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The Regulatory State and Turkish Banking Reforms in the Age of Post-Washington Consensus

Caner Bakir and Ziya Öniş

ABSTRACT

The new era of the Post-Washington Consensus (PWC), promoted under the auspices of International Financial Institutions such as the International Monetary Fund and the World Bank, centres on the need to develop sound financial regulation and strong regulatory institutions, especially in the realm of banking and finance in post-financial crisis developing countries. This article uses an examination of the Turkish banking sector experience with the PWC in the aftermath of the 2001 financial crisis to show its considerable strengths and weaknesses. The authors argue that the emergent regulatory state in the bank-based financial system has a narrow focus on strengthening prudential regulation, whilst ignoring the increased 'financialization' of the Turkish economy. They identify the positive features of the new era of the PWC in terms of prudential regulation, which has become much more robust in its ability to withstand external shocks. At the same time, however, the article highlights some of the limitations of the new era which resemble the limitations of the PWC. These include the distributional impact of the regulatory reforms within the banking sector, and notably the emergence of foreign banks as the major beneficiaries of this process; weaknesses in promoting productive bank intermediation that finance the real economy and economic growth, leading to poverty reduction via growth of employment whilst stimulating financialization within the economy; and finally, the exclusive focus on prudential regulation, whilst ignoring regulatory costs, consumer protection and competition regulation.

INTRODUCTION

The recent wave of neoliberal restructuring in the developing world has increasingly been accompanied by a process of re-regulation. The notion of the *regulatory state* clearly underlines the growing recognition on the part of key transnational and domestic actors that market liberalization *per se* in the absence of effective regulation will fail to translate into successful economic performance (Majone, 1997; Vogel, 1996). In this view, independent regulatory bureaucracies constitute the main organizational manifestation of the

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regulatory state (Gilardi, 2008). Although the emergence of the regulatory state in advanced developed economies and its consolidation towards regulatory capitalism (i.e. growth in regulation by state and regulation of state) over the last two decades have been subject to extensive research (Braithwaite, 2008; Levi-Faur, 2005), research on the emergence and limits of the regulatory state in developing countries has been much less pronounced.

The basic premises of the Washington Consensus (WC) faced a serious challenge following a series of crises in emerging markets during the course of the 1990s. The International Monetary Fund (IMF), in particular, faced an identity crisis and was confronted with severe criticism from within the dominant Washington academic and policy establishment, notably in the aftermath of the Asian financial crisis of 1997. The criticism of scholars such as Joseph Stiglitz was particularly influential (Stiglitz, 2002). Critical scholars drew attention to the perverse consequences of financial liberalization and capital account liberalization, the absence of effective regulation and the lack of emphasis on stable and equitable economic development (Rodrik, 1997; Stiglitz, 1998). Attention was simultaneously drawn to the need to regulate volatile, short-term capital flows at the global level and the need to undertake regulatory reforms at the domestic level in key emerging markets. Admittedly, international financial institutions (IFIs) had not totally ignored the rule of law, the establishment of legally independent regulatory agencies and good governance practices such as transparency and accountability during the era of the WC. Yet, the emphasis was predominantly on liberalization of markets rather than creating strong supporting institutions.

Following the Asian financial crisis in 1997, the key IFIs such as the IMF and the World Bank put much greater emphasis on the development of independent central banks and regulatory institutions, notably in the realm of banking and finance (Bello, 1998; Jayasuria, 2001; Jayasuriya and Rosser, 2001; also Teichman, 2001, for the Latin American context). This clearly marked a turning point, perhaps underlining the beginning of a new era of Post-Washington Consensus (PWC). This new era is characterized by its much greater emphasis on the creation of new supporting regulatory institutions, as well as a concern with social consequences of market-oriented reforms. It is important to stress from the outset that the key financial institutions were largely impervious to the more radical criticisms advocating a drastic reform of the international financial architecture (Öniş and Şenses, 2005). At least until the global financial crisis of 2008, their primary concern was how to improve regulatory structures in the domestic spheres of major emerging markets as a means of strengthening their economies and their ability to withstand future financial crises.

Turkey is an interesting case to consider in the context of the new era of the PWC. The key Washington institutions, notably the IMF, have been heavily involved in the latest wave of neoliberal restructuring that combined the WC with the PWC in Turkey from 1999 onwards, deepening their influence considerably in the aftermath of the major crisis of 2001. The IMF's approach in the Turkish context clearly reflects the new emphasis on the prudential regulation of banking sector.

This article has two objectives. First, it uses the Turkish case to shed light on the process by which a 'regulatory state' emerges specifically in the realm of banking. Second, it examines the performance of this emerging regulatory state with respect to key economic policy objectives such as financial and macroeconomic stability, long-term economic growth leading to poverty reduction via growth of employment, and equitable income distribution. We argue that the emergent regulatory state in the bank-based financial system narrowly focuses on strengthening prudential regulation whilst ignoring the increased financialization in the Turkish economy. Financialization here refers to 'a process whereby financial markets, financial institutions and financial elites gain greater influence over economic policy and economic outcomes' (Palley, 2007: 1). Its two main impacts in Turkey include economic growth based on private debt rather than productive investment, and transfer of income towards the banking sector, especially from the household sector.

The Turkish experience also highlights how the combination of powerful external actors and a supporting pro-regulation coalition at home can contribute to the emergence of a regulatory state and an improvement in the performance of the banking sector with respect to the first broad objective, namely creating a relatively robust banking system in terms of its ability to withstand powerful shocks, representing a case of real rupture from the pre-crisis era. We argue, however, that the effects of the new regulatory reforms have been much less impressive judged by other major indicators, namely long-term economic growth, growth of employment and income distribution objectives. This was due to growing financialization. In spite of the improvements in prudential regulation in banking, the intermediation performance of the banking sector continues to exhibit important weaknesses particularly in terms of its ability to finance the real economy. Foreign banks, as a powerful arm of the new pro-regulation coalition, have emerged as the principal beneficiaries, whereas small and medium-sized enterprises (SMEs) largely shoulder the regulatory costs but are excluded from the potential benefits generated from a more tightly regulated banking system. Furthermore, since 2001 the regulatory reform has been exclusively concerned with prudential regulation rather than competition regulation and consumer protection. It ignored the increased risk of a potential household debt crisis due to a financialization process which embodies significant redistributive consequences.

From a comparative perspective, what makes the Turkish experience interesting is how the domestic political context helped shape and distort the process of financial liberalization with significantly negative economic consequences, notably during the course of the 1990s. By highlighting the significance of the domestic political context, our analysis differs from that of an important group of scholars who approach Turkey's neoliberal restructuring process from a radical political economy perspective. Such scholars tend to explain crises and weak economic performance in Turkey during the neoliberal era as a natural outcome of global forces and negative interventions on the part of key external actors such as the IMF (Akyüz and Boratav, 2003). The domestic political and institutional context is not sufficiently emphasized in these studies. We also recognize the problems posed by unregulated financial markets at the global level and are quite critical of certain dimensions of neoliberal reforms (Öniş and Şenses, 2005). At the same time, however, we argue that a balanced assessment must pay significant attention to the domestic political context and must acknowledge that external actors can also play a positive role in terms of prudent monetary and fiscal governance.

The Turkish experience also illustrates the crucial role of crisis in changing the balance of power between the key external and domestic actors and empowering the former to facilitate the implementation of major regulatory reforms (Bakir, 2006; Öniş and Şenses, 2007). The 2001 financial crisis, has had a radical political impact (i.e. the effects on government and political parties in the parliament) on the formation of a pro-regulation coalition, as well as a policy impact (i.e. a window of opportunity was opened for policy entrepreneurship for neoliberal policy and institutional changes in a punctuated equilibrium) (Bakir, 2009a).

STATE–BANK–BUSINESS RELATIONS IN THE 1990s: THE ANATOMY OF A RENT-SEEKING COALITION

During the 1980s, country after country decided to adopt more liberal domestic and international financial policies (Helleiner, 1994). Turkey was no exception (Arıcanlı and Rodrik, 1990; Atiyas and Ersel, 1995). Following the major crisis of import substituting industrialization in the late 1970s, the impetus for the liberalization drive came from the key external actors, the IMF and the World Bank.

In the political realm of the 1980s, Turkish democracy displayed a number of underlying deficits which were not unique to this period (Alper and Öniş, 2003; Kalaycıoğlu, 2001). These included a system of party politics based on clientelism and the distribution of patronage resources. Key political institutions such as major political parties and the parliament were characterized by low levels of accountability. The institutional checks and balances which are part of advanced democracies were conspicuous by their absence. These underlying democratic deficits were magnified during the 1990s by successive coalition governments contributing to further fragmentation and politicization of the system.

Turkey's deepening democratic deficits, in turn, were at the heart of the country's deteriorating macroeconomic performance. Turkey witnessed macroeconomic instability in the form of huge budget deficits and public debts, high and volatile inflation, and low economic growth.

Implementation of the basic notions of the WC in this institutional structure created an environment ripe for rent-seeking activities rather than productive financial intermediation. Indeed, a rent-seeking coalition of corrupt politicians, bureaucrats, businessmen and the mafia was formed over banking related issues (Bakir, 2006). This, in turn, contributed to financial crises that further weakened the banking sector. In this context, there were two interrelated factors that hampered the ability of the bank-based financial system to act as a catalyst for economic growth: a soft budget constraint as a perverse incentive structure and the politicization of banking affairs.

Soft Budget Constraint and the Perverse Incentive Structure

A soft budget constraint led to crowding out of private investment by government debt. During the 1990s, successive Turkish governments adopted a 'hot money' policy of high real interest rates for treasury bills and domestic currency appreciation to attract short-term, unproductive and speculative capital in order to finance the uncontrolled growth in government expenditures. High real interest rates and financial arbitrage encouraged banks to focus on government deficit funding via large, open foreign exchange positions (i.e. foreign bank loans), which generated lucrative profits. For example, the annual *real* interest rate for government securities averaged 32 per cent between 1992 and 1999 (Treasury, 2001: 1, 3). Not surprisingly, both public and private banks channelled most of their funds to the government debt market rather than to corporate lending; the share of government securities in total bank assets increased from 10 per cent to 23 per cent between 1990 and 1999 (ibid.: 6). In this kind of banking environment, the crowding out of private investment by government public debt became unavoidable.

One might have expected that the perverse financial incentive structure would have attracted the hostility of industrial capital which would, in principle, have found it hard and costly to finance its investments, while its real income would have been eroded by unexpected high inflation. Although the largest 500 manufacturing firms directed a considerable portion of their gross profits towards the banking sector in the form of interest expenditures, the high real interest rates were paradoxically the major source of net corporate profits. For example, the ratio of financial revenues to net profits before tax among these firms increased from about 33 per cent in 1990 to 219 per cent in 1999 (Yeldan, 2001: 156). These firms adapted to the high real interest environment by switching some of their working capital to liquid government debt instruments (Boratav, 2007: 200–01). These observations imply that powerful private actors were able to capitalize on these perverse incentives. Further, the fact that industrial firms generated their profits from predominantly financial activities and lending to the government at high real interest rates had clearly negative ramifications from a social welfare standpoint, as illustrated by Turkey's comparatively weak domestic saving and investment performance.

The perverse incentive structure also had implications for the regulatory bureaucracies. The Treasury, for example, had no incentive to push for tight financial regulation and supervision of the banks, which were essentially seen as instruments for funding government deficits, or to pressure the state banks to augment their capital base, given the fear that this would worsen the fiscal deficit. Instead, the banks were allowed to have up to 50 per cent of their capital in open positions, which were used to fund the government securities portfolio.

Politicization of Bank Lending and the Regulatory Process

Banking became such an integral part of politics that it has been at the centre of the establishment and collapse of governments in Turkey.[1] A striking characteristic of the Turkish banking sector was the high degree of politicization of bank lending and regulation. Politicized bank lending refers to heavy rent-seeking political intervention in the allocation of bank credit. The dramatic consequences of this included inefficient credit allocation for productive investments and the absence of a regulatory state. The financial aspect of this politicization process prevented bank loans being allocated through market-based supply and demand mechanisms for credit and finance. Duty losses of state banks were notable examples. The state banks' duty of lending at below market interest was abused during this period by channelling cheap loans to corporate and individual donors as well as farmers and other electoral constituencies. Uncompensated lending subsidies and payments generated the 'duty losses' of the largest two state banks which increased from nearly 3 per cent of Gross National Product (GNP) in 1993 to about 12 per cent of GNP in 2000. The state banks' Non-Performing Loan (NPL) portfolio reached about 37 per cent of their total loans in 2001 (BRSA, 2003). As a result of politicization, the state banks had largely become instruments for channelling deposits into political rent distribution. Not surprisingly, these banks became illiquid and covered their funding needs by borrowing from the market at very high rates with short maturities.

Within this politicized environment of bank lending, private banks also displayed a dual structure of rent-seeking behaviour. At one end of the spectrum, one could identify banks which were not involved in corruption but nevertheless capitalized on the perverse incentives generated by the overall

1. For example, in 1997 a fragile coalition government received the support of the opposition party in a vote of confidence in exchange for 28 per cent of the shares of İşbank which were left to the Republican People's Party. The same government collapsed in 1998 when the scandal broke of the rigged privatization of a state-owned bank, Türkbank, in favour of the eventual winner, who received support from a leading mafia leader.

macro-political environment. These uncorrupted segments of commercial banks mainly focused on the lucrative gains derived from the high real interest-bearing government securities funded via foreign borrowing. More significantly, at the other end of the spectrum, corrupt private banks were directing public deposits and profits derived from arbitrage into group financing (i.e. connected lending) and 'bad loans to good friends'. The private banks' NPL ratio reached 28 per cent in 2001 (BRSA, 2003). Not surprisingly, the banking sector, both public and private, was at the heart of the twin financial crises Turkey experienced in November 2000 and February 2001.

Bank regulation also became politicized, with heavy rent-seeking political intervention in the licensing, regulation and supervision of banks which generated weak state capacity in the banking sector. This politicization process was responsible for the poor supervision and regulation of the banking sector, which mainly generated inadequate internal and external control, poor risk assessment and management mechanisms, and poor corporate governance in the banking sector. There were two principal institutional obstacles to the emergence of a regulatory state. The first was a legal environment conducive to the establishment of a rent-seeking coalition through statutory decrees in banking; Statutory Decree No 512 enacted in 1993 constituted a striking example. This decree legally protected corrupt bank managers by: (1) removing their individual responsibility in unlawful acts or misconduct leading to loss and/or bankruptcy of a bank; (2) removing the clause stipulating the expulsion of such bankers from any bank management activities; (3) removing the 5 per cent limit to loans provided by a bank to its partners which had 5 per cent or above share in the bank capital; (4) reducing the number of required partners in a bank establishment from one hundred to five; and (5) failing to restrict the participation of banks in non-financial entities.

The second main obstacle was the concentration of ultimate decision-making power on bank licensing in the hands of economics ministers, whereby bank entry and exit decisions were based primarily on political criteria. This effectively integrated the formal and informal pillars preventing the emergence of the regulatory state, creating an environment in which a few wealthy individuals dominant in financing political campaigns were actively acquiring or establishing banks with the help of the party they had supported during the elections (see Tartan, 2003). The corrupt private bankers involved had also utilized loans from state banks to keep afloat their own banks, which later became insolvent (see BRSA, 2003: 72–101; Tartan, 2003: 72–74). Rent-seeking behaviour was also rampant among some of the bureaucrats working for the key financial regulatory agencies such as the Treasury and the Board of Sworn Bank Auditors (see *Radikal*, 26 August 2003). Not surprisingly, six banks which were granted entry following the 1991 general elections, failed in less than a decade. By 1999, they were all insolvent due to connected lending and were taken over by the Savings and Deposit Insurance Fund (SDIF), also known as SDIF banks (see BRSA, 2003: 17).

In retrospect, the implementation of the WC framework failed to produce an efficient allocation of resources and could not provide a strong foundation for economic growth and development. The weak domestic institutional environment contributed to this failure. More specifically, the persistence of soft budget constraints and the associated politicization of the regulatory process constituted the principal sources of disequilibrium in the banking sector that prevented the emergence of an efficient banking system capable of promoting sustainable economic growth via allocation of loanable funds to productive investments. The rent-seeking coalition formed in state–bank–business interactions flourished in this environment. This coalition not only generated costs in terms of economic growth, systemic stability and the public purse but also created considerable obstacles to the emergence of the regulatory state.

THE POST-CRISIS TRANSFORMATION OF THE TURKISH BANKING SECTOR: ELEMENTS OF EFFECTIVE REGULATION

In December 1999, in the midst of acute disequilibrium in the overall macroeconomic environment and the banking sector, the Turkish government agreed to implement an exchange rate-based Disinflation Programme supervised by the IFIs. In return for the financial support of the IMF, the government committed itself to the economic and financial policies of the programme. The IFIs along with the EU were the key proponents of the regulatory state guided by the PWC in the banking sector. Its institutional foundations included: (1) rehabilitation of insolvent state banks via public money and their subsequent transfer to private players; (2) enactment of a new banking law facilitating legal adaptation to Basel II, Banking Core Principles and banking norms of the EU; (3) establishment of a new formally independent financial regulatory agency; (4) the granting of legal independence to the Central Bank (see CEC, 1999; IMF, 1999).

Under the new banking law, banks were required to maintain proper internal and risk controls as well as management systems. This new act and its provisions were in compliance with the recommendations introduced by the Basel Committee of the Bank for International Settlements, and in accordance with the directives of the EU. Following the new law in 1999, regulatory limits on connected lending were reduced from 75 per cent to 25 per cent, whilst those on open positions were tightened from 50 per cent of capital to 20 per cent. Five insolvent banks were taken over by the SDIF in December 1999. The Banking Regulation and Supervision Agency (BRSA) was established in June 1999 following the ratification of the IMF sponsored Banks Act No 4389 by the Parliament (see IMF, 1999). At the same time, a new central banking law granting legal independence from the government was being drafted. These efforts were the clearest examples of a movement toward depoliticization of bank lending and the rise of the regulatory state in monetary and financial governance in Turkey under the auspices of the IFIs, guided by the PWC.

However, there was no strong domestic constituency allied with the IFIs and the EU in supporting the emergence of the regulatory state, and only a weak commitment from the incumbent government. In the period leading up to the January 2001 crisis, for example, both connected lending and open positions were well above the regulatory limits, with the full knowledge of the Treasury and the Central Bank. Moreover, appointments to the BRSA board took more than a year — the agency did not commence operations until 31 August 2000. It became clear that the government's move was mainly motivated by the prospects of receiving IMF financial support (*Financial Times,* 27 January 1999), and that government ownership and implementation of the IMF programme was weak.

Emergence of Pro-Regulation Coalition Led by a Policy Entrepreneur

Turkey's home-grown financial/economic crisis resulted in the largest economic recession in its history, as real GDP contracted by 7.5 per cent in 2001. Inflation (the consumer price index) was realized at 68.5 per cent and the Turkish lira depreciated by 115.3 per cent against the US dollar, whilst interest rates on government securities averaged 96.2 per cent (CBRT, 2002: 16; 2003: 12). The number of insolvent banks under SDIF administration increased, reaching twenty-two in 2003 (SDIF, 2003). The SDIF held the biggest portfolio of NPLs, which constituted 29.3 per cent of total gross loans in the sector in 2001.

The 2001 crisis punched a hole in the 'crony capitalism' embedded in the Turkish financial system, eventually opening the way for policy entrepreneurship leading to fundamental economic policy and institutional changes towards a neoliberal restructuring of the economy (Bakir, 2009a). The crisis provided 'a window of opportunity' for banking sector restructuring through several channels. First, it undermined the political power and legitimacy of the incumbent coalition government. There was strong public distrust of and anger at the government, as evidenced by opinion polls.[2] Specifically, three parties in the weak coalition government were accused of corruption and of obstructing the three-year disinflation reform programme backed by the IFIs since 1999. Corrupt bankers and businessmen — previously forceful supporters of the government — were among the first groups to be hit hard financially during the crisis period; their power was weakened

2. In one poll, two-thirds of respondents indicated that they did not trust the government and 55 per cent thought it should resign. Voters preferred the opposition parties above the three parties in the ruling coalition (*Wall Street Journal,* 15 March 2001: 18).

as their stronghold on the market was put in jeopardy. Second, the financial crisis exposed the structural weaknesses and the fragility of the banking sector as some banks, both state and private, faced erosion of their capital base and deterioration of their asset quality (BRSA, 2003). Third, the EU accession process, the supervision of the IFIs, and Turkey's need for adherence to internationally acceptable regulatory standards in the post-crisis era, all provided external pressures for the emergence of the regulatory state (see BRSA, 2004: v). Fourth, the 2001 crisis created a space for the involvement of transnational actors; this paved the way for the formation of a strong pro-regulation coalition between external and domestic actors, which played a fundamental role in the emergence of the regulatory state in the post-2001 era.

The formation of the pro-regulation coalition gathered significant momentum with the appointment in March 2001 of a well-respected and highly influential transnational bureaucrat, Kemal Derviş, as the new minister responsible for the management of economic reforms. He was the World Bank's Vice President for Poverty Reduction and Economic Management at the time and had served as an advisor to the Prime Minister in the late 1970s. Derviş was a policy entrepreneur. He played an important policy entrepreneurship and mediation role between domestic and transnational policy communities, helping to translate the new line of thinking on banking regulation, as promoted by IFIs, to the domestic political sphere (Bakir, 2009a). It should also be noted, however, that the appointment of Derviş was a top-down process and involved a relocation of political authority in the implementation of the new economic programme from a democratically elected coalition government to a new kind of quasi-political authority, raising serious doubts about the democratic credentials of the way that the reform process was implemented, at least in the initial stages.

Although Derviş was not an insider to the domestic political process, his background and presence helped to inject an element of optimism and to build trust in the viability of the reform project among the key private and state actors.[3] A pro-regulation coalition among the key public sector actors in the banking policy community was formed by Derviş around the Economics Ministry and key economic bureaucratic agencies.[4] He quickly achieved the much needed bureaucratic co-ordination and collaboration among the principal agencies of the economic bureaucracy.

Derviş declared that '[t]he current crisis has stemmed from the problems of the banking sector' which was 'the most urgent problem' (quoted in *Anadolu*

3. For example, within a month of his arrival on Turkish political scene, Derviş had '63 per cent approval rating which is three times more than the next most popular political leader' (*Euromoney*, April 2001: 38).
4. The new Head of BRSA, the Governor of the Central Bank, the Undersecretary of Treasury, and the Chairman of the Public Banking Executive Board were all appointed by Derviş between 14 March and 3 April 2001.

Agency, 14 March 2001; *Wall Street Journal*, 15 March 2001). The solutions proposed were based on elements of the WC such as prudent fiscal (e.g. tax reforms, fiscal restructuring and the removal of extra-budgetary funds) and monetary policy measures, rationalization and privatization; and on elements of the PWC such as good governance, central bank independence where price stability was defined as a single objective, new banking law requiring the adaptation to international norms such as Basel II, and rehabilitation and restructuring of the banking sector including socialization of bank failures (Treasury, 2001).

These solutions were translated into the fifteen laws mentioned in the comprehensive IMF programme. Derviş noted that these legal reforms were needed to achieve three objectives: building confidence in the economy, setting inflation on a downward trend and generating economic growth. The IMF programme was legitimized in the rhetoric of the EU convergence: 'the economic program is prepared in full compliance with the National Program to the EU . . . . Indeed, our economic program represents the economic dimension of the National Program to the EU' (Derviş, 2001). As such, the international banking community was supportive of the restructuring programme personalized by Derviş (*BBC News*, 12 June 2001).

Derviş strove to secure societal co-operation and consensus building over the new economic programme through meetings with representatives of business associations and labour unions (*Cumhuriyet*, 18 May 2001). In meetings and public announcements, he focused on aggregate welfare improvements rather than on the distributive effects of neoliberal restructuring arising from tight fiscal and monetary policies and regulatory change. This strategy contributed to broad public support for the policy and institutional change initiatives (*Anadolu Agency*, 9 April 2001).

The Turkish experience with the PWC also involved multilevel governance including IFIs and supranational actors. These actors included the IMF with its Standby Agreements, according to which IMF lending was conditional on the adoption of its policy prescriptions; the World Bank, with its technical assistance for reforms via Programmatic Financial and Public Sector Adjustment Loans; and the EU, which required Turkey to adopt and implement the complete EU legislation and standards — the *acquis communautaire* — as part of the accession process. Instead of supervising the economic reforms directly, the EU offered feedback through regular reports on Turkey's progress towards accession. The compliance of the banking sector with international standards and best practices was assessed by the IFIs via the Financial Sector Assessment Programme.

Progress Towards the Regulatory State in the Banking Sector

In this environment, the government adopted a new stabilization programme following the crisis. The IMF required the implementation of this programme in return for US$ 19 billion to be provided over the course of three years (*Radikal*, 16 May 2001). The major initiative of this pro-regulation coalition was the Banking Sector Restructuring and Rehabilitation Programme (BRSA, 2001, 2003; HC Istanbul Securities, 2002). This programme had two main pillars: the first was the nationalization and rehabilitation of insolvent banks, and the restructuring of state banks. Between 2000 and 2003, fourteen banks were taken over by the SDIF, with the total number of the SDIF banks reaching twenty-two (SDIF, 2003: 9–10). The rehabilitation of the banks involved recapitalization and debt consolidation. Recapitalization included the elimination of about US$ 27 billion stock of duty losses and related interest receivables; between January 2001 and September 2002, non-cash bonds amounting to US$ 23 billion were injected into these banks for their recapitalization. The consolidation process included strengthening of private banking by the Treasury voluntary debt swap of US$ 8 billion on 15 June 2001, which meant that the banks' foreign exchange-based government securities were swapped with lira-based securities with longer maturity. The banks' short foreign exchange position was thus reduced substantially. Following the debt swap, the short position of the banks declined from US$ 6 billion to US$ 2.2 billion. The restructuring of the state banks also included strengthening of management and downsizing, both in the number of branches and in personnel.

The second pillar of the restructuring was the establishment of institutional foundations of the regulatory state. The banking law amendments aimed to bring the regulation and supervision of the Turkish banking sector closer to EU standards such as 'the definition of thresholds for a bank's own funds, the definition of credit, as well as rules on provisions against bank losses' (CEC, 2001: 52). Accordingly, the banking legislation aimed to incorporate market risk into capital adequacy requirements (CAR), clarify definitions for reporting and accounting purposes, include repurchase agreements on the balance sheet, improve monitoring in the supervision of the banking system, and adopt international accounting standards between 2001 and 2002 (Bakir and Brown, 2004: 433). For example, connected lending was limited and banks were also required to set up appropriate internal inspections and risk management tools by January 2002.

Paradoxically, an agency with no expertise in bank management, the SDIF, emerged as a key bureaucratic agency with relative administrative and financial autonomy. With the enactment of Act No 5020 on 26 December 2003, the management of the SDIF was separated from the management of the BRSA. The Ministry of Justice also drafted new bankruptcy and foreclosure laws in consultation with the World Bank. Following these laws drafted in late 2003, the SDIF effectively nationalized companies and personal property of insolvent bank owners who failed to propose a plan to pay the debts arising from the collapse of their banks. The legal changes clarified the authority of the SDIF in its dealings with the SDIF banks and the administration of legal procedures for the SDIF to collect receivables of those banks. The SDIF move towards the enforcement of rules and laws to recoup taxpayers' money marked the end of a 'light touch' approach that had prevailed during the previous decade. Furthermore, blanket deposit insurance, which had caused a moral hazard problem and unfair competition among banks, was ended in July 2004 and deposit insurance was aligned instead with the EU-15 average level.

Progress towards a regulatory state in the banking sector was facilitated by a transformation in the overall political environment. The financial crisis and its economic consequences, including a deep recession and high unemployment, had created public awareness of the costs of having a rent-seeking coalition. In elections in November 2002, the first single-party government in Turkey for fifteen years was formed under the aegis of the Justice and Development Party (hereafter AKP), obtaining 34 per cent of the vote and a 66 per cent majority in the Grand National Assembly. Nine out of ten political parties of the previous parliament were pushed out of the legislature by the electorate, whilst for the first time in forty years there was only one opposition party in the new parliament. In its first term in power, the AKP quickly gained domestic and international credibility by translating parliamentary stability into political and economic stability. The Transition Programme, designed by the pro-regulation coalition led by Derviş and revised in early 2002 to cover the 2002–04 periods, was adopted and successfully implemented by the AKP government. The AKP had made a firm commitment to fight corruption, to implement structural economic reforms sponsored by transnational financial capital, and to continue the political and legal reforms necessary to meet the Copenhagen criteria for EU membership. Politicians facing corruption charges were sent by the new parliament to the High Tribunal to stand trial over the bank privatization scandals, while corrupt bank owners and bureaucrats faced imprisonment and fines.

In retrospect, a key element of the early post-2001 period was a relative deepening of the democratization process in Turkey, responding to strong signals from the EU. The move towards democratic consolidation in Turkey, with much greater emphasis on accountability, the strengthening of institutions and the rule of law, helped to create an environment conducive to improved economic performance. This overall improvement was also reflected in the pro-regulation turn in the banking sector. At the same time, one should note that the process of democratic consolidation is still ongoing and incomplete in Turkey. Although Turkish democracy is in better shape now than in the 1990s, democratic deficits persist; they continue to negatively influence bank lending and to determine the limits of the regulatory state. These democratic deficits became increasingly apparent during the second term of the AKP.[5] The AKP was not immune to corruption and nepotism:

5. The AKP won a comfortable victory in the general election on 22 July 2007, seeing its power consolidated further with 46.4 per cent of the popular vote.

it too used public banks and mobilized regulatory agencies for political purposes in a manner rather reminiscent of the political parties that had ruled Turkey during the 1990s.[6]

Elements of Improvement in the Performance of the Banking Sector

Before discussing improvements in the banking sector, it is important to look at some of the main macroeconomic and public sector debt indicators. Public finance and debt-related indicators improved significantly due to a primary surplus which averaged about 5 per cent of GDP in the post-crisis era. As a result, between 2002 and 2008, EU-defined general government budget deficit (i.e. 3 per cent of GDP) and public sector gross debt stock (i.e. 60 per cent of GDP) decreased from 10.2 per cent to 2.2 per cent and from 73.7 per cent to 39.5 per cent, respectively (Treasury, 2009: 72–80). Not surprisingly, during the same period, the public sector borrowing requirement declined from 10 per cent to 0.1 per cent, whilst annual inflation, nominal interest rates for government securities and GDP growths rate averaged about 13.3 per cent, 26 per cent and 5.9 per cent respectively (see Treasury, 2009). As a result of prudent fiscal and monetary policies, the banking sector focused more on the provision of credit in the post-crisis era where the share of government securities in total assets declined (see Table 1). It should also be noted that following the 2008 world financial crisis, there has been a decline in financial intermediation of the banking sector.

The emergence of the regulatory state has had some positive prudential regulatory consequences in the banking sector. Sector regulations set maximum exposures to interest rate, liquidity and foreign exchange risks and also limit related-party exposure. As such, the NPL to gross loans ratio, which was 29.3 per cent in 2001, declined sharply to 17.6 per cent in 2002 and 3.6 per cent in 2008, although there has been an increase in the NPL ratio in 2009 due to the impact of the global financial crisis. Improved capital structure was also among the key results of financial restructuring. In particular, the banks' capital was strengthened as a direct result of the Bank Capital Strengthening Programme which required private bank owners to reach 8 per cent CAR by December 2001. Against this background, one possible qualification is that the CAR will fall with the full application of the Basel II standard depending on the size of foreign currency Turkish government securities holdings, which will be the 100 per cent risk weight. Some of the domestic banks benefited in terms of bank risk management

6. For example, on 22 April 2008, two Turkish state-owned banks stepped in to provide US$ 750 million in loans to a holding which is owned by a close friend of the prime minister, in order to enable it to purchase the second largest media group in Turkey (*Hürriyet,* 24 April 2008). In 2009, the Ministry of Finance imposed a US$ 2.5 billion fine for tax evasion on Turkey's largest media group.

Table 1. Improved Financial Depth, Intermediation and Capital Adequacy in the Banking Sector

	2002	2003	2004	2005	2006	2007	2008	June 2009
Assets/GDP	76.6	69.4	71.2	81.5	86.7	87.3	77.1	n/a
Deposits/GDP	51.6	44.3	45.8	51,5	53	55	47.7	n/a
Loans/GDP	22.6	21.8	25.8	33.6	39	44	38.7	n/a
Deposits/Assets (per cent)	64.6	62.3	62.8	61.7	61.6	61.9	62	60.8
Loans/Assets (per cent)	23.3	27.3	33.3	38.3	43.8	49.1	50.2	47.9
Loans/ Deposits (per cent)	36.0	43.9	53.1	62.0	71.1	80	80.8	78.7
Securities Portfolio/Assets (per cent)	39.7	41.9	39.4	35.2	31.8	28.3	26.5	28.9
Non-Performing Loans/Gross Loans (per cent)	17.6	11.5	6.0	4.8	3.8	3.5	3.6	4.9
Capital Adequacy Ratio	25.1	30.9	28.8	23.7	22.3	18.9	18	19.2

Source: BRSA (2006, 2008, 2009).

experience and capital support provided by their foreign partners. Arguably, a significant improvement in NPL and CAR constituted one of the most striking elements of success compared with the pre-crisis era. As a result, the banking sector has become much more robust in terms of its ability to counteract possible shocks which became particularly evident in the context of the recent global financial crisis. However, as will be discussed in the next section, the IMF-supervised 'prudent' fiscal and monetary policies coupled with regulatory reform not only helped to sustain the privileged position of bank capital but also led to increased financialization of the economy.

POSSIBLE LIMITS OF THE REGULATORY STATE: THE IMPORTANCE OF GROWTH AND INCOME DISTRIBUTION OBJECTIVES

The previous sections have shown that the implementation of the WC and the PWC prescriptions, which included a combination of macroeconomic discipline and the emergence of the regulatory state, resulted in a significant improvement in bank intermediation and regulation. To provide a balanced picture, however, this section highlights some of the weaknesses of the neoliberal restructuring during the PWC era, focusing on additional criteria for judging the success of the regulatory state — economic and employment growth and income distribution objectives. We argue that there were four main weaknesses. First, the monetary and fiscal policy regime and the new banking regulatory regime privileged the interests of financial capital. Second, it was not successful in terms of channelling domestic savings to productive investment and hence to long-term economic growth and employment due to the growing financialization of capitalism in Turkey where finance rather than production became the engine of economic growth. Third, it had serious negative repercussions in terms of its income distributional consequences. Finally despite improvements in prudential regulation, it has several formal and informal institutional weaknesses. These limits are documented below.

Privileging the Interests of Financial Capital

The financial cost of the crisis in 2001 was US$ 47.2 billion in taxpayers' money, with capital support provided to banks to rehabilitate the banking sector (SPO, 2004: 72). The cost constituted 32 per cent of GDP in 2001. The SDIF held the biggest portfolio of NPLs in Turkey. The amount of funds injected into the SDIF banks reached US$ 27.8 billion in 2004 (ibid.: 73). By the end of 2007, the financial cost of SDIF bail-outs had reached over US$ 60 billion, while the SDIF collected only US$ 16 billion (*Sabah*, 14 December 2007).

One of the key winners of neoliberal restructuring in the banking sector has been foreign bank capital. There were several reasons why foreign bankers did not bear the cost of the crisis and were able to penetrate the banking market. First, major international banks had privileged access to the Central Bank's foreign exchange reserves immediately before the 2001 financial crisis: for example, four major foreign banks had access to US$ 2.9 billion offered by the Central Bank (Boratav, 2007: 202). Second, foreign banks which provided loans to Turkish banks did not have to face the losses when these domestic banks became insolvent, because of comprehensive Treasury guarantees which were part of the IMF conditionality (IMF, 2000): US$ 5.4 billion worth of foreign loans locked in insolvent banks taken over by the SDIF were covered by the Treasury guarantee (*Aksiyon*, 26 June 2006). Third, foreign banks took the lion's share in the post-crisis consolidation of the banking sector by directly or indirectly acquiring domestic banks that were recapitalized by public money: bank consolidation included nationalization of failed banks and their subsequent sale to domestic banks, which were later taken over by foreign banks. Thus, the emergence of the regulatory state facilitated foreign bank penetration into the Turkish market.

Between 2001 and 2002, thirteen SDIF banks were merged with two other SDIF banks creating two big SDIF banks (SDIF, 2003: 10). During the same period, five SDIF banks were sold to two foreign-owned banks and three domestic banks, including one of the two biggest SDIF banks, which were subsequently sold to foreign banks. All this activity resulted in a massive jump in the share of foreign-owned banks in terms of equity ownership. Table 2 shows that the new phase of restructuring in the banking sector led to several interrelated phenomena: a striking increase in market concentration, foreign-owned bank penetration, a decline in state-owned banks, and high bank profitability. Privatizations, mergers and acquisitions had an important influence on this market concentration. In addition to perverse financial incentives, such as high real interest rates and appreciation of the Turkish lira, bank concentration has been one of the factors contributing to high bank profitability.

Financialization and the Limited Role of the Banking Sector in Productive Intermediation

Table 3 shows that financialization impaired fixed capital investment in terms of the industrial capital and domestic savings to be channelled to productive investments. There has been a decline in the share of domestic savings and a minor increase in fixed capital investment in GDP which could have played a major role in economic growth. Between 2002 and 2007, the share of fixed capital investments in GDP, which is regarded as one of the major determinants of economic growth, remained virtually constant at 24 per cent, whilst there has been a notable decline in the savings to GDP ratio from 20.7 per cent to 16.1 per cent, showing erosion of domestic savings and reliance on foreign capital in a world of capital mobility (SPO, 2008).

Table 2. Banking Sector Concentration, Profitability and Foreign Bank Penetration

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Number of banks	54	50	48	47	50	50	49
Share of top five banks in total assets	57.4	59.0	58.1	61.4	60.9	59.8	60.1
After tax Return on Asset (ROA)	1.5	2.5	2.4	1.7	2.5	2.8	2.0
After tax Return on Equity (ROE)	15.46	18.08	16.5	10.9	19.2	21.8	16.5
Share of state-owned banks according to equity ownership	38	38	38.2	31	28	25.5	26.8
Share of foreign-owned banks according to equity ownership	4.3	4.3	4.3	12.4	22.4	22.3	21.4

Sources: BRSA (2006, 2008, 2009).

Table 3. Financialization and Macroeconomic Indicators

	2002	2003	2004	2005	2006	2007	2008
Savings/GDP	20.7	19.6	20.6	18.5	15.6	16.1	15
Investment/GDP	21.5	23.0	25.8	24.8	23.5	23.4	22.4
GDP growth	6.2	5.3	9.4	8.4	6.9	4.6	0.9
Unemployment	10.3	10.5	10.3	10.3	9.9	9.9	11.0
Current account balance/GDP (per cent)	−0.3	−2.5	−3.7	−4.6	−6.0	−5.9	−5.7
Central bank reserves (billion US$)	28.0	35.1	37.6	52.4	60.7	74.0	69.7
Business loans/GDP	2	2	4	4	5	8	8.7
Business loans/total loans	16	13.1	18.9	15.0	15.1	19.9	22.6
Consumer loans/GDP	2	4	6	9	12	13	8.7
Consumer loans/total loans	6.6	9.0	13.1	19.1	21.6	22.8	22.5
Credit card loans/GDP	1	2	3	3	4	4	3.7
Credit card loans/total loans (per cent)	9.1	10.9	14.3	11.4	10.0	10.3	9.5

Sources: Compiled and calculated from BRSA (2006, 2008); SPO (2008).

With regard to savings, although deposit banks constitute the largest group in the sector, with a 94 per cent share in banking sector assets (CBRT, 2007: 30), and most domestic savings are held in bank deposits, the banking community prefers to mobilize these weak savings to household consumption via individual loans (i.e. the sum of consumer loans and credit card loans) and government securities, rather than productive investments (i.e. business loans). Although there has been improvement in the private sector intermediation function of the banking sector, the sector is far from contributing to the rate of economic growth and employment creation by financing productivity-enhancing innovative activities. It should also be noted that banking sector loans to real sector do not always indicate that loanable funds are being channelled to productive investment. For example, banks also play a significant role in sponsoring property bubbles through construction credits.

The high real interest rates that attracted global liquidity were the main factor behind increased foreign capital inflows which contributed to financialization and a debt-driven economic growth rate (see also Table 4). Further, this monetary policy was responsible for an increased current account deficit, by creating perverse incentives for banks and non-financial firms to borrow from international foreign currency markets. Apart from deposits, the bank loans were funded via syndicated or securitized foreign borrowing. As such, there was a significant increase in the total external debt of the banks from US$ 11.7 billion in 2002 to US$ 60 billion in March 2008 (CBRT, 2002, 2003, 2008). Non-financial corporations substantially increased their foreign debt due to the high domestic interest rates institutionalized by the Central Bank. The long-term foreign exchange denominated debt of these corporations increased from US$ 24.3 billion in 2002 to US$ 99.3 billion in September 2008, an increase of 324 per cent (CBRT, 2009a). It should also be noted about 40 per cent of this foreign debt (US$ 38.8 billion) will mature in three years between 2009 and 2011. The perverse incentives were the major factor behind a substantial increase in the foreign indebtedness of the non-financial corporations, which increased from about US$ 30 billion in 2001 to over US$ 100 billion, or 65 per cent of Turkey's total gross external debt stock, in 2007, representing the main source for financing Turkey's current account deficit in 2007 (CBRT, 2008).

In this environment, Turkish economic growth became dependent on sharp increases in household debt. Consumer loans, such as housing and vehicle loans, and credit card loans rather than business loans (i.e. working capital loans) have emerged as the key growth areas in the post-crisis financialization. The combined share of consumer and credit card loans (i.e. individual loans) in GDP was more than double the ratio of business loans to GDP. The banking sector's massive concentration on consumer loans and credit cards as key profitable growth areas fuelled private consumption expenditures contributing to economic growth and the current account deficit. Not surprisingly, despite economic growth and a relatively low

Table 4. Distributional Indicators in the New Regulatory Regime

Years	Real Interest Rates (per cent)	Financial Arbitrage (per cent)	Net Bank Profits/ GDP	FX Position in the Balance Sheet (in billion dollars)	Consumer Loan Interest Burden	Household Debt Stock/ Disposable Income	Individual Loans / Final Consumtion Expenses	Household Interest Expenditures/ Disposable income	Household Financial Liabilities/ Assets
2002	25.22	52	0.8	−0.6	58.6	n/a	n/a	n/a	n/a
2003	27.35	26.6	1.6	0.0	60.2	8.3	2.5	2.4	7.6
2004	10.43	22.6	1.5	−1.4	41.2	14.4	4.5	3.5	13.5
2005	13.86	1.3	1.2	−1.9	26.0	21.9	8.4	3.8	22.5
2006	5.96	17.1	2	−5.5	18.1	25.5	11.2	3.8	27.9
2007	11.75	17.4	2	−7.7	17.0	28.1	13.2	4.0	35.0
Average	15.76	22.8	1.5	−2.85	36.85	19.64	9.06	3.48	21.3

Sources: Data for real interest rates and financial arbitrage are from SPO (2008); other figures are from BRSA (2006, 2008, 2009); CBRT (2007, 2008, 2009b).

inflation environment, the unemployment rate remained virtually constant at 10 per cent.

Distributional Effects of the PWC

The perverse financial incentives privileging bank capital have been preserved and remained intact in the post-crisis era. The IMF-supervised 'prudent' fiscal and monetary policies coupled with regulatory reform not only helped to sustain the privileged position of bank capital but also led to an increased financialization of the economy. It has been previously noted that the IMF-supervised tight fiscal policies and the appreciation of the Turkish lira against the US dollar generated improvements in public debt ratios. Thus, one would expect a sharp decline in crowding out of private loans by the government debt. However, although the perennial soft budget constraint of the public sector had been eliminated, the securities portfolio constituted about one-third of total bank assets in June 2009 (see Table 1).

The perverse financial incentives were mainly due to the monetary policy of the Central Bank (which was granted legal independence), where price stability was defined as a single objective in April 2001 (Bakir (2007). More specifically, the Central Bank, preoccupied with price stability, kept interest rates artificially high in an effort to push inflation down to single digits through cheap imports whilst allowing the Turkish lira to appreciate in real terms against major currencies. Although there has been a decline in the real interest rates, Turkey offered one of the highest real interest rates among emerging markets. For example, in mid-August 2008, the Central Bank's *real* policy rate of 4.7 per cent (i.e. the nominal rate deflated by inflation) was the second highest rate among a selected group of thirty-seven emerging countries (IMF, 2008: 46). Between 2002 and 2007, real interest rates for government securities averaged 15.76 per cent whilst financial arbitrage averaged 22.8 per cent (Table 4). Not surprisingly, weak domestic savings were largely channelled to the government securities by the banks. During the period between October 2008 and November 2009, deposits held by the banking sector increased by 69 billion Turkish lira, where 68 billion were transferred to government securities portfolio. This marked an increase of 36 per cent in the banks' securities portfolio (*Zaman*, 13 December 2009).

Some of the main implications of this monetary policy include perverse incentives boosting bank profitability, social costs of the Central Bank's foreign exchange reserves, and increased non-financial sector and household sector debt. Although inflation rates and nominal interest rates decreased, the high real interest rates coupled with appreciation of the Turkish lira (i.e. financial arbitrage) provided a lucrative environment for the banking community by encouraging bank-based foreign borrowing. The high real interest rates were the key factor behind the increased net bank profits: the ratio of net bank profits to GDP increased from 0.8 per cent in 2002 to 2 per cent in 2007.

There are also social costs in maintaining excess central bank reserves (i.e. reserves that are above short-term foreign debt stock) which basically fund external deficits of developed countries. For example, in 2006, excess reserves were 69.1 per cent above short-term debt stock and 4.7 per cent of GDP, which was substantially higher than the share of government health, education and investment expenditures in GNP (for a detailed discussion, see Bakir, 2007: 198–202).

The post-2001 era marked the rapid growth of household (i.e. family) financial debt. Between 2003 and 2008, the share of individual loans in household final consumption expenses increased sharply from 2.5 per cent to 14.6 per cent (BRSA, 2008: 15). In this environment, Turkish households increasingly lived beyond their means by borrowing. For example, between 2002 and 2007, the annual compounded rate of growth in household debt was about 50 per cent, while the real growth in household income was around 8.5 per cent (UniCredit, 2008: 33). Since consumption expenditures have been rising much faster than income, the result has been a rise in the ratio of overall household debt to disposable income. Average indebtedness of Turkish households reached 28 per cent of disposable income in 2007, suggesting a four-fold increase since the end of 2003. The actual financial impact of the household debt is shown by the debt service ratio (i.e. consumer debt service payments to consumer disposable income). During the same period, the share of the financial burden derived from consumer loans to GDP showed a phenomenal increase from 1.2 per cent to 11.5 per cent, whereas the consumer loan interest burden (i.e. the ratio of consumer loan interest payments to average consumer loan debt balance) averaged about 37 per cent during the same period. The household financial leverage (ratio of financial liabilities to assets) rose from about 8 per cent to 35 per cent during the same period. Although these aggregate ratios do not point to the impact of household debt on various income groups, they show that a considerable amount of household disposable income has been transferred to the banking sector. The post-crisis banking environment has thus had negative repercussions in terms of sustainability of consumer spending-driven economic growth contributing to weak domestic savings mobilization and the rising current account deficit. Indeed, the economic growth rate trend has been falling since 2004.

Regulatory capture and failure were most visible in the regulation of the credit card market by the Central Bank and BRSA. With regard to overpricing of products and consumer protection, there have been significant regulatory failures in the credit card market. The Central Bank, which is the sole authority determining the monthly maximum interest rate and the monthly maximum default interest rate to be applied to credit card transactions, set rates well above its year-end inflation targets. In this environment, the highest-yielding lending instrument of the banking sector has been credit cards (see HSBC, 2005). In 2004, for example, annual interest yields of the four largest private banks for credit cards were above 100 per cent, whereas deposit rates, bond yields and consumer loans were about 17 per cent, 18 per cent and 23 per cent, respectively (ibid.: 5). The generous margin between deposit rate and credit card yield also points to the banks' exercise of power over customers in the context of a highly concentrated oligopolistic market structure.

The BRSA also failed to demonstrate its bureaucratic autonomy from private banking interests in regulating the credit card market. Before the new credit card law, which became effective on 1 March 2006, common international practices in credit card operations had been ignored. For example, credit cards were issued and limits were increased by banks without the permission of the holder, there was no payment control system to prevent late and non-payment and, more significantly, banks charged extremely high interest on the portion of the credit card debt that was not paid on a compound basis. The new law addressed these issues. However, the main feature of this law was to enable credit card holders to pay their debt in monthly instalments. The result was a rapid increase in the share of defaulted credit card holders, from 39.4 per cent in December 2006 to 53.7 per cent of total credit card holders in June 2009 (BRSA, 2009: 19). Between February 2006 (a month before the credit law became effective) and February 2009, credit card expenditures increased by 94.5 per cent, whilst non-performing credit cards increased by 104.7 per cent (ATO, 2009). During the same period, consumer loans increased by 159 per cent, whilst non-performing consumer loans increased by 989.9 per cent (ibid.). Paradoxically, the credit card regulation became the root cause of the *de facto* regulatory failure in credit card lending as the NPL ratio in credit cards increased sharply from 4.9 per cent in 2002 to 8.3 per cent in June 2006 and 8.7 per cent in March 2008 (BRSA, 2006: 51; CBRT, 2009b: 66). It is striking that such failures are taking place when the consumer interest burden (see Table 4) is on a downward trend. Apparently, a decline in interest rates did not make it easier to service the debt but it rather stimulated further financialization under the current credit card regime. As such, the establishment of a relatively independent prudential regulator and a central bank does not necessarily lead to a strong regulatory state in the banking sector; this requires better linkages between the letter and the spirit of financial regulation and supervision with broader public interest.

In the current global economic recession, Turkey may face a home-grown crisis if households' repayment capacity disappears (leading to a household debt crisis) and if non-financial firms have significant difficulties in finding external financing to roll-over their foreign debt should the economy experience a deep recession under limited access to credit and higher levels of unemployment (Bakir, 2009b).

Remaining Weaknesses of Formal and Informal Institutional Infrastructure

In addition to socialization of private business failures, financialization and privileging sections of bank capital at the expense of broader public interest, the implementation of this new regulatory framework marked the absence of a strong formal and informal institutional infrastructure, associated regulatory costs in banking regulation and supervision. Formal institutional capacity includes the a*ctual* independence of central bank and regulatory agencies from powerful political and societal influences as well as effective bureaucratic co-ordination and collaboration, and the existence of institutionalized conflict resolution mechanisms (Bakir, 2006: 190–2). The failure of Imarbank in August 2003 and the tug of war between SDIF and BRSA over banking affairs (*Hurriyet,* 20 August 2007) exposed these weaknesses in the regulatory state. Thus, the state capacity in the banking sector generated reactive rather than proactive sectoral policy responses.

Informal institutional capacity is about cognitive and normative ideas in bank regulation and supervision. The lack of cognitive (e.g. rating-based approach) and normative (e.g. risk management culture) institutional infrastructure implanted potential future regulatory and supervisory failures. Specifically, Basel II with its risk-based model is a market-based approach to measure and manage financial risks. However, the newly established BRSA had a limited capacity to monitor risk management procedures and practices (i.e. risk models) utilized by banks in the new regulatory environment. When it started its operations, the BRSA did not have regulatory expertise on measuring, supervising and regulating financial risks. This was reflected in the subsequent series of revisions and public announcements made by BRSA on its legally binding regulatory and supervisory decisions.

Moreover, most of the banks did not have their own risk management systems either: a risk management culture was lacking among both public and private sector actors. This normative dimension and institutional backwardness were legacies of the 1990s, shaped by perverse financial incentives (i.e. high real profits derived from the default-free government securities portfolio) and the absence of effective regulation. Neither the BRSA nor the domestic banks in Turkey had sufficient experience with or knowledge about this new regulatory institutional structure as there was no credit-rating tradition in risk assessment. Hence, it was not surprising that in 2005 there were only five banks whose assets were adapted to Basel II at advanced level, whilst seventeen banks had attained medium-level and twenty-seven banks had beginning-level adaptation; five banks had not made any progress at all in this respect (BRSA, 2005). Consequently, while the implementation of Basel II was planned for 2008, it has been postponed over and over again. It should be noted that Turkish banks with foreign participation did not face significant regulatory costs of adaptation to Basel II as they benefited from support and supervision in internal control and risk management techniques and capital injection provided by their foreign partners.

Furthermore, banking regulation is not limited to prudential regulation. Another major weakness of the emerging regulatory state in the banking sector has been its focus on prudential regulation only, ignoring consumer protection and competition regulation. Measures designed to prevent overpricing of products and under-provision of banking services vital to economic growth are fundamental to competition regulation in the banking sector. In terms of access to bank credit, there were no major attempts in the PWC era to minimize the costs of adapting to a new model of risk management negotiated at the global level by powerful foreign bank capital. The SMEs were key actors whose interests were excluded; however, it was they who had to bear the distributional costs of the regulatory change. The SMEs have been hit hard in the new bank regulatory environment, because they do not have a credit rating tradition and they do have a weak capital base. As such, their access to bank loans is limited due to higher costs.

CONCLUSION

The Turkish banking sector is in stronger shape now than it was prior to 2000–01 and therefore better able to cope with the current global economic crisis: foreign exchange and interest rate risks have been minimized, asset quality (3.5 per cent NPL ratio) and capital structures (18.9 per cent CAR) have improved considerably. This is partly due to the PWC-guided progress towards a regulatory state in the realm of banking: the new banking law was introduced; BRSA was established as a relatively independent banking regulation agency; risk management mechanisms were strengthened; the SDIF was empowered and emerged as a key bureaucratic agency in the nationalization and rehabilitation of insolvent banks and their subsequent privatization.

Turkey's encounter with the novel logic of the PWC dates back to the IMF programme of 1999. What is interesting here is the manner in which the crisis helped to change the balance of power between external and domestic actors, which was crucial to the process of generating space for the relatively autonomous action of the new regulatory agency. The new pro-regulation coalition, with a supporting domestic component, helped to dismantle the previous rent-seeking coalition. We argue that in the absence of such a parallel development at the domestic level, the power of the key external actors to push for the regulatory state would have been considerably limited.

However, relative stability should not be the only criterion for judging the performance of regulatory reforms. The performance of the banking sector is much less impressive when judged from a developmental and income distributional perspective. From a developmental perspective, one of the obvious limitations of the new environment is that it cannot make a sufficient contribution to the financing of the real economy, as evidenced in the weak share of savings and fixed capital investments in GDP, whilst a considerable amount of household disposable income was transferred to the banking sector. The SMEs, with a weak capital base and no credit rating tradition, have limited access to credit. Clearly, the emergence of the regulatory state in line with the new logic of the PWC is not a purely technical issue of economic management, but embodies serious distributional consequences.

A parallel development has been a significant reconfiguration of power relations. The new transnational pro-regulation coalition represents financial interests of bank capital which occupy a privileged position in the post-2001 neoliberal restructuring, with foreign banks becoming increasingly dominant actors. The primary regulatory interest of the pro-regulation coalition in the banking sector has been the convergence of the prudential regulation toward international standards, which facilitates penetration of international bank capital into the developing country banking sector through mergers and acquisitions. However, consumer protection and competition regulation in the banking sector, which were of vital public interest, were not in the agenda of the pro-regulation coalition. Like the WC, the PWC represents a new phase of privileging and advancing the interests of international bank capital via selective regulatory arrangements. Hence, the move toward a 'regulatory state' is an intensely political process. Finally, and significantly, rent-seeking elements may persist in the new pro-regulation coalition, which may limit the degree of progress achieved with respect to effective regulation exercised over the banking system. In the Turkish context, new kinds of regulatory failure are evident in the inability to control consumption-oriented lending by commercial banks with its costly consequences for sustainable economic growth. These observations suggest that the new era of neoliberal restructuring which we have termed the era of PWC represents elements of both change and continuity. The new regulatory structure exhibits considerable strengths in its contribution to financial and macroeconomic stability, but at the same time displays striking limitations in terms of financing the real economy, achieving a balanced allocation of credit and laying the foundations for sustainable economic growth.

A robust banking system has enabled Turkey to avoid the kind of financial crisis experienced by advanced market economies during the autumn of 2008. This was partly due to the relatively underdeveloped nature of the financial system and the conspicuous absence of investment banking. Nevertheless Turkey's experiences share many similarities with advanced liberal market economies which suffered from the global financial crisis due largely to financialization — the growth of finance via a rapid rise in especially household debt which stimulates the economy, enormous financial profits, and stagnation (i.e. slow economic growth and production, and rising unemployment). The emergence of the regulatory state in the banking sector has been coupled with a growing financialization of capitalism in Turkey, with all its negative consequences.

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Caner Bakir is an Assistant Professor of International Political Economy in the Department of International Relations at Koç University, Istanbul, Turkey. His areas of research include institutional change in monetary, financial and fiscal governance, globalization and public policy. His work has been published in *Public Administration*, *Governance,* and many other academic journals. His new book, *Globalization, Governance and Public Policy: Banking in Australia* is forthcoming from Palgrave Macmillan.

Ziya Öniş is Professor of International Political Economy and former Director of the Graduate School of Social Sciences and Humanities at Koç University in Istanbul, Turkey. He has published widely on different aspects of contemporary Turkish political economy as well on broader issues of globalization and development. He is the co-author of *Turkish Politics in a Changing World, Global Dynamics and Domestic* Transformations (Bilgi University Press, 2007) and co-editor of *Turkey and the Global Economy: The New Phase of Neo-liberal Restructuring and Integration in the Post-Crisis Era* (London: Routledge, 2009).