period.

21 The 1960s and the 1980s in Turkey also witnessed the emergence of the
22 family controlled conglomerate groups which established or acquired al-
23 ready-existing banks to fund their own operations (Akguc, 1992, pp. 66–69).
24 The repressive financial and regulatory practices were visible before the mid-
25 1980s. This included interest rate controls, the direct involvement of the
26 state in the allocation of credit mainly through state banking (e.g., directed
27 credit programs and subsidized lending), barriers on foreign bank entry, and
28 high liquidity and reserve requirements (see Akyuz, 1990, p. 98, see also
29 Onder, Turel, Ekinici, & Somel, 1993). Not surprisingly, repressive financial
30 policies “coupled with the exit of a significant number of banks [i.e., 23]
31 between 1960 and 1980 gave rise to a concentrated market dominated by
32 public and private banks owned by industrial groups with excessively large
33 branch networks and high overhead costs” (Denizer, 1997, p. 1).

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1 2.2. *The Era of Lack of Effective Governance in Banking: The “Crony*
2 *Capitalism” of the Late 1980s and the 1990s Embedded in the Bank-Based*
3 *Financial System*

5 The lack of legal rules, accountability and transparency for money sources
6 financing politicians and political parties have provided the larger institu-
7 tional structure for the Turkish “crony capitalism” embedded in the bank-
8 based financial system.⁹ A few wealthy individuals who dominated political
9 campaign financing were active in acquiring or establishing private banks
10 and did this with the help of the party that they had supported during the
11 elections (see Tartan, 2003). In a similar vein, especially during the 1990s,
12 the state banks had largely been the instruments of channeling deposits into
13 political rent distribution. They were controlled by political parties and
14 abused during this period through channeling cheap loans to corporate and
15 individual donors as well as farmers, and other electoral constituencies (see
16 Euromoney, April 1998, p. 138; *Economist*, 19 May 2001, p. 48). In this
17 environment, both state and some of the private banks had been indirect
18 sources financing political system in Turkey. Further, the “crony capital-
19 ism” also manifested itself in a “corruption triangle” formed among pol-
20 iticians, businessman, and the mafia. Rigging the privatization of a state-
21 owned bank, Turkbank, in favor of the eventual winner in 1998 was a major
22 case illustrating this “corruption triangle” (see Sener, 2004a).¹⁰ At least in
23 this instance, the mafia has been one of the non-regulatory entry barriers to
24 the bank-based financial system in Turkey.

25 In the 1990s, Turkey inevitably witnessed huge budget deficits which nec-
26 essitated an extensive reliance on domestic and foreign borrowing. The
27 Turkish government adopted a “hot money” policy of high real interest
28 rates for treasury bills and domestic currency appreciation to attract short
29 term, unproductive and speculative capital to compensate for increasing
30 growth in government expenditure; the annual real interest rate for gov-
31 ernment securities averaged 32 percent between 1992 and 1999 (Treasury,
32 2001, p. 3). Not surprisingly, during the same period, both public and pri-
33 vate banks channeled most of their funds to the government debt market
34 rather than to corporate lending; the share of total bank loans in total assets
35 decreased from 36 to 24 percent.¹¹ In this environment, the public banks
36 also became the instruments of government deficit funding, whilst private
37 banks increasingly preferred high yield but safer government securities to
38 commercial lending. The share of government securities in total bank de-
39 posits increased from 10 percent in 1990 to 23 percent in 1999 (Treasury,
40 2001, p. 6). The private sector version of the state banking behavior in the

1 1990s had been to direct public deposits and profits derived from arbitrage
2 into group financing (i.e., connected lending)¹² and “bad loans to good
3 friends”¹³ (see Organization for Economic Cooperation and Development
(OECD), 2002, pp. 78–79). Not surprisingly, six banks which were granted
4 entry following the 1991 general elections failed in less than a decade. They
5 were all insolvent due to connected lending and were taken over by the
6 Savings Deposit and Insurance Fund (SDIF) in 1999 (see Banking Regu-
7 lation and Supervision Authority (BRSA), 2003, p. 17).¹⁴ Between 1997 and
8 2003, 20 banks were taken over by the SDIF. Majority shareholders of these
9 20 banks used US\$9.1 billion from their own banks (BRSA, 2003, Table 11,
10 p. 25).¹⁵ Further, they also used loans from state banks and other SDIF
11 banks which later became part of non-performing loans (see BRSA, 2003,
12 pp. 72–101; Tartan, 2003, pp. 72–74). The legacy of the crony capitalism in
13 the financial system has been devastating: The share of non-performing
14 loans in the gross loans reached 29.3 percent in 2001 (SPO, 2004, p. 72).

15 In December 1999, in the face of the above-mentioned structural prob-
16 lems in fiscal, monetary, and financial governance, the Turkish government
17 agreed to an exchange rate-based “Disinflation Program” sponsored by the
18 IMF and World Bank (hereafter the “twin organizations”). In return for the
19 financial support of the IMF, the government promised to implement the
20 economic and financial policies of the program. The stand-by agreement of
21 US\$15 billion was approved on 22 December 1999 and expired on 4 Feb-
22 ruary 2002 (IMF, 2004a). The IMF program was based on tight fiscal and
23 monetary targets aimed at reducing the real interest rates and inflation.
24 Monetary policy stability is regarded by the IMF as a function of the central
25 bank’s independence from political authority. Paradoxically, the Central
26 Bank of Turkey (hereafter the Central Bank) lost its independence with
27 regards to monetary policy instruments due to the IMF’s conditions.¹⁶
28 Specifically, the program imposed limits on Central Bank’s balance sheet
29 items, in line with a pre-announced targeted currency basket. As such, the
30 monetary pillar of the program had tied the Central Bank’s liquidity crea-
31 tion to foreign capital inflows. However, the program was too foreign to
32 take the fragility of the domestic financial system into account. During the
33 implementation of the disinflation program, the banking sector was highly
34 vulnerable to the program due to its dependence on high real interest bear-
35 ing government securities funded largely by open foreign exchange posi-
36 tions, making the sector vulnerable to the foreign exchange risk. For
37 example, the banking sector’s open position increased to US\$20.6 billion in
38 November 2000 (Central Bank of Republic of Turkey (CBT), 2002, p. 113)
39 up from US\$12.6 billion at the end of 1999 (Kaplan, 2002, p. 22). Further,

1 the share of short-term foreign debt in the Central Bank's international
reserves increased from 112 percent in June 2000 to 147 percent in December
3 2000 (Cizre & Yeldan, 2002, p. 11).

In this environment, the program "failed to meet its inflation targets
5 despite full implementation of its monetary and fiscal policy targets" (Akyuz
& Boratav, 2003, p. 1550). This reinforced "expectations of a sharp depre-
7 ciation at the time of pre-announced exit date [from the crawling peg],
[causing] an earlier attack on the currency" (Akyuz & Boratav, 2003, p.
9 1553). The increased capital outflows resulted in an increase in interbank
money market interest rates. The result was a liquidity crisis as the Central
11 Bank initially could not provide liquidity to the market due to its commit-
ment to the program.¹⁷ The IMF provided US\$7.3 billion in December
13 2000. However, tight monetary and fiscal policies implemented subsequently
via the IMF intervention caused the financial crisis of 2001 and "served to
15 deepen recession" (Akyuz & Boratav, 2003, p. 1550). Not surprisingly, the
stabilization program and its sponsors were rightly criticized by academics
17 and observers from various ideological persuasions for creating the "twin
crises". The criticisms were directed at the design of the program which led
19 to the liquidity crisis of November 2000 and the mismanagement in crisis
intervention which led to the subsequent February 2001 financial crisis
21 (Akyuz & Boratav, 2003, p. 1549; see also Egilmez & Kumcu, 2003; Alper & Onis, 2004).¹⁸ Arguably, the Turkish economic bureaucracy failed to con-
23 vince the IMF about the shortcomings in both the design and the imple-
mentation of the program. Apparently, there were problems in the diffusion
25 of information and learning between the twin organizations and the do-
mestic financial policy community in Turkey. However, not only the IMF
27 but also the domestic policy community shares the responsibility for the
"twin crises." For example, the implementation of banking reforms and the
29 Banks Act of 1999 by the domestic policy community was poor. Specifically,
BRSA, which was established due to the direct pressure of the IMF in June
31 1999, became fully operational only in September 2000 – 2 months prior to
the liquidity crisis (for a detailed discussion, see Alper & Onis, 2004, pp. 41–
33 47). Evrensel (2004, p. 5) also concludes that "the primary targets of stab-
ilization programs are not implemented during the program years."

35 To sum up, the Turkish version of "crony capitalism" and the lack of
effective governance – that is, the inability of the financial policy community
37 (i.e., key regulators and regulated firms) to find collective solutions to mar-
ket, government, and regulatory failure – marked the country's major step
39 away from its integration into the European financial area during the period
between the late 1980s and the 1990s. As will be detailed in the next section,

1 the result has been the powerful penetration of extraterritorial actors into
2 domestic policy-making in Turkey.

3 4 5 *2.3. Governance by Supranational Interdependence, Policy* 6 *Entrepreneurship, and Policy Change*

7
8 The financial crisis of 2001 was triggered by the dispute between the then
9 Prime Minister Bulent Ecevit and President Ahmet Necdet Sezer, after the
10 president, on 20 February 2001, criticized the government for failing to fight
11 corruption. The result was the largest economic recession in Turkey's history; real gross domestic product (GDP) contracted by 7.5 percent, whilst
12 the consumer price index (CPI) realized at 68.5 percent in 2001 (CBT, 2003,
13 p. 12). The Turkish lira depreciated by 115.3 percent against the US dollar
14 and 111.3 percent against the euro (CBT, 2002, p. 16). Following the crisis,
15 Turkey returned to floating exchange rate regime with the central bank
16 having control over short-term interest rates.

17
18 In addition to the mistakes of the twin organizations prior to and during
19 the crises and the government's poor implementation of the banking re-
20 forms,¹⁹ it also became clear that "corruption cancer" had destabilized
21 Turkish financial markets by breeding financial/economic crises, by under-
22 mining the rule of law and sustainable economic development, and by
23 jeopardizing good governance in the public and private sectors. Conse-
24 quently, the legacy of "crony capitalism" has been devastating for the
25 Turkish financial system. The SDIF held the biggest portfolio of non-per-
26 forming loans in Turkey. As of December 2004, 21 banks have been trans-
27 ferred to the SDIF (also known as the SDIF banks) since 1997. The cost of
28 the financial restructuring program has been US\$47 billion in taxpayer's
29 money, with capital support provided to banks to rehabilitate the banking
30 sector in 2004 (SPO, 2004, p. 72). The amount of funds injected into the
31 SDIF banks reached US\$27.8 billion in 2004 (SPO, 2004, p. 73).²⁰ The CEC
32 (2004b, p. 62) also reported in 2001 that "bailing out the banking sector and
33 taking account of the costs of agricultural support resulted in a deficit of
34 29.8 percent of GDP".

35 Three parties in the ruling coalition government were accused of corrup-
36 tion and of obstructing a 3-year disinflation reform program backed by the
37 twin organizations since 1999. Following the devastating financial crisis,
38 there was strong public distrust and anger towards the government, as evi-
39 denced by opinion polls.²¹ With this as background, Ecevit followed the
twin organizations' recommendation and called a well-respected and highly

1 influential transnational bureaucrat for a rescue mission: in March 2001,
2 Kemal Dervis, the World Bank's vice president for poverty reduction and
3 economic management at the time, became an *unelected* member of the
4 Turkish Parliament and a Minister of State in charge of Treasury.²² This
5 was the first time that the relations between Turkey and the twin organiza-
6 tions moved beyond bilateral agreements between the parties. As will be
7 detailed below, governance by supranational interdependence in financial
8 and economic realms was institutionalized with Dervis and his team. Here,
9 governance by supranational interdependence refers to the significant role
10 played by extraterritorial actors (e.g., individuals and supranational organiza-
11 tions) and institutions (e.g., norms, rules, regulations) on domestic policy
12 change in financial and monetary governance.²³ In the Turkish context,
13 governance by supranational interdependence came with effective carrot
14 and stick policies linked to: (1) the EU accession process which requires
15 Turkey to adopt and implement the complete EU legislation and standards
16 – the *acquis communautaire*; (2) “IMF conditionality” where IMF lending is
17 conditional on the adoption of IMF policy prescriptions; (3) The World
18 Bank “Programmatic Financial and Public Sector Adjustment Loans”
19 which require implementation of financial and public sector reform program
20 in Turkey. As such, Turkey's satisfactory progress in microeconomic and
21 macroeconomic reforms serves as “collateral” for the prospect of EU ac-
22 cession and IMF/World Bank loans.

23 Dervis was part of an epistemic community – a “network of professionals
24 with recognized policy expertise and competence in a particular domain and
25 an authoritative claim to policy-relevant knowledge within that domain or
26 issue area” (Haas, 1992, p. 3). He was an influential actor with joint mem-
27 berships of the domestic and transnational policy communities (for a theo-
28 retical framework, see Coleman & Perl, 1999). As such, both the
29 government and the twin organizations needed Dervis as a “mediator”,
30 moving between the parties in the intergovernmental negotiations environ-
31 ment (see *Economist*, 24 March 2001, p. 58). The government needed him
32 not only because it had lost its domestic and international credibility²⁴ but
33 also because it needed a mediator to effectively administer relations with the
34 twin organizations. Similarly, the twin organizations also needed him fol-
35 lowing the crisis, not only because he would effectively translate policy ideas
36 and policy paradigms into domestic policy but also because he would fa-
37 cilitate *implementation* and *policy formulation* which would prevent both a
38 debtor moral hazard and a road accident similar to one that happened in the
39 design and implementation of the previous program imposed by the twin
40 organizations for Turkey. In spite of Turkey's lack of political will to im-

1 plement the IMF's conditionality, the IMF had been providing financial
support which led to a debtor moral hazard (see Evrensel, 2004).²⁵ With
3 regards to the debtor moral hazard problem, Dervis was the right person
who could satisfy the IMF's expectation on the implementation of the eco-
5 nomic and financial reforms. Indeed, Dervis through the Treasury Depart-
ment gathered monthly data regarding the implementation of the economic
7 program (*Milliyet*, 18 May 2001). Highly influential Turkish Industrialists'
and Businessmen' Association, the peak association of big business, also
9 supported Dervis and pressured strongly for the implementation of the
economic program (*Cumhuriyet*, 18 May 2001). With regards to the policy
11 design, Dervis effectively translated the financial system fragility in Turkey
to the "twin organizations". For example, the IMF traditionally opposes
13 direct public financing by the Central Bank. However, the IMF did not
oppose the exceptions in the new Central Bank Law (2001) that permitted
15 the Central Bank to finance government expenditures on banks taken over
by the SDIF.²⁶

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17 There had been widespread consensus among the key actors of this
epistemic community that one of the major problems was "crony capital-
19 ism" embedded in the Turkish bank-based system. Policies to tackle this
problem had already been out there due to a process of a gradual accu-
21 mulation of knowledge and solutions among specialists in the financial/
economic policy area. The particular problems of the Turkish political and
23 economic system came to the fore due to both the crisis and the change in
the national mood. As Kingdon notes policy change occurs when influential
25 individuals (i.e., "policy entrepreneurs") can "couple" problems, policies,
and politics. However, according to Kingdon (1995), this is possible only
27 when a short-run opportunity (i.e., a "policy window") is opened for en-
trepreneurs to push certain policies, solutions, or just bring attention to a
29 particular problem. In Turkey, a "window of opportunity" for a radical
economic restructuring opened following the crisis which exposed "crony
31 capitalism" as being embedded in the Turkish financial system. Dervis, as a
"policy entrepreneur", used this window of opportunity, and combined
33 problems, policies (e.g., solutions), and politics. He identified problems and
solutions in a "Transition Program to a Strong Economy" (see Treasury,
35 2001). For example, he declared that "[t]he current crisis has stemmed from
the problems of the banking sector" (Dervis, 2001). The banking sector was
37 "the most urgent problem" (quoted in *WallStreet Journal*, 15 , p. A.15).
With regards to solutions, the program had both macroeconomic (e.g., tax
39 reforms, fiscal restructuring, and the removal of extra-budgetary funds) and
microeconomic reform agenda (e.g., reform of the prudential and disclosure

1 regulations and supervision; the rationalization and privatization; the re-
2 structuring and eventual sale of state-owned banks). The program also in-
3 cluded legal reforms including new commercial and central banking laws,
4 and the introduction of good governance principles.

5 Economic, financial and legal reforms, agreed on with the twin organ-
6 izations were accepted by the coalition government in March 2001. Specif-
7 ically, financial and public sector reform program received financial and
8 technical support from the World Bank (World Bank, 2002).²⁷ The banking
9 sector reform legislation aimed to: “incorporate market risk into capital
10 adequacy requirements (CAR); clarify definitions for reporting and ac-
11 counting purposes; include repurchase agreements on the balance sheet;
12 improve monitoring the supervision of the banking system; and adopt in-
13 ternational accounting standards between 2001 and 2002” (Bakir & Brown,
14 2004, p. 433; see also BRSA, 2001a, b).

15 These reforms were “part and parcel of a national program that will
16 prepare the country for accession talks with the EU” (*WallStreet Journal*,
17 20, p. A.17). As such, most of the microeconomic and macroeconomic re-
18 forms needed for convergence in Turkey towards EU standards were al-
19 ready embedded in the twin organizations – supervised reforms.²⁸ As Dervis
20 noted “the economic program is prepared in full compliance with the Na-
21 tional Program to the EU ... Indeed, our economic program represents the
22 economic dimension of the National Program to the EU” (Dervis, 2001).²⁹
23 As such, both the EU Term President at the time and his successor declared
24 their strong support for the new economic program and Dervis (*Cumhuriyet*,
25 18 May 2001). Instead of supervising the economic reforms directly, the EU
26 offered feedback through regular reports on Turkey’s progress towards ac-
27 cession.³⁰

28 The IMF required the implementation of the program in return for the
29 release of US\$8 billion in May 2001. Dervis years (March 2000–August
30 2002) witnessed major structural reforms including amendments to the
31 Central Bank Law in 2001, the institutionalization of an independent bank-
32 ing supervision system that involved the BRSA and the SDIF in 2000, “Law
33 on Public Sector Banks” between 2000 and 2001, “Private Banking Sector
34 Restructuring Program” in 2001, “Istanbul Approach” for corporate loan
35 restructurings in 2001, “Public Financing and Debt Management Law” in
36 2002 (for details, see OECD, 2004, Table 4.1, pp. 115–117). The IMF (2002)
37 declared that “Turkey has maintained the strong implementation of its
38 economic program.” As a result, on 4 February 2002, the IMF approved a
39 new stand-by agreement of US\$12.8 billion which expired on 3 February

1 2005 (IMF, 2004a). And further committed US\$19 billion for 3 years in a
new stand-by agreement in February 2002.

3 However, the three-party coalition government was too weak to initiate
further reforms and their successful implementation. Political and economic
5 instability was largely created by weak coalition governments in Turkey.³¹
Dervis resigned in August 2002. Following the early general elections on 3
7 November 2002, the first single party government in 15 years was formed
with 34 percent of the vote and 66 percent of majority in the Grand National
9 Assembly under the aegis of the Justice and Development Party (hereafter
the Adalet ve Kalkinma Partisi (AKP)). This was also the first time in 40
11 years that there was only one opposition party in the new parliament.³² As
the *Economist* noted “[a] wave of hope has swept a nation long hostage to
13 economic mismanagement, repressive laws and corrupt politicians” (*Econ-*
omist, 9 November 2002, p. 39). The new and untested AKP had promised a
15 strong commitment to fight corruption, to implement structural economic
reforms sponsored by the twin organizations, and to continue political and
17 legal reforms to meet the Copenhagen criteria for EU membership (*Wall-*
Street Journal, 4–5 November 2002). The AKP gained domestic and inter-
19 national credibility and experience quickly, and managed to translate
parliamentary stability into political and economic stability. The Transition
21 Program designed jointly by Dervis and “twin organizations” was fully
adopted by the AKP. Indeed, the AKP government successfully imple-
23 mented the program which was revised in early 2002 to cover the 2002–2004
periods. New Prime Minister, Recep Tayyip Erdogan, has been the key
25 domestic individual actor moving towards to the discursive construction of
the EU accession process which is about “how [state] elites form their
27 identities, define their interests, and legitimate both the European integra-
tion process in general and specific policies by framing them in convincing
29 ways” (Dyson, 2000, p. 646).

Further, the AKP did not fully adopt the previous government’s “inac-
31 tion” policy in enforcement.³³ The Ministry of Justice drafted new bank-
ruptcy and foreclosure laws in consultation with the World Bank.
33 Empowered by the World Bank sponsored laws, the SDIF effectively seized
control of companies and personal property of insolvent bank owners who
35 failed to propose a plan to pay the debts due to the collapse of their banks in
2004. The SDIF’s move towards enforcement of rules and laws to recoup
37 the tax payer’s money *may be* the end of a “light touch” approach that
prevailed during the previous decade.³⁴

39 This progress, however, should be interpreted with cautious optimism.
Turkey’s overall international ranking in corruption,³⁵ and economic³⁶ and

1 political freedom³⁷ is far from being satisfactory. As such, any improve-
2 ments in financial and monetary governance arrangements would be inef-
3 fective without broader democratic, judicial, and legal consolidation in
4 Turkey.

5

7 2.4. *The Post-2001 Era: Financial Governance and Monetary Governance* 8 *by Supranational Interdependence?*

9

10 Financial market governance is about systemic stability. Therefore, it is
11 essentially about “the regulation of competitive conditions and prudential
12 control” (Moran, 2002, p. 258). Similarly, “governance by regulation” in
13 banking is about “efficiency and safety” (Pagoulatos, 1999, p. 76). Accord-
14 ingly, regulation and supervision plays a pivotal role in financial market
15 governance (or governance by regulation). This section will argue that partial
16 financial regulatory and supervisory consolidation and increased central
17 bank legal independence in Turkey were the domestic responses to the IMF
18 pressures.

19 Financial governance in banking can be analyzed with special reference to
20 a *supervisory structures*, “whether there should be one or multiple super-
21 visory authorities, and whether the central bank should be involved in bank
22 supervision”, the *scope of supervision*, “whether bank supervisor authorities
23 should supervise other financial service industries, including in particular
24 securities and insurance”, and the *independence of supervisory authorities*,
25 “the degree to which bank supervisors should be subject to political and
26 economic policy pressure and influence” (Barth, Nolle, Phumiwasana, &
27 Yago, 2003, p. 67).³⁸

28 With regards to the financial supervisory structure, Turkey has been
29 characterized by fragmentation and a lack of coordination and institution-
30 alized consensus building among supervisors. Before 2000, Turkey had
31 multiple supervisors with the Central Bank involved in off-site bank super-
32 vision. However, the Central Bank was not the only agency involved in
33 banking supervision. The Banks Act of 1985 authorized the Treasury and
34 Sworn Banks Auditors with on-site inspection in bank regulation and/or
35 supervision, whilst the Council of Ministers had power to replace the boards
36 of troubled banks. The SDIF which was established in 1983 to insure sav-
37 ings deposits was incorporated into the Central Bank. The Capital Markets
38 Board of Turkey (CMB) has been responsible for disclosure regulation/
39 supervision and investor protection. The Insurance Supervisory Office at the
40 Treasury Undersecretariat was responsible for insurance supervision.

1 Apart from this fragmented state apparatus in financial services industry,
2 there were also conflict of interest problems and the lack of adequate co-
3 operation among financial supervisors. For example, the Treasury had no
4 incentive to push for tight financial regulation and supervision of banks
5 which were essentially funding government deficits, and/or beef-up the cap-
6 ital of the state banks, which would worsen the fiscal deficit. The CMB also
7 failed to introduce Chinese walls between banking and non-banking activ-
8 ities (see OECD, 2002, n. 45, p. 79).

9 With regards to the scope of supervision, there has been a move towards
10 partial consolidation since 2000. A new agency, the BRSA, was established
11 in June 1999 following the ratification of the IMF sponsored Banks Act no.
12 4389 (IMF, 1999). It took responsibility for banking supervision and reg-
13 ulation from the Central Bank and became operational in September 2000.
14 The BRSA was empowered with on-site and off-site supervisory powers.
15 The BRSA also incorporated the Sworn Banks Auditors. The SDIF has
16 become both the deposit insurance fund and agency responsible for the
17 liquidation of the insolvent banks. It was also incorporated into the BRSA
18 in 2001. Further, the regulation and supervision of non-bank financial in-
19 stitutions has been transferred from the Treasury to the BRSA in 2005.

20 With regards to the supervisory independence, the BRSA, however, does
21 not have a strong institutional independence from the government; its pres-
22 ident and senior executives are appointed by the Council of Ministers which
23 has also final authority on cancellation of the banking and deposit taking
24 licenses. In 2002, the BRSA failed to demonstrate competence and inde-
25 pendence when it took over the administration of Pamukbank, the sixth
26 largest bank at the time and a member of the Cukurova Group. The deal
27 made between the group and the BRSA was tragic; the bank's debt of US\$6
28 billion was postponed for 15 years at Libor + 0.5 with no payment require-
29 ment in the first 3 years (Tartan, 2003, p. 140).

30 The failure of Imarbank in 2003 also exposed regulatory and supervisory
31 failure in banking (Fort & Hayward, 2004). The bank hid the real amount of
32 deposits, sold non-existing treasury bonds and channeled funds into off-
33 shore accounts (see Sener, 2004b). It became clear that the BRSA failed to
34 detect misreporting in Imarbank and to conduct on-site inspections effec-
35 tively.³⁹

36 The financial regulatory and supervisory arrangements also demonstrated
37 weaknesses in financial regulation and supervision. Specifically, there was a
38 lack of coordination and cooperation between the government regulatory
39 agencies. For example, the CMB canceled Imarbank's license to participate
40 in the government debt market in 1996 but the bank, through massive public

1 advertisements, continued to sell non-existent treasury bills to the public
 3 until 2002; this should have been examined properly by the banking super-
 visors and the bank's license for collecting deposits should have been can-
 celed.

5 Nevertheless, the Banking Sector Restructuring Program, like the Euro-
 7 pean Banking Legislation Program, aimed to strengthen systemic stability
 through enhancing the efficacy of financial regulation and supervision
 through reforms in prudential regulation (see BRSA, 2001). Improved **QA :3**
 9 transparency, profitability, risk management, and capital structure in the
 sector were among the key results of financial restructuring. In particular,
 11 the banks' capital strengthened following the Bank Capital Strengthening
 Program introduced in 2001. The result has been spectacular; the CAR of
 13 the banking sector increased dramatically from 9.3 percent in 2000 to 30.9
 percent in December 2003 (BRSA, 2004, p. 38). This improvement was due **QA :2**
 15 to a move from CAR calculations based on non-inflation-adjusted financial
 statements in 2000 to that of inflation-adjusted financial statements, in-
 17 creased profitability, fund injections, and the banks' capital beef-up. Fur-
 19 ther, blanket deposit insurance, which had caused a moral hazard problem
 and unfair competition between banks,⁴⁰ ended in July 2004 and aligned
 with EU-15 average level (see Table 2). However, a deposit coverage of
 21 €27,027 is high for Turkey, as the country's per capita income is about one-
 fifth that of EU-15.

23 The restructuring, along with strong economic growth generated im-
 25 provements in terms of asset and profitability growth, and improved asset
 quality and capital adequacy. Total bank assets increased from US\$130.1
 27 billion in December 2002 to US\$184.9 billion in June 2004, whilst net profits
 increased from US\$1.8 billion in 2002 to US\$4 billion in December 2003
 (SPO, 2004, p. 72). However, it should be noted that the main source of
 29 asset growth and bank profitability was the banks' securities portfolio and
 repo transactions, which generated high real interest income rather than the
 31 expansion of commercial lending and/or fees and commissions. The share of
 non-performing loans in gross loans decreased from 29.3 percent in 2001 to
 33 6.3 percent in June 2004 (SPO, 2004, p. 72).

The EU accession process, the supervision of the twin organizations, and
 35 Turkey's need for adherence to internationally acceptable regulatory stand-
 ards in a world of global finance created a pressure for financial regulatory
 37 convergence. As the head of the BRSA put it:

39 For strengthening the regulatory and supervisory framework, the BRSA's regulatory
 activities aiming at meeting the needs of the sector continue in accordance with the
 European Union regulations primarily and with other international practices. The new

1 Draft Banks Act prepared within this framework aims at both strengthening the reg-
2 ulatory and supervisory framework and achieving compliance with the EU legislation in
3 the light of the realities, needs of our country and the sector as well as experiences
4 gained. Besides, the BRSA continues its effort for preparing [sic.] the banking sector to
5 [sic.] international competition.

(BRSA, 2004, p. v)

7 Monetary governance is about price stability where an independent central
8 bank plays a pivotal role. Central bank independence has been promoted by
9 international organizations (e.g., the EU and the IMF) and regarded as a
10 condition for entry into Economic and Monetary Union (EMU) by the EU.

11 The monetary governance in the EU is administered by the European Central
12 Bank (ECB) which is guided by a strong cultural and ideological com-
13 mitment to price stability. The EMU is shaped by the ECB and its strong
14 commitment to price stability. The Central Bank is responsible for monetary
15 governance in Turkey. Over the last 5 years, between 2001 and 2005,
16 progress has been made in strengthening the independence of the Central
17 Bank (see Yazgan, 2003). The new Central Bank Law of 25 April 2001
18 which was part of the IMF conditionality increased the legal independence
19 of the Bank; price stability is stated as a primary objective, and the Bank
20 shall not lend to the public sector with the exception permitting the Central
21 Bank to finance government expenditures on banks taken over by the SDIF.
22 The Law has also been an important step in the process of harmonizing
23 Turkish laws with the EU's legal standards. Further, the Central Bank will
24 adopt explicit inflation targeting in 2006. Parallel to this, the transparency of
25 the central bank has also been increasing, as the bank reports to the Council
26 of Ministers twice a year, and publishes interest rate decisions within 2 days
27 of their public announcement (with special reference to the minutes of the
28 meeting of the Monetary Policy Board).

29 The EU, with its accession process, and the twin organizations, with their
30 stand-by agreements and technical assistance for reforms, serve as the ex-
31 ternal anchors for financial governance and monetary governance. Direct
32 manifestations of a move towards such governance arrangements can be
33 increasingly seen in improvements via reform of regulatory/supervisory
34 processes and of institutions in the financial services industry in Turkey (see
35 OECD, 2004, Table 4.1, pp. 115–117). For example, increased central bank
36 legal independence, financial reporting rules and corporate governance
37 guidelines, prudential and disclosure regulation, regulation on accounting,
38 bank establishment rules and ownership, and deposit insurance, etc. have
39 been increasingly aligned with international standards via amendments to
relevant laws.⁴¹ As the EU Commission puts it:

1 Turkey's institutional and regulatory setup underwent substantial modernization. Key
 2 regulatory and supervisory institutions, such as the Turkish Central Bank and the
 3 Banking Regulation and Supervision Agency, gained independence. In addition, the
 4 regulatory framework of important markets, such as the financial sector [sic], was
 5 aligned with international standards. State interference has been reduced, for example,
 6 by winding down political influence on the state banks.
 7 (CEC, 2004b, p. 58)

9 3. AN OVERVIEW OF THE PEP, THE BANKING 10 SECTOR, CAPITAL MARKETS, AND CORPORATE 11 GOVERNANCE

13 3.1. PEP: A Roadmap Towards the Maastricht Criteria

15 An analysis of the financial system of any accession country will be incom-
 16 plete without a reference to her PEP. An analysis of Turkey's current shape
 17 in this context also enables the assessment of key challenges in 2005 and
 18 beyond. Turkey submitted her latest PEP to the European Commission on 1
 19 December 2004. The PEP shows macroeconomic targets and the structural
 20 reform agenda needed for EU membership (Table 1). The ultimate objective
 21

23 *Table 1.* The PEP.

	2003	2004E	2005E	2006E	2007E
25 GDP (US\$, billion)	247	298	300	317.6	350
Real GDP growth (% , YoY)	5.8	9.6	4.8	5.1	5.1
27 CPI (% , end year)	18.4	10	8	5	4
Exports (US\$, billion)	47.3	62.0	71.0	79.7	88.9
29 Imports (US\$, billion)	69.3	95.5	104.0	114.2	125.2
Current account balance	-7.9	-14.6	-11.1	-10.8	-10.5
Current account balance/GDP (%)	-3.2	-4.9	-3.7	-3.4	-3
31 PSBR/GDP (%)	-10.1	-6.3	-4.4	-2.1	-0.5
Primary surplus/GDP (%)	6.7	7.8	7.5	7.2	7
33 Internal debts/GDP (%)	54.8	54.3	52.7	52.1	50
External debts/GDP (%)	25.4	24	22.7	20.1	18.3
35 Gross public debt stock/GDP (%)	80.2	78.4	75.3	72.2	68.3
Employment (thousand people)	21,147	21,649	22,182	22,741	23,304
Unemployment (%)	10.5	10	9.8	9.6	9.3
37 FDI (US\$, billion)	1.1	2.0	3.7	3.8	3.9

39 *Source:* SPO (2004).

PSBR: public sector borrowing requirements

1 of this ambitious but quite feasible program is to meet the Maastricht cri-
2 teria for Turkey. It should be noted that the PEP program is based on the
3 policy prescriptions of the IMF stand-by agreements since 2001, and serves
4 as the basis for Turkey's new stand-by agreement with the IMF in February
5 2005 (see Babacan, 2004).

6 With regards to inflation criterion, Turkey currently overshoot the Ma-
7 aastricht CPI criterion that states that inflation should not be higher than 1.5
8 percentage points above that of the average of the three lowest Euroland
9 inflation figures. However, inflation fell by 18.4 percent in 2003, and an
10 average of 77.5 percent in the 1990s, to a better than expected 9.3 percent,
11 the lowest since 1975.⁴² Turkey expects to bring the CPI down to 4 percent
12 in 2007, aligning inflation with the Maastricht criterion. Tight monetary
13 policy coupled with the operational independence of the Central Bank with
14 the new Central Bank Law of 2001 played a significant role in this spec-
15 tacular success. On 1 January 2005, this also enabled the Central Bank to
16 drop six zeroes from the Turkish lira, the world's largest denomination
17 banknote, to the new redenominated currency, Yeni Turk Lirasi (YTL), in a
18 million-to-one conversion (1 YTL is approximately €0.55).

19 With regards to the public finance criteria of having a government deficit
20 of no greater than 3 percent of GDP and a national debt of 60 percent GDP,
21 Turkey needs to improve; the public sector borrowing requirement (PSBR)
22 is projected at 6.3 percent of GDP in 2004 while the government targets a
23 0.5 percent government deficit by 2007. Parallel to this, gross public debt
24 stock is projected to decline to 68.3 percent of GDP in 2007 (down from an
25 estimated 78.4 percent in 2004). As such, Turkey is far from meeting the 60
26 percent Maastricht debt ceiling for general government gross debt. How-
27 ever, Turkey may have the potential to reduce its public debt due to a
28 primary surplus (over 6.5 percent of GDP) and high privatization revenues
29 which are expected to increase in the short term.⁴³

30 Convergence in long-term (10-year) domestic bond yields is another Ma-
31 aastricht criterion. The achievement of a primary budget surplus helped the
32 government lower real domestic interest rates to 11 percent in 2004 (from an
33 average of 33 percent in 2001).⁴⁴ The 3-year average for Turkey's 30-year
34 Eurobond yields averaged about 10.63 percent against a reference value of
35 6.4 percent (Deutsche Bank, 23 December 2004, p. 4). The attainment of the
36 interest rate criterion is directly related to Turkey's future progress in mon-
37 etary and fiscal consolidation.

38 In terms of the exchange rate stability criterion, Turkey is vulnerable to
39 unwanted exchange rate adjustments due to large external imbalances in the
40 high levels of the current account deficit and external debt, which are ex-

1 pected to be 4.9 and 24 percent of GDP in 2004, respectively. Projected
3 growth in the foreign direct investment (FDI), coupled with tourism receipts
and an improving export capacity, may reduce external imbalances to sus-
tainable levels in the medium term.

5 The PEP program served as the basis for Turkey's new US\$10 billion 3
years stand-by deal agreed with the IMF on 13 December 2004. The IMF
7 program requires reform in three key areas: (1) the social security system
which is in deficit at about 4.5 percent of GDP; (2) the harmonization of the
9 Banking Law with the EU in bank ownership, management and licensing,
and connected lending; and (3) the implementation of tax reform. The EU
11 accession process keeps Turkey anchored with an economic and financial
restructuring program supported by the twin organizations. This is coupled
13 with strong public support for the AKP government (i.e., a 55 percent
approval rating in November) and the prospect of EU membership (i.e., a 79
15 percent approval rating) in the opinion polls, strengthening the govern-
ment's position to implement new institutional frameworks for fiscal, mon-
17 etary, and financial governance.

19

3.2. *The Banking Sector in a Comparative Perspective*

21

The Turkish financial system had been dominated by a weak and inefficient
23 banking sector which did not play a significant role in economic develop-
ment. Financial intermediation indicators, such as the share of assets, de-
25 posits, and loans of GDP, show that the sector is still underdeveloped
(Table 2). It is over branched, and the share of state banks and government
27 debt securities in total banking assets is high. The share of bank loans of
GDP is a fraction of the EU-15 countries.

29 Table 3 provides a brief comparison of some of the key indicators of the
Turkish financial system with four central and eastern European countries
31 (i.e., the Czech Republic, Hungary, Poland, and Slovak Republic – hereafter
referred to collectively as CEC4). Although both Turkey and CEC4 coun-
33 tries have underdeveloped financial services industries, Turkey contrasts
with CEC4 in that she has the lowest share of loans to GDP and the highest
35 share of government securities in total banking assets (Table 3). In Turkey,
banks channel most of their funds to the government debt market rather
37 than to corporate lending. The analysis of three major items in the con-
solidated bank balance sheet reveals the underdeveloped role of the banking
39 sector in economic development. As of September 2003, deposit items con-
stituted a major source of funding with a 65 percent share in total liabilities.

Table 2. The Turkish Banking Sector in a Comparative Perspective (2001).

	EU-15 Countries	EU-10 Countries	Turkey
Assets/GDP	474	117	97
Deposits/GDP	186	83	61
Loans/GDP	167	57	19
Average bank size (total assets/number of banks, million euro)	4,494	1,025	2,472
Number of branches per bank	36	33	113
Debt securities/total assets (Government's crowding-out)	21.68	N/A	34.5
Concentration ratio of five largest banks (%)	59	75.8	57.7
Share of state banks (public share, %)	10	24	33
CAR	12.04	16.24	16.5
Deposit insurance (in euro) ^a	30,667	11,939	27,027

QA :11

Source: Pazarbasioglu (2003).

Table 3. The Main Indicators of the Financial System (%).

	End-year Total Assets/GDP		Loans/GDP		Securities/GDP		Capital and Reserves/GDP		Non-bank Deposits/GDP	
	1999	2001	1999	2001	1999	2001	1999	2001	1999	2001
Czech Republic	124	119	46	40	24	32	10	7	59	69
Hungary ^a	64.5	64	29	35	12	13	6	7	41	41
Poland	58	62	27	28	13	13	5	6	37	41
Slovak Republic	91	92	43	27	13	27	12	8	60	66
Turkey	89	92	24	18	20	36	5	8	56	61

Source: OECD (2003).

^aFor only commercial banks.

However, loans constituted only 27 percent of total assets, whilst securities constituted 43 percent of total assets (Bankers Association of Turkey (BAT), 2004a, p. 81). Private deposit banks provided 71.3 percent of total loans in 2003 (CBT, 2004, Table III.1.5, p. 87). The same figure for state deposit banks and foreign deposit banks was 23.2 and 5.5 percent, respectively. Not surprisingly, the banking sector was unable to channel funds to the real sectors. The share of loans in total assets was only 28 percent in

1 2003, below the pre-crisis level of 32 percent in 2000 (BAT, 2004a, p. 24).
2 The banking assets have been dominated by high real interest bearing gov-
3 ernment securities; 90 percent of these securities were government debt in-
4 struments. For example, the share of the securities portfolio in total assets
5 increased from 35 percent in 2001 to 41.5 percent in June 2004. Further, the
6 major source of bank profitability has been the securities portfolio due to
7 high real interest rates: “Turkish banks have been among the most prof-
8 itable in the world despite low efficiency” (see also OECD, 2002, Fig. 5, p.
9 66). Further, weak competition is “suggested by high interest margins
10 alongside high operating costs” (OECD, 2002, p. 67).

11 Foreign bank entry and cross-border mergers and acquisitions, along with
12 government-led restructuring, played a significant role in the bank consol-
13 idation process in emerging market banking sectors (Gelos & Roldos, 2004).
14 For example, foreign banks dominate commercial bank assets and registered
15 bank capital in CEC4 countries (Mero & Valentinyi, 2003). In contrast,
16 despite highly liberal financial regimes, developed technological infrastruc-
17 ture and skilled labor in the banking sector, the presence of foreign banks
18 (which mainly operate in foreign trade and corporate finance) has been
19 limited in Turkey. As of December 2003, 13 foreign banks had 209 branches.
20 Their share in total bank assets, loans, and deposits was 2.8 , 4.1 and 2.0
21 percent, respectively (BRSA, 2004, pp. 14–15).⁴⁵

22 Bank consolidation in CEC4 countries has been mainly due to both a
23 legacy of the privatization of large state-owned banks and the entry of a
24 large number of domestic and foreign banks into their respective markets;
25 this followed the financial deregulation of the mid-1990s (Gelos & Roldos,
26 2004). In contrast these countries, the main feature of bank consolidation in
27 Turkey has been bank failures rather than foreign bank entry. Not surpris-
28 ingly, bank failures led to state-led consolidation and a drop in the number
29 of banks in Turkey following the Financial Restructuring Program of 2001
30 that followed the twin crises. As a result of a blanket deposit guarantee, the
31 BBKD and the SDIF played a pivotal role in this consolidation process in
32 dealing with market and regulatory failures following the financial crisis. QA :4
33 Nineteen out of 21 insolvent banks transferred to the SDIF. Banks have
34 been dissolved, sold and/or merged with other banks. The total asset size of
35 mergers and acquisitions in the sector was around US\$26.5 billion (BRSA,
36 2003, p. 53). The total number of banks has declined from 81 in December
37 1999 to 49 in December 2004. The reduction in the number of banks trans-
38 lated into an increase in market concentration in the sector. For example,
39 the share of the largest five banks in total assets increased 12 percentage
40 points, from 48 percent in 2000 to 60 percent in 2004 (BAT, 2004a, p. 82).

1 This concentration rate, however, is close to the EU average (see Table 2).
 2 During the same period, the total number of bank branches declined from
 3 173,988 to 126,970, whereas the number of bank employees declined from
 4 7,691 to 6,050 (BAT, 2004b).

5

7

3.3. Capital Markets

9 In Turkey, capital markets are undiversified and underdeveloped (Bakir &
 10 Brown, 2004). Table 4 shows the percentage distribution of total financial
 11 assets in Turkey by the end of September 2003. The bank-based system also
 12 evidenced 41.1 percent share of deposits in total financial assets. The public
 13 and private sector securities together make only 58.9 percent of total finan-
 14 cial assets. Government bonds and treasury bills had a 47.3 and 9.9 percent
 15 share of total public securities, respectively (Table 4). The debt market is
 16 mainly dominated by government debt instruments. For example, out-
 17 standing government securities had a 91.7 percent share of total securities
 18 issued, whilst that of private sector securities was 8.3 percent in October
 19 2003 (CBT, 2004, Table iv.2.1, p. 124). Stocks are the only private sector

21

Table 4. Total Financial Assets (% Share).

	1999	2000	2001	2002	2003 ^b
<i>Total deposits</i> ^a	59.7	56.2	43.7	44.7	41.1
Total loans deposits	32.3	30.8	18.9	19.5	21.5
Saving deposits	19.8	17.9	11.5	11.7	12.5
Other	12.4	12.8	7.4	7.9	9
Fixed deposits	27.4	25.4	24.8	–	19.7
<i>Securities</i>	40.3	43.8	56.3	55.3	58.9
Public	34.7	36.9	51.8	50.9	53.9
Treasury bills	4.8	2.1	8.4	–	9.9
Government bonds	29.3	34.5	43.1	–	43.7
Other	0.6	0.4	0.3	–	9.9
Private	5.6	6.9	4.4	4.4	4.9
Stocks	5.6	6.9	4.4	4.4	4.9
Asset-backed securities	0	0	0	–	0
Other	0	0	0	0	0
<i>Total</i>	100	100	100	100	100

37

Sources: CMB, CBT, Treasury various tables.

39

^aExcluding interbank deposits.

^bProvisional figures by the end of September.

1 securities issued and have a 4.9 percent share of total financial assets, illustrating the low degree of market depth in the financial system.

3 The corporate sector raised US\$12.7 billion in the corporate debt market until the mid-1990s (Turkiye Sermaye Piyasasi Araci Kuruluslari Birliđi (TSPAKB), 2004, p. 115); then, for over 8 years, the corporate debt market did not exist in Turkey. Between 1990 and 2004, funds raised by the private sector in the share market totaled about US\$2 billion. The OECD noted that “[t]he stock of bank deposits exceeds that of total private securities by a factor of 10 ... and the use of non-bank savings vehicles lags far behind the rest of the OECD” (OECD, 2002, p. 67). The share of domestic debt stock in M2Y (i.e., the sum of currency in circulation, sight deposits, time deposits, and fixed deposits held by residents) increased from 112 percent in 13 December 2002 to 125 percent in October 2003 (SPO, 2004). This high ratio illustrates both a crowding-out effect of government deficit funding in the loanable funds market and a lack of financial market depth. The rate of dollarization (i.e., the ratio of foreign exchange deposits to total deposit of 17 residents) decreased from 56.7 percent in 2001 to 49.3 percent in 2004, showing a slow improvement in confidence in the Turkish lira (see CBT, 19 2004, Table III.1.4, p. 84).

21 Over the course of 15 years, between 1990 and 2004, only US\$22 billion was raised in Turkish capital markets (TSPAKB, 2004, p. 113). The private sector raised a total of US\$15 billion during this period. In 2003, the share of public sector security stocks in GDP was 54.3 percent, whereas that of the private sector was only 5 percent (Table 5). In the same year, total capital market capitalization was 26.7 percent of GDP, whilst total equity issues had 0.48 percent share in GDP. Not surprisingly, retained earnings rather than banks or capital markets play a pivotal role as domestic sources of corporate finance in Turkey. However, Turkey’s steps towards becoming a member of the EU facilitates overseas funding for long-term corporate

31 **Table 5.** Main Indicators of Capital Markets in Turkey (%).

	2001	2002	2003
Total capital market capitalization/GDP	38.5	20.4	26.7
Stock market total transaction volume/GDP	52.2	38.5	40.8
Total equity issues/GDP	0.94	0.57	0.48
Total public sector securities stocks/GDP	69	55	54.5
Total private sector securities stocks/GDP	5.9	4.8	5.0

39 *Source:* CMB (2004). Compiled from Tables 4.2, 4.3, 4.5, and 4.6.

1 borrowers.⁴⁶ It should also be noted that high real interest rates have two
2 paradoxical consequences for large firms; total interest expenditures of the
3 top 500 firms reached 45 percent of total value added between 1997 and
4 2001, whilst their interest income exceeded their operating income between
5 1999 and 2002 (see Boratav, 2003, p. 197).

7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31

3.4. Corporate Governance

11 Separation of management and ownership is at the core of good corporate
12 governance. However, in most emerging market economies, domestic banks
13 are owned by family businesses under family controlled conglomerates.
14 Family control is generally strengthened through pyramid ownership, cross-
15 shareholdings, and interlocking directorates.

15 In Turkey, capital markets do not provide a market for corporate control.⁴⁷ This is not only because of the bank-based financial system but also
17 because of the pyramidal ownership structure. Specifically, the family
18 owned holding companies through pyramidal structures are the dominant
19 corporate model in Turkey (Demirag & Serter, 2003).⁴⁸ A pyramid own-
20 ership corporate structure embedded in the bank-industrial cross-holding
21 system in Turkey is a significant obstacle for good corporate governance.
22 Such an ownership structure, coupled with still less than perfect prudential
23 and disclosure regulation/supervision, has encouraged a lack of informa-
24 tion, transparency, and accountability in corporate practices. This is one of
25 the major obstacles to good corporate governance practices and market-
26 driven consolidation processes in the Turkish financial services industry.
27 Apparently, the family ownership, the low utilization of capital markets and
28 the bank-dominant financial system are interrelated phenomena.

31 32 33 34 35 36 37 38 39

4. SUMMARY AND CONCLUSIONS

33 The crony capitalism version of the bank-industrial cross-holding system,
34 the use of both state and some of the private banks as instruments of rent
35 distribution and deficit funding, along with poor fiscal, financial, and mon-
36 etary governance in the Turkish national context, marked the country's
37 major step away from its integration into the European financial area during
38 the 1990s. However, Turkey has made remarkable progress via economic
39 and financial restructuring programs following the crises of 2000 and 2001.
"Turkey's Transition Program", which aimed to achieve macroeconomic

1 stability, and “The Banking Sector Restructuring Program”, which aimed to
 2 strengthen monetary and financial governance in the banking sector, were
 3 introduced following the crises. These reform programs, which benefited
 4 from substantial financial and technical assistance from the “twin organiza-
 5 tions”, were institutionalized due largely to the policy entrepreneur, and
 6 carried out effectively by the AKP government following the early elections
 7 in November 2002. The EU, with its accession process, and the twin or-
 8 ganizations, with their financial and technical support, serve as the external
 9 anchors for financial and monetary governance by supranational interde-
 10 pendence.

11 Turkey is in the long process of Europeanization, embedded in new policy
 12 processes, organizations, and institutional arrangements. There are a
 13 number of untouched areas; how political parties are funded is unknown
 14 in Turkey and “[a]s regards to fight against money laundering no progress
 15 can be reported” (CEC, 2004, p. 86). The alignment of political funding, and
 16 money laundering legislation with the EU is not yet on the agenda. How-
 17 ever, there is an urgent need for convergence towards EU norms.

18 With regards to good governance in the financial services industry, Tur-
 19 key faces a few major challenges. The regulatory state, which can adopt a
 20 proactive approach in the financial services industry by steering and coordin-
 21 ating policy community, does not exist (for theoretical frameworks, see
 22 Coleman, 1996). The degree of centralization of the state apparatus (or
 23 regulatory/supervisor consolidation), and the existence of institutional ar-
 24 rangements, which ensure a balance between the perspectives of the BRSA,
 25 Treasury and the Central Bank, are needed. As such, the Turkish state is
 26 weak and cannot adopt a proactive approach in the financial services in-
 27 dustry by steering and coordinating policy community. “Governance with
 28 government” in the financial services industry will be a function of the
 29 government’s political entrepreneurialism and skill of setting and imple-
 30 menting its *own* agenda. As such, the fundamental issue for Turkey is “how
 31 to develop institutions with the capacity to determine appropriate policies,
 32 implement them and stick to them until circumstances change” (Eichen-
 33 green, 2002, p. 59). Enhancing the state’s “transformative capacity” – to use
 34 Weiss’ term (1998, 2003) – to manage change and to steer institutional
 35 adjustment in a world of global finance may be a credible answer. The
 36 policy-making in Turkey should be open, transparent and accountable to
 37 the public. The negotiation process between the relevant state actors (which
 38 must be also sufficiently insulated against sectoral interest groups) and
 39 business and labor organizations representing regulated sectors (which must

1 have membership coherence to represent the whole of the sector) must be
institutionalized and regularized, rather than being ad hoc in character.

3

5

UNCITED REFERENCES

7 Amir (1995); Banking Regulation and Supervision Authority; Egilmez &
Kumcu (2001); Farr, Lord, & Wolfenbarger (1998); Weiss (1998); Weiss
9 (2003).

11

NOTES

13

1. The author thanks Korkut Boratav and Ziya Onis for their encouragement and
comments, and Zehra Tasdemir for her research assistance.

15

2. As Bakir and Brown (2004, fn. 1, p. 24) summarized, Turkey’s relations with
the EU are basically governed by the stipulations of the Association Agreement of
1964 (Ankara agreement) which has been supplemented and specified by an Addi-
tional Protocol in 1973. Its basic goal was the establishment of a customs union
between Turkey and the EU. The European Parliament ratified the customs union on
13 December 1995. Turkey was recognized as a candidate for accession at the Hel-
sinki European Council in December 1999. This marked a new era in relations
between Turkey and the EU. Accordingly, the EU has been the major external actor
supervising political reforms in Turkey since December 1999. Further, on 13 De-
cember 2002, the Copenhagen European Council decided that “if the European
Council in December 2004, on the basis of a report and a recommendation from the
[European] Commission, decides that Turkey fulfils the Copenhagen political crite-
ria, the EU will open negotiations without delay” (Anatolian Agency, 2002). The
Copenhagen criteria led the Turkish government to commit itself to political re-
forms. As a result, the EU has been increasingly effective in its carrot-and-stick
policy.

17

19

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QA :2

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3. Of course, governance by supranational interdependence is by no means the
only source of domestic policy change, but, as will be detailed below, it has been an
important one in the Turkish context.

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4. The IMF stand-by agreements and the World Bank Programmatic Financial
and Public Sector Adjustment Loans are the examples of such financial assistances
(see IMF, 2001, 2004; World Bank, 2002, 2004).

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QA :6

5. It should be noted that the major weakness of Zysman’s typology is its focus on
external sources of corporate finance (e.g., bank-based and market-based finance)
ignoring the significant role of internal sources of funding (e.g., retained earnings).
For example, net internal sources of corporate finance between 1984 and 1994 av-
eraged 92.1 percent in France (Cobham & Serre, 1996), 71.8 percent in Germany,
71.2 percent in Japan, 81.2 percent in the UK and 109.8 percent in the USA (Corbett
& Jenkinson, 1997). The same figure for Italy averaged 83.7 percent between 1983
and 1993 (Cobham, Cosci, & Mattesini, 1996). The general conclusion for external

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1 sources of corporate finance derived from these studies shows that market-based
 2 finance is always small, and when external sources of finance relatively large, it is
 3 banks rather than markets that dominate funding.

6. Governance here is defined as “collective problem solving within the public
 realm” (Caparaso, 1996, p. 32, cited in Pagoulatos, 1999, p. 69).

5 7. Demirguc-Kunt and Levine (2003) are mistaken in their identification of the
 Turkish financial system as “market-based”.

7 8. For example, T.C. Ziraat Bankasi, the biggest state-owned bank provided loans
 to farming, T. Halk Bankasi funded small–medium-sized businesses, Etibank fin-
 9anced and owned mines, Sumerbank offered loans to textiles and other household
 goods, Sekerbank provided loans for sugar farming, and T. Emlak Bankasi con-
 tributed to real estate finance.

11 9. Turkish version of the “crony capitalism” has flourished under the following
 conditions: (1) “Public banks have created major distortions in the sector because of
 13 their large size and their abuse for political rent distribution purposes” (OECD,
 2002, p. 80); (2) “Bank entry and exit was highly politicized. The granting of bank
 licenses was based primarily on political criteria during the 1990s” (OECD, 2002, p.
 15 80); (3) “Tax policies and accounting procedures reinforced the channeling of re-
 sources to government, while preventing corporate governance practices which un-
 17 derpinned distortions in the allocation of private sector credit” (OECD, 2002, p. 78);
 (4) “An ineffective bankruptcy law and court system also were not conducive to
 19 quick restructuring efforts (it took 8 years to liquidate the banks taken over after the
 1994 crisis)” (OECD, 2002, p. 80); (5) “Deficiencies in internal control and risk
 21 management in banks are compounded by weakness in the supervisory and regu-
 latory framework” (OECD, 2002, p. 79); (6) “[The Savings Deposit and Insurance
 23 Fund’s] ineffectiveness was highly constrained *inter alia* by an inefficient asset re-
 covery process [coupled with the creation of a Banking Regulation and Supervision
 25 Agency] which became operational too late to prevent the banking crisis from
 erupting late 2000” (OECD, 2002, p. 80); (7) “... failure to limit moral hazard
 27 problems arising from full deposit insurance imposed after the 1994 crisis” (OECD,
 2002, p. 80).

10. Korkmaz Yigit, a leading contractor and real estate developer at the time, won
 a US\$600 million bid for the privatization of Turkbank on 4 August 1998. However,
 29 the sale was suspended on 22 October, after the leak of a tape recording proving a
 deal between Yigit and the Turkish Al Capone, Alaattin Cakici, a deal which elim-
 31 inated rivals in the privatization bid. The Turkbank scandal led to the collapse of the
 government in 1998.

11. For example, three state-owned banks, T.C. Ziraat Bankasi, T. Halk Bankasi
 and T. Emlak Bankasi, were forced by politicians to “hide bad debts [i.e., duty losses]
 33 of about US\$20 billion, or nearly [13]% of Turkey’s entire annual economic output
 in 2001” (*WallStreet Journal*, 30 April 2001, p. A13).

12. Following the banking reform in 1999, regulatory limits on connected lending
 were reduced to 25 from 75 percent, whilst that of open positions was tightened to 20
 37 from 50 percent (OECD, 2002, n. 44, p. 154).

13. This expression is borrowed from Kang (2002, p. 177).

14. The SDIF banks were provided with bonds against their losses. As a result,
 39 Turkey’s domestic debt stock deteriorated significantly.

1 15. There were 12 banks out of 20 which “were taken over on the grounds that
2 their financial positions were seriously distorted and on that banks’ resources were
3 used in favor of the majority shareholders thereby creating losses on the part of the
4 banks” (BRSA, 2003, p. 17).

5 16. Arguably, the Central Bank independence in Turkey has domestic and inter-
6 national dimensions. The former is about the independence of the central bank from
7 the government, whilst the latter refers to that of from the twin organizations which
8 do not have any public accountability for their policy mistakes.

9 17. The result was the collapse of Demirbank which used to fund its government
10 securities portfolio in short-term money market.

11 18. As Akyuz and Boratav notes, [s]uch programs typically use the exchange rate
12 as a credible anchor for holding down inflationary expectations, often leading to
13 currency appreciations and relying on capital inflows attracted by arbitrage oppor-
14 tunities to finance growing external deficits. The consequent build-up of external
15 financial vulnerability eventually gives rise to self-fulfilling expectations of sharp
16 currency depreciations and a rapid exit of capital, resulting in an overshooting of the
17 exchange rate in the opposite direction and hikes in interest rates (Akyuz & Boratav,
18 2003, pp. 1549–1550).

19 19. As will be detailed below, the combination of liberalization process and weak
20 state apparatus and financial institutions made Turkey vulnerable to speculative
21 capital movements. Turgut Ozal’s, who dominated the Turkish politics as Prime
22 Minister between 1983 and 1989, neo-liberal policy paradigm that privileged market
23 liberalization over state-led industrialization came with “the creation of totally new
24 layers of bureaucracy which often resulted in a serious intra-bureaucratic conflicts ...
25 the implementation of the reform process in Turkey was associated with a weakening
26 of the bureaucratic or the state apparatus, arguably with costly consequences” (Onis,
27 2004, p. 114). During Ozal years, as Boratav, Turel, and Yeldan (1996, p. 378) note
28 “Decision making and implementation on rent-allocating activities definitely shifted
29 into the prerogative of the political layer of the state structure as the upper bu-
30 reaucracy was pushed increasingly into a passive position.”

31 20. However, the SDIF has so far collected only US\$2.2 billion as of the end of
32 2004.

33 21. For example, according to a poll, two-thirds of respondents indicated that
34 they did not trust the government and 55 percent thought it had to resign. It has been
35 shown that voters preferred the opposition parties far more than the three parties in
36 the ruling coalition (*WallStreet Journal*, 5 March 2001, p. A.18).

37 22. Between 1973 and 1976, Dervis served Ecevit as an advisor on economic issues
38 and international relations. He was strong advocate of trade liberalization and in-
39 tegration of the Turkish economy with the international economy (e.g., see Dervis &
40 Robinson, 1978).

41 23. Pagoulatos (1999, p. 84) uses term “supranational interdependence” in the EU
42 context. The term “denote[s] all the stages of policy making at the EU level, that is,
43 the initiation, formulation, negotiation, and adoption of EU legislation”.

44 24. For example, within a month’s time following his arrival on the Turkish
45 political scene, unelected Dervis had “63 percent approval rating which is three times
46 more than the next most popular political leader” (Euromoney, April 2001, p. 38).

1 25. This was mainly due to Turkey's geo-strategic importance to the USA. As the
 3 *Financial Times* (16 May 2001) commented on the IMF bailout, "[t]he main reason
 5 for supporting Turkey once again is political rather than economic. A debt default
 would destabilize an important US ally in a vital and sensitive region." Turkey
 became the second biggest borrower with a total of US\$23 billion outstanding loans
 in 2004 (IMF, 2004a).

26. According to the CEC, however, the central bank should not have this ex-
 7 ception which is regarded as "direct public financing by the central bank" (CEC,
 2004, pp. 104–105). This perspective certainly reflects the lack of understanding of
 the financial system fragility in Turkey. QA :5

27. The World Bank approved the first PFPSAL for US\$1.1 billion in July 2001 to
 9 support the reform program. In April 2002, a US\$1.35 billion (PFPSAL II) was QA :7
 11 approved. The PFPSAL III of US\$1 billion was approved in July 2004.

28. Indeed, as Amin (1995, p. 17) notes, "[the IMF is] merely the executive of QA :8
 13 strategies defined by the G7 – strategies that are defined by the least common de-
 nominator among the positions of the United States, Japan and the [EU]."

29. Similarly, IMF managing director, Rodrigo de Rato recently said that "[i]n
 15 the banking sector, the goal over the next three years will be to align Turkey's
 supervisory framework more closely with EU standards" (Rato, 2004).

30. The EU, however, played a pivotal role in political and legal reforms in Tur-
 17 key as the extraterritorial source of influence.

31. There have been 16 different governments in the past 25 years.

32. Nine out of 10 political parties of the previous parliament were pushed out of
 19 the legislature by the electorate.

33. For example, only 6 years after the Turkbank scandal, on 27 October 2004,
 21 the then Prime Minister and Minister for Economic Affairs were sent by the Turkish
 23 parliament to the High Tribunal to stand trial over Turkbank privatization scandal.
 The number of the former ministers who were sent by the Turkish Parliament to the
 Supreme State Court due to corruption charges reached eight in 2004. The 2004 also
 25 witnessed the imprisonment of corrupt bank owners and the mafia leaders (see BBC
 Monitoring Service, 24 December 2004; *Turkish Daily News*, 15 October 2004).

34. Not surprisingly, "[t]he owners of bankrupt banks have started to line up in
 27 front of the [SDIF], fearing the same fate as the Uzan Group and asking for a
 29 payment plan for their debts to be drawn up" (*Turkish Daily News*, 20 February
 2004).

35. On 20 October 2004, Turkey was ranked the 77th most corrupt country
 31 among 145 countries in the world, behind four central and eastern European coun-
 33 tries Poland, Slovak Republic, Czech Republic, and Hungary, which ranked 67, 57,
 51, 42, respectively (Transparency International, 2004). Turkey's corruption percep-
 tion index score worsened from 4.5 in 1995 to 3.2 in 2004. More significantly, her
 score has not changed since 2001, in spite of the EU-induced legal reforms.

36. A comprehensive index of the Economic Freedom of the World (EFW) shows
 37 that Turkey increased its EFW rating, measured by chain-linked index, from 3.5 in
 1980 to 4.8 in 1990 and to 5.8 in both 1995 and 2000 (Gwartney & Lawson, 2004, p.
 19). However, Turkey's rating fell to 5.3 in 2001 and 5.5 in 2002, which was sub-
 39 stantially below the mean summary rating of 6.5 in 2002.

1 37. According to the 2004 Freedom in the World survey, Turkey's "partly free"
country status has not changed since 1994 (Freedom House, 2004). However, Tur-
3 key's combined average of Political Rights and Civil Liberties ratings improved from
4.5 that prevailed from 1996 to 2001 to a score of 3.5 in 2002/2003.

5 38. There is no single financial market governance model in the EU (see Barth et
al., 2003).

7 39. For example, the Imarbank's actual amount of deposits was 10 times higher
than its official balance sheet deposit figures (see Fort & Hayward, 2004, p. 4). Most
recently, the report of the Inspection Board of the Prime Ministry blamed the then
9 heads of the BRSA and Sworn Bank Auditors for negligence and wrongful acts in
recognizing under-reporting of deposits and keeping false accounting books (*Ra-
dikal*, 4 January 2005).

11 40. Those banks which did take excessive risks with less liquidity and capital
gained advantage over other banks which observed prudential guidelines and adopt-
ed a conservative approach to risk and capital management.

13 41. A letter of intent of the government of Turkey on 15 July 2004 indicated that:
We have completed a comprehensive review of the Banking Act and prepared a new
15 draft Law on Credit Institutions to bring the legal framework more closely in line
with EU standards. The law will place particular emphasis on strengthening the legal
17 framework in the following areas: (i) "fit and proper" criteria for bank owners; (ii)
on-site inspections; (iii) lending to related parties; (iv) legal protection for BRSA and,
19 SDIF board members and staff for actions taken in good faith during the course of
their duties; and (v) delineating the responsibilities of BRSA and SDIF respectively
and providing for their effective coordination (IMF, 2004b).

21 42. Morgan Stanley notes that "coupled with sound macroeconomic policies,
productivity gains and investment growth are behind this phenomenal performance.
23 Labor productivity in the manufacturing sector, for example, surged by 30% in the
post-crisis period, raising the country's potential growth rate and lowering unit labor
costs by 38.5% in the same period" (Morgan Stanley, 21 December 2004, p. 2).

25 43. The primary surplus, fiscal surplus before interest payments, target was agreed
with the IMF in 2001 to tackle a debt load of more than US\$200 billion.

27 44. The compounded real interest rate for domestic debt stock was 11.9 percent in
2003 (Treasury, 2004, p. 48).

29 45. Foreign bank entry into the Turkish banking sector was prohibited until 1980.
There were only four foreign banks operating in 1980. Between 1981 and 1990, 16
new foreign-owned banks started wholesale banking in Turkey. They specialized in
31 foreign trade and corporate finance. Foreign banks gradually entered into retail
banking: HSBC bought Demirbank following its seizure by the SDIF in December
33 2000, Unicredit had a 49 percent partnership with Kocbank, BNP Paribas bought
a 50 percent share in TEB, whilst already established Deutschebank recently received
authorization to collect deposits. The number of foreign banks decreased from 15 in
35 2002 to 13 in 2003. This was due to Credit Suisse First Boston and ING Bank N.V.
which ceased their activities.

37 46. For example, in October 2004, Finansbank, Turkey's fifth largest privately
owned bank, issued the longest-dated bond, a subordinated debt with a 10-year
39 maturity. However, special features and a high price were attached to the debt. As
the *Financial Times* (7 October 2004) notes "[a] special feature was the inclusion of a

1 political risk insurance that would protect coupon payments to investors for two
 2 years if the government were to deny lira conversions or transfers abroad. The bond,
 3 rated Ba1 by Moody's Investors Service, pays a coupon of 9 per cent, which increases
 4 to 11.79 per cent after five years if it is not bought back."

5 47. In particular, the possibility of (hostile) takeovers in capital markets is assumed
 6 to be a device for disciplining managers.

7 48. A study on ownership concentration, structure and control in the top 100
 8 companies traded on the Istanbul Stock Exchange (ISE) as at the end of 1999 showed
 9 that "families own 68 of the largest traded 100 companies; 53 of these companies
 10 families have majority control with over 50 per cent of voting rights" (Demirag &
 11 Serter, 2003, p. 47). Specifically, seven of the eight traded banks on the ISE "are
 12 ultimately owned by families. Family owned banks serve as the main bank of a group
 13 companies organized around a holding company [which incorporates other financial
 14 and non-financial firms]."

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AQ4	Please provide expansion for BBDK.	
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