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Understanding banking sector reforms in Turkey: assessing the roles of domestic versus external actors[1]

AYTÜL GANIOĞLU

Introduction

Prudential regulation and supervision is a major condition for successful financial liberalization and the proper sequencing of financial liberalization. However, the early 'sequencing literature' puts less emphasis on the role of prudential regulation and supervision of the banking system. While the combination of macroeconomic stabilization, trade and financial liberalization was strongly emphasized in the Washington Consensus policies in the early 1990s, less attention was given to the institutional/governance issues within appropriate sequencing.[2] Hence, McKinnon (1998, p. 57)[3] criticized the 'Washington Consensus' approach for underemphasizing the need to invest in institutional infrastructure before introducing liberalization reforms, while favouring financial liberalization.

Inclusion of prudential regulation and supervision of the banking system to the Washington Consensus approach and to stabilization programmes as an important precondition of successful financial liberalization follows the severe crises in emerging market economies in the 1990s. Especially after the Asian crisis, weak prudential regulation and supervision[4] is regarded to have led to financial sector vulnerability, which was claimed to be at the root of the Asian crisis.[5] Then, the Washington Consensus approach composed a new agenda through encompassing the importance of prudential regulatory framework in its policy line,[6] while financial liberalization continued to be promoted as welfare

[1]The views, interpretations and conclusions expressed in this paper are entirely those of the author and do not represent the views of the Central Bank of Turkey. I am grateful to Professor Dr Fikret Şenses for his valuable comments and guidance.

[2]M. Naim, 'Fads and fashion in economic reforms: Washington Consensus or confusion?' Paper prepared for the IMF Conference on Second Generation Reforms, Washington, DC, 26 October 1999.

[3]See R. McKinnon, 'Beware the overborrowing syndrome', in *United Nations Development Programme (UNDP)*, 1998.

[4]Previously, Diaz-Alejandro claimed that both premature financial liberalization and lax prudential regulation had been instrumental in the Chilean crisis in the early 1980s. See C. Diaz-Alejandro, 'Good-bye financial repression, hello financial crash', *Journal of Development Economics*, 19(1), 1985.

[5]J. Boorman, T. D. Lane, M. Schulze-Ghattas, A. Bulir, A. R. Ghosh, A. J. Hamann, A. Mourmouras and S. Phillips, 'Managing financial crises: the experience in East Asia', *Carnegie-Rochester Conference Series on Public Policy*, 53(1), 2000, p. 5.

[6]D. Kapur, 'Expansive agendas and weak instruments: governance related conditionalities of international financial institutions', *Journal of Policy Reform*, 4(3), 2001.

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enhancing. In other words, the original Washington Consensus has not changed, but was augmented with institutional elements, one of which is prudential regulation and supervision of the banking sector. The official Washington view, therefore, continues to be the argument that financial liberalization is worth having despite the risks, as solution entails building a regulatory framework, which can support it.[7]

This renewed approach, named 'Augmented Washington Consensus'[8] policies, was then reflected in the conditionalities of the IMF programmes for many countries, particularly as observed in the IMF stabilization programme of 1999 for Turkey. Likewise, the recent literature on sequencing suggests the appropriate sequencing as macroeconomic stabilization and prudential regulation and supervision first, and only after the satisfaction of these conditions, recommends capital account liberalization.[9]

In parallel to the late recognition of prudential regulation and supervision within proper sequencing of financial liberalization, the analysis performed by Kaminsky and Schmukler (2003, p. 22)[10] on 28 country experiences regarding the timing of financial liberalization and institutional reforms suggests that reforms to institutions occur mostly after liberalization is completed. In other words, countries generally do not tend to improve their financial systems before liberalization as opposed to latest policy prescriptions. According to the analysis of Williamson and Mahar (1998, p. 29), only two industrialized countries, Germany and Japan,[11] improved supervision prior to reforms and among the developing countries, Israel, Morocco and Peru strengthened their prudential supervision system during their financial liberalization period, while only Peru raised the level substantially. Williamson and Mahar (1998, p. 29) counted 16 countries within their sample of 34 countries that waited at least two years after liberalization had begun before starting to improve prudential regulation and supervision. Hence, in many countries, prudential regulation seems to have seriously lagged the process of financial liberalization in practice.

What is more striking in this process for our purposes is that even after countries have established the legal framework, banking regulation and supervision remains weak due to implementation failures, which may have a major role in falling into severe financial crises. On the basis of an analysis by Ganioğlu (2006) on seven country experiences[12] as regards to the timing of effective implementation of banking regulation and supervision, the weak

[7]A. Walter, 'Financial liberalization and prudential regulation in East Asia: still perverse', IDSS (Singapore) Working Paper, October 2002, p. 5.

[8]This specific naming belongs to D. Rodrik. See D. Rodrik, 'The global governance of trade as if development really mattered', *United Nations Development Programme (UNDP)*, New York, 2001; available at: <http://ksghome.harvard.edu/~drodrik/undptrade.pdf>.

[9]J. Williamson and M. Mahar, 'A survey of financial liberalization', *Princeton Essays in International Finance*, No. 211, Princeton University, International Finance Section, Princeton, NJ, 1998.

[10]See G. Kaminsky and S. L. Schmukler, 'Short-run pain, long-run gain: the effects of financial liberalization', IMF Working Paper, WP/03/34, 2003.

[11]Japan, however, still has a low level of prudential regulation by industrial country standards. See J. Williamson and M. Mahar, op. cit., p. 29.

[12]The countries examined in this analysis are Argentina, Chile, Mexico, Paraguay, Indonesia, the Philippines and Korea.

implementation of existing rules and regulations from the beginning of the process is the major problem rather than absence of them.[13]

The Turkish experience is evaluated as the one in which there was a strong resistance against implementing reforms up to the point where a major economic crisis made a drastic change inevitable.[14] In other words, it is asserted that 'unless the financial system reached a point of complete collapse', which is a crisis, resistance force remains intact. Nevertheless, even the crisis sometimes may become incapable of initiating the implementation of rules and regulations, as happened in the aftermath of the Asian crisis in some countries.[15] In other words, the problem is that although formal convergence towards 'best practices' occurs, implementation failures may still continue due to the regulatory forbearance. Alper and Öniş (2002, p. 13), for instance, characterize the distinguishing factor between emerging economies like Turkey and developed economies as weak implementation of rules and regulations in practice rather than absence of such rules and regulations.

As regards the reasons of these implementation failures, in the literature, the reason why, in practice, so many countries diverged from implementation of banking reforms is a rarely mentioned issue. They are, in part, due to little attention given to governance/prudential regulatory and supervisory conditions within the sequencing framework by the international financial community. Hence, the Bretton Woods Institutions (BWI) are criticized to have recommended deep and bureaucratic reforms without adequately understanding the difficulties of achieving successful reforms of this kind.[16] Moreover, the IMF is criticized for severely underestimating 'the political and institutional problems associated with the construction of strong regulatory institutions'.[17] Moreover, the political economy factors also play a major role in these implementation failures. Existing bureaucratic resources might also be inadequate to enforce new prudential rules. Sometimes enforcing a new rule may be impossible due to institutional capacity or corruption.[18] Furthermore, there may be some issues of particular relevance to countries that international best practices do not cover explicitly or do not stress sufficiently.

In this study, turning our particular attention to the case of the Turkish banking sector, reasons behind implementation failures of banking sector reforms in the period preceding the crises of 2000 and 2001 will be discussed with a special focus on the role of political and institutional forces at work in the 1980s and 1990s in Turkey as well as the role of external anchors such as the IMF's emphasis on regulatory reforms in Turkey. On the other hand, whether the implementation of these reforms would be sufficient to prevent a crisis is the

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[13]Walter asserts that this was the case in most of the East Asian countries, especially due to political economy reasons. See A. Walter, opt. cit., p. 2.

[14]C. E. Alper and Z. Öniş, 'Soft budget constraints, government ownership of banks and regulatory failure: the political economy of the Turkish banking system in the post-capital account liberalization era', Boğaziçi University Department of Economic Working Paper ISS/EC, 2002, p. 3.

[15]A. Walter, op. cit., p. 7.

[16]A. Walter, op. cit., p. 6.

[17]Z. Öniş, 'Argentine crisis, IMF and the limits of neo-liberal globalization: a comparative view from Turkey', 2002, p. 18; available at: <http://home.ku.edu.tr/~zonis/publications.htm>; A. Walter, op. cit., pp. 2, 4.

[18]A. Walter, op. cit., p. 7.

subject of discussion of another study.[19] Hence, in this study, the focus is not on the role of implementation failures on the emergence of crises in Turkey, but to search for the reasons behind resistance of the authorities to implement existing reforms. In that context, we try to find out whether the domestic political and institutional factors outweigh the role of external actors. On the basis of the analysis in this paper, it is concluded that political factors and institutional weaknesses outweigh the external factors in explaining the degree of implementation of banking regulatory and supervisory reforms in Turkey, while the role of external actors in establishing the legal framework has been much stronger.

The organization of the paper is as follows: Section 2 gives an overview of banking sector reforms in Turkey in the post-1980 era until the crises of 2000 and 2001 in terms of establishing effective prudential regulation and supervision in the banking sector. In the next section, the underlying political and institutional reasons behind implementation failures with a focus on the role of domestic actors are discussed. In the fourth section, the role of external actors is assessed. The final section concludes.

Banking sector reforms in Turkey

Institution of a strong banking system through prudential regulation and supervision was not satisfied at any stages of financial liberalization in Turkey. The liberalization process was initiated with the stabilization programme in 1980. The first phase of financial sector reforms in the early 1980s, until the financial crisis of 1982, was undertaken in the presence of a weak regulatory framework of the financial sector. In this period, the reformers' main belief was that enhancing competition is enough for ensuring a sound and strong development in the banking sector. However, lack of regulatory structure to oversee the players in the market when financial liberalization reforms began, led to increased risky behaviour of banks and brokers.

The eventual financial crisis of 1982 represents the first turning point in terms of the policies designed to change the Turkish financial system. The financial crisis of 1982 provided important lessons in terms of prudential regulation and supervision of the financial institutions and brought the issues related to banking regulation and supervision to the forefront. Only after that crisis, in the second phase of the reform process starting in 1983, the structural and institutional characteristics of the Turkish financial system began to be discussed.[20] During 1983, some steps were taken in terms of regulation of the financial sector in the general and banking sector in particular.[21] The importance of the sequencing

[19]For instance, Cizre and Yeldan discuss the reasons of the 2001 crisis with a special focus on political aspects and criticize the official stance that 'the crisis was the result of the failure of the public sector to maintain the austerity targets and the failure to implement fully the free market rationale of globalization'. See Ü. Cizre and E. Yeldan, 'The Turkish encounter with neo-liberalism: economics and politics in the 2000/2001 crises', *Review of International Political Economy*, 12(3), 2005, pp. 387–408.

[20]G. Sak, *Public Policies Towards Financial Liberalization: A General Framework and an Evaluation of the Turkish Experience in the 1980s*, Capital Markets Board Publication No. 22, 1995, p. 60.

[21]For instance, Savings Deposit Insurance Fund (SDIF) was established at the Central Bank through an amendment to the Banks Act in 1983 and banks were required to participate in the SDIF. 'Savings Deposit Insurance Fund' had been founded with the Decree of Law on Banks No. 70 dated 22 July 1983, which annulled Act No. 7129. The purpose was to provide insurance for savings deposits. While this original regulation involved an upper limit for each saving account, it was subsequently

of the reforms and the need for an appropriate regulatory and supervisory legal and institutional framework were also recognized at that time in Turkey. However, reflection of this awareness to the implementation of reforms in the aftermath of 1982 is questionable.

The first substantial change in the legal framework and the major attempt to regulate the banking sector following the crisis of 1982 came together with the major banking reform legislation[22] enacted on 2 May 1985.[23] The Banks Act of 1985 included issues related to the structural problems of the banking system with the aim of providing a legal basis for prudential regulation and supervision of the banking system.[24] The Treasury was responsible for regulating and supervising both on-site and off-site. To increase market discipline further, a division at the Central Bank of Turkey (CBT) was founded in 1986, which mainly undertook off-site supervision based on a very comprehensive reporting system, and if it was deemed necessary, it carried out on-site supervision of banks as well. In addition, external auditing became mandatory for banks in 1987. The government was authorized to change the management of banks in trouble.

In October 1989, the capital adequacy ratio[25] in line with the BIS guidelines was adopted to ensure that banks hold enough capital for their risky assets. Furthermore, 'credit extended to a single customer as well as to related parties was tightly limited. Banks were forced to report non-performing loans separately and they were required to cover defaulted loans through provisions.'[26] Furthermore, the regulatory barriers restricting the entry into the banking system were relaxed, leading to a significant increase in the number of banks operating in the market, which occurred partly through the establishment of new banks and partly through the arrival of foreign banks into the market.

Then, the second turning point in the banking sector came together with the crisis of 1994, which revealed the deep accumulated and neglected problems of the system. The crisis severely hit the banking system due to accumulated risks such as currency risk, interest rate risk, liquidity risk and credit risk inherent in the banking system. The government revoked the banking licences of three small-sized banks. In the face of substantial withdrawal of deposits from banks during the crisis, on 5 May 1994, the government introduced a full guarantee[27] to all savings deposit holders to restore confidence in the banking system.

Footnote 21 continued
amended in 1986 so as to leave the determination of the upper limit for deposit insurance to the discretion and authority of the Council of Ministers.

[22]Banks Act No. 3182 published in the Official Gazette on 2 May 1985.

[23]The first Banks Act of Turkey was approved by Parliament in 1936. This act was replaced by Act No. 7129 in 1958.

[24]It also contained provisions regarding the establishment and capital structure of banks, branch banking, foreign banking, deposits, credits and other investments, deposit insurance as well as the transfer, merger and liquidation of banks. See Central Bank of Turkey, *The Impact of Globalization of the Turkish Economy*, Ankara, 2002, p. 17; Y. Bayazıtoğlu, H. Ersel and E. Öztürk, 'Financial market reforms in Turkey between 1980–1990', Central Bank of the Republic of Turkey Discussion Paper No. 9102, 1991, p. 11.

[25]This ratio was raised to 8 per cent in 1992 from 5 per cent in 1989, by one-percentage point in each year.

[26]H. Ersel, 'Managing financial liberalization in Turkey: consistent banking regulation', 2000, p. 4; available at: <http://www.worldbank.org/mdf/mdf3/papers/finance/Ersel.pdf> .

[27]The first legal arrangement regarding the protection of savings deposits is the Deposit Protection Law No. 2243 dated 1933.

In the aftermath of the 1994 crisis, the major regulatory measure introduced in 1995 was to impose the ratio of 'Foreign Exchange Net Position/Capital Base', in order to monitor and control foreign exchange risk of banks through keeping foreign exchange assets and liabilities compatible with capital base.[28] On the other hand, this measure had not been sufficient to prevent excessive foreign exchange exposure of the banks. Banks used new financial instruments to hide their foreign exchange positions through carrying to off balance sheet transactions by fictitious contracts.

The next and latest turning point in the banking sector was the substantial reform in the Banks Act[29] enacted in June 1999, which was a major step in the direction of overcoming the weaknesses that were known to exist in the system for a long time. The Banks Act was substantially reformed with the aim of strengthening the supervisory authority and to provide a proper framework to deal with the problem of banks. This new Banks Act No. 4389 introduced radical changes to the regulation of the banking system. One of them was the establishment of the Banking Regulation and Supervision Agency (BRSA) as an independent regulatory and supervisory body for the Turkish banking sector. It was intended to unite the regulatory and supervisory power on banks that was divided between the CBT and the Treasury, as well as eliminating the political interference on supervisory and regulatory matters. BRSA was established on 23 June 1999 as an independent supervisory body with full authority to adopt and enforce prudential regulations. Until 1999, the Treasury and the CBT had been the main regulatory bodies of the financial sector in Turkey. Furthermore, the management of the Security Deposit Insurance Fund (SDIF) was transferred to the BRSA from the CBT.

Domestic political reasons behind implementation failures of the banking sector reforms

Although it seems that the legal framework was in place after the Banks Act of 1985 and 1999, the crises in 1994, 2000 and 2001 revealed the weaknesses of the banking system[30] highlighting the weak implementation of existing rules and regulations.

It is pertinent to ask in the first place why politicians delay enhancing and implementing prudential regulatory and supervisory frameworks, being aware of the large costs even in the form of financial crises. Although there might be various political and economic reasons behind these pervasive implementation failures in Turkey in the pre-crises period, the focus here will be on the political dynamics that were instrumental in leading to implementation failures of the legal framework.

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[28]According to legislation, the net foreign exchange position of banks, which is the difference between the Turkish lira equivalent of foreign exchange assets and foreign exchange liabilities, to their capital base was 50 per cent. By the end of December 1998, the net foreign exchange exposure ceiling was reduced to 30 per cent and in late September 1999, the limit was lowered to 20 per cent of capital.

[29]For information about Regulation on the Establishment and Operations of BRSA see <http://www.bddk.org.tr/turkce/mevzuat/Teskilat_Yonetmeligi_bddk2005.doc>.

[30]See A. Ganioğlu, 'Sequencing, pace and timing of financial liberalization in Turkey with implications on the macroeconomic environment', PhD Dissertation Thesis, Middle East Technical University Economics Department, 2006 (unpublished), for detailed discussion of the weaknesses of the banking sector in the period preceding the crises of 2000 and 2001.

From the political economy perspective, politicization of banking regulation and supervision is the main reason behind serious implementation failures. There were two key institutions in Turkey, namely, the Treasury and the Central Bank, responsible for the banking regulation and supervision, with the Treasury acting as the principal institution until the Banks Act No. 4389 in 1999, as previously mentioned. Hence, the unification of the banking regulation and budgetary financing responsibilities in a single institution as well as political involvement to the regulatory and supervisory authority laid the basis of this politicization process, which will be discussed in detail below.

Politicization of banking supervision and regulation

Conflict of objectives of the supervisory and regulatory authority The problem was that the Treasury had performed its supervisory role to a limited extent in practice because, first of all, there was a fundamental conflict of objectives in the operations of the Treasury. The conflict was between having cheap financing of the public sector borrowing requirement on the one hand and bank regulation on the other. Although the Treasury was the key institution responsible for banking sector regulation, this responsibility was put into a secondary place in terms of its objectives. The primary focus of the Treasury was directed to financing of the budget. To that purpose, the banking sector became the main customer of government securities, mostly with the contribution of the incentives introduced.[31] For instance, government securities were granted tax exemptions and carried a stable and risk-free net yield higher than other types of securities.[32] More importantly, the fact that they could be used as collateral in the interbank money market and be held against the liquidity (disponibility) requirements raised their attractiveness for the banking sector. Therefore, the increase in the disponibility ratio after 1985 led commercial banks to raise the share of government securities in their portfolios. Furthermore, only the banks were allowed to be primary dealers in the government bond market. Banks were holding quite high shares of the cash debt of the government, which reached almost 93 per cent in 1991 (Figure 1).

A change in the composition of banks' assets in favour of government securities can be seen from Figure 2. Furthermore, the share of loans in total assets declined from about half of the banks' assets (54 per cent) in 1980 to 30 per cent in 1999, as the securities, mainly the government securities, became the next largest item among the assets of the banks after loans (Figure 2). Especially in recessionary periods, banks' claims on government securities as a percentage of total assets showed a continuous increase as occurred during the 1997–99 period. The regulatory treatment of government securities is viewed as the main reason behind this trend.[33] In other words, the sole function of the financial sector

[31]Moreover, although the yields on private bonds and shares on average were higher than the net rate of returns of the public debt instruments, since their margin of fluctuation had been very wide and erratic, commercial banks have shifted into government instruments. See A. E. Yeldan, 'Financial liberalization and fiscal repression in Turkey: policy analysis in a CGE model with financial markets', *Journal of Policy Modeling*, 19(1), 1997, p. 85.

[32]Y. Akyüz, 'Financial system and policies in Turkey in the 1980s', in T. Arıcanlı and D. Rodrik (eds), *Political Economy of Turkey: Debt, Adjustment, and Sustainability*, Macmillan, London, 1990, p. 102.

[33]L. Rojas-Suarez, 'Can international capital standards strengthen banks in emerging markets?', Institute for International Economics Working Paper No. 01-10, 2001, p. 14.

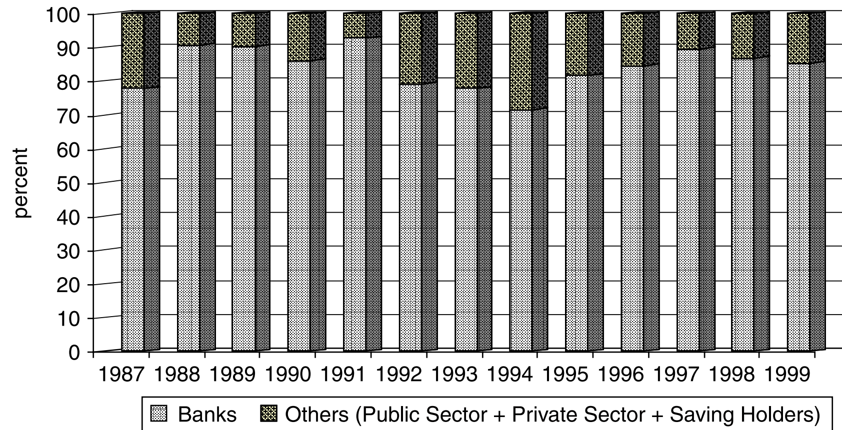

Figure 1. Domestic borrowing by buyers in Turkey, 1987–99.
Source: State Planning Organization <http://ekutup.dpt.gov.tr/ekonomi/gosterge/tr/>.

in Turkey throughout the years turned out to be transferring funds from the domestic and international markets to the Treasury. Therefore, the financial structure of the economy in the post-liberalization period was characterized by dominance of the public sector in the financial markets and banking sector as the main intermediary in the financing of fiscal deficits.

In such a scheme, the Treasury faced very little incentive to regulate the banks whose holdings of government securities reached excessive amounts,[34] while providing cheap financing for public sector deficit as well as maturing debt. In particular, there were few incentives that would push the Treasury to regulate undercapitalized banks with excessive holdings of government securities due to the objectives of eased deficit finance and roll-over of maturing debt.[35] On the other side, possible restructuring of banks would have involved measures such as injection of liquidity using public funds, which would have come into conflict with budget financing.

Politically subordinate supervisory authority Article 64 of the Banks Act of 1985 assigned excessive discretionary power to the Minister in charge, as the Minister was authorized 'to take all measures' to improve the condition of the bank. Hence, political authority, in particular the Minister in charge of Economic Affairs, who was argued to be more exposed to the influence of bank lobbies and political pressures than the Treasury, was directly involved in the regulatory process, which restricted the autonomy of the regulatory authority to make

[34]Demirbank's case is given as an example to the obvious conflict of interest between the two primary objectives of the Treasury. It is argued that Demirbank implicitly helped the Treasury with its large portfolio of government securities. Therefore, it is asserted that for that reason, the authorities decided to pursue a policy of regulatory inaction. The November 2000 crisis was triggered by Demirbank's severe liquidity problems.

[35]See OECD, *OECD Economic Surveys 2001–2002: Turkey*, OECD, 2002, p. 79.

[36]C. Denizer, M. Gültekin and B. Gültekin, 'Distorted incentives and financial development in Turkey', prepared for the conference 'Financial Structure and Economic Development' organized by the World Bank, 2000, p. 12; C. E. Alper and Z. Öniş, op. cit., p. 13.

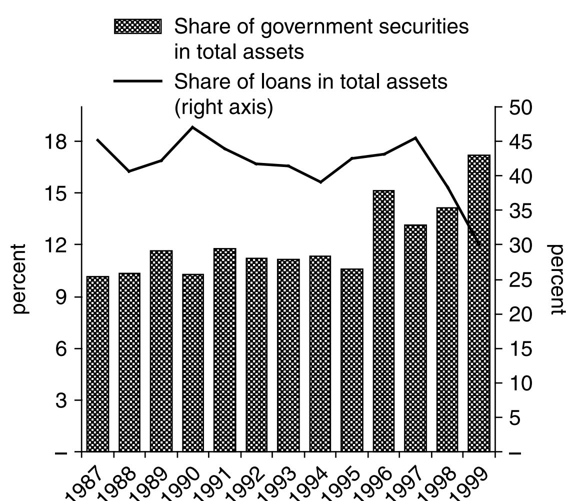

Figure 2. Share of government securities and loans in total assets of banks.
Source: Banks Association of Turkey <http://www.tbb.org.tr/turkce/40yil.htm> and author's calculations.

difficult decisions. If a bank was identified as operating in an unsatisfactory manner, then it would have been reported to the Minister himself. Then, in principle, according to Article 64, the Minister could set in motion a regulatory process and place the bank under the surveillance of the Treasury. Nevertheless, this did not automatically result in a consequent punishment or enforcement to exit from the system under the Banks Act of 1985, if the banks in question do not restructure themselves. Furthermore, the banks under Article 64 did not have any incentive to improve their condition.[36] This means that there was no exit strategy for poorly performing banks.

Consequently, politicization of the regulation process impeded the effectiveness of the regulatory process, leading to a bias towards keeping failing banks in the system and granting of new bank licences on the basis of political criteria during 1990s. There were a large number of bank entries throughout the 1980s and 1990s. In 1980, there were 42 banks and then this number increased rapidly throughout the years reaching 66 in 1990 and 81 in 1999 (Table 1). Although foreign bank entries took place mostly in the mid-1980s, new privately owned bank entry increased in the 1990s, as their number increased from 26 in 1991 to 38 in 1998. As of December 1999, there were 81 banks operating in the system (Table 1).

[37]C. E. Alper and Z. Öniş, op. cit., p. 11; OECD, op. cit., p. 80.

[38]For instance, it is argued that the explosive potential of Demirbank's high-risk high-profit strategy was already well known to participants as well as the regulatory authorities well before the crisis in 2000 had occurred. See C. E. Alper and Z. Öniş, op. cit., p. 17.

[39]C. Denizer, M. Gültekin and B. Gültekin, op. cit., p. 13.

[40]This new law authorizes the SDIF to participate in financial restructuring arrangements, exempts some of its operations from taxes, duties and levies, allows it broad freedoms in restructuring operations, and provides legal protection and rights for SDIF.

[41]Ç. Koğar, PhD Dissertation Thesis, Middle East Technical University Economics Department, 2004.

Table 1. Number of banks in the banking system (1980–2001)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Number of banks	**42**	**44**	**47**	**45**	**46**	**49**	**55**	**56**	**60**	**62**	**66**	**65**	**69**
Commercial banks	40	42	45	43	44	47	49	50	52	53	56	55	57
State	12	12	12	14	12	12	8	9	8	8	8	8	6
Private	24	24	24	19	19	20	24	24	25	24	25	26	31
Foreign	4	6	9	10	13	15	17	17	19	21	23	21	20
Banks under SDIF	–	–	–	–	–	–	–	–	–	–	–	–	–
Development and ınvestment banks	2	2	2	2	2	2	6	6	8	9	10	10	12

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of banks	**70**	**67**	**68**	**69**	**72**	**75**	**81**	**79**	**61**
Commercial banks	58	55	55	56	59	60	62	61	46
State	6	6	5	5	5	4	4	4	3
Private	32	29	32	33	36	38	31	28	22
Foreign	20	20	18	18	18	18	19	18	15
Banks under SDIF	–	–	–	–	–	–	8	11	6
Development and investment banks	12	12	13	13	13	15	19	18	15

Source: The Banks Association of Turkey.

It is quite instructive that all six banks that were allowed to enter the banking sector during and immediately after the elections of 1991, subsequently failed within a decade of their inception.[37] As Alper and Öniş (2002, p. 12) have commented that in the absence of a well-regulated and closely supervised banking system, the only type of bank that was interested in entering are those typically 'interested in collaborating with domestic banks in sharing excess profits originating from market imperfections'.

The number of banks under Article 64 was about 15 or more for eight to ten years in the 1990s. Denizer *et al.* (2000, p. 12) assert that removal from this list seems to have been a negotiated process rather than a regulatory decision. This is quite apparent from the evidence that no single bank was closed[38] whose financial condition was poor and deteriorating until 1999, except during crises period such as 1982 and 1994.[39] In 1994, three small banks were closed and sent into liquidation. From 1997 to early 1999, ownership of three more banks was transferred to the SDIF.[40] Reform efforts accelerated in 1999 and immediately after legal changes were made to the Banking Act through Law No. 4491 the IMF required the closing of five banks for the Stand-by agreement of December 1999. Those banks were all operating under Article 64 for a long period of time. As a result of the 2001 crisis, the financial condition of private banks deteriorated sharply, necessitating further interventions by the SDIF. Hence, additional banks were transferred to the SDIF, bringing the number to 21 banks. Koğar (2004, p. 151)[41] presents on the basis of a report by BRSA that the banks that misuse depositor's money and/or extend credits to their own groups had ended up with insolvency and were transferred to SDIF between the period 1997 and 2001, confirming the inefficient supervision (Table 2).

Role of external actors

External pressures can be effective in terms of introduction of the legal structure of regulatory reforms in developing countries, especially for countries such as Turkey, which very often stick to the IMF programmes. On the other hand, this does not guarantee the implementation of these reforms. The striking point here is that implementation failures can be realized despite external pressures. Alper and Öniş (2002, p. 19) argue that while the primary impetus for regulatory reform originates from the external actors such as the IMF and the World Bank, their role has been in general a discontinuous process. It is asserted that they have little power to push the implementation of these reforms once the legal structure of reform is introduced.

This scheme has almost been realized in Turkey, where external pressure such as the IMF programme, which insists on regulatory reforms, has played a major role in establishing banking regulatory reform in 1999. The Banks Act of 1999 formed a landmark in terms of bank regulation in Turkey in which the IMF was directly

[42] C. E. Alper and Z. Öniş, op. cit., pp. 20–21.

[43] C. E. Alper and Z. Öniş, op. cit., p. 21.

[44] C. E. Alper and Z. Öniş, op. cit., p. 20.

[45] This attempt has also been confirmed by C. E. Alper and Z. Öniş, op. cit.

[46] The Board, the decision-making body of the Agency, consisting of seven members—one of which is the Chairman and another one is the Vice-Chairman—has been recognized as 'the sole authority to

Table 2. Banks taken over by the SDIF

	1997	1998	1999	2000	2001	2002	2003	Total
Number of banks taken over by the SDIF	1	1	6	3	8	1	1	21

Source: Banking Regulation and Supervision Agency (BRSA).

involved, especially in the establishment of BRSA. The IMF's role in the Turkish case might be partially due to pervasive criticisms against its policies in the aftermath of the Asian crisis. Hence, the IMF seems to have started to give banking sector regulation a priority in its stabilization programmes with a certain time lag. Later, the possibility of Turkey's EU membership also contributed to the reform process. Hence, recently Turkey even faced a double external anchor pushing for regulatory reform.[42]

It is also asserted that an equally important factor that increased the power of the IMF in the Turkish context in the late 1990s was the growing realization on the part of politicians and public at large of an impending fiscal and financial crisis.[43] Therefore, important steps were taken in a protracted manner with the main initiative coming from external rather than domestic actors with the possibility of a crisis also playing a part. Hence, the external actors succeed in getting heavily involved in the two major regulatory attempts (Banks Act No. 3821 in 1985 and Banks Act No. 4389 in 1999), as they have been the primary actors in the process of instituting regulatory reform.[44]

On the other hand, on certain issues external actors became ineffective in the introduction of reforms in Turkey. It has been acknowledged by Ganioğlu (2006) on the basis of the interviews that although establishment of an independent regulatory and supervisory authority such as BRSA was intended[45] in 1988, this process failed. The general intention was in the direction of establishing this independent regulatory authority within the Central Bank. While the IMF, the World Bank and the leading officials of the Central Bank was in favour of such an attempt, this proposal turned into a power struggle between the Central Bank and the Treasury. It is asserted that bureaucrats in the Treasury had been more influential on the government and convinced the government to reject this proposal. People interviewed have argued that controlling banks, that is, being the sole regulatory and supervisory authority, gave enormous advantage and power to the hands of the government. The importance of this power was such that even the Ministers within the cabinet competed for it amongst each other. Hence, the government did not want to leave this power of controlling the banks to another

Footnote 46 continued
license as well as to withdraw the license of banks, and to decide on the takeover of failing banks by the SDIF'. The board members are appointed by the Council of Ministers for a term of six years upon the proposal of the State Minister in charge of the economy and they cannot be dismissed before the expiry of their tenure. 'The Council of Ministers designates one of the appointed candidates as the chairman and another as the vice-chairman.' See Banks Association of Turkey, *The Turkish Banking System*, 2000, p. 9; available at: <http://www.tbb.org.tr/english/v12/research.htm>.

[47]According to Banking Law No. 4389, dated June 1999, the Board of BRSA should have been appointed by the end of September 1999 and the BRSA should have commenced its operations by the end of 1999. However, the BRSA could not commence its operations until September 2000, creating a period of regulatory forbearance.

authority. In this case, it seems that domestic political concerns dominated and eliminated the external pressures.

Although the external actors have been more effective in the introduction of the reforms in Turkey, this role has been limited for the implementation of the reforms, as experienced especially in aftermath of the Banks Act of 1999. Although an independent regulatory agency with full licensing authority was created under the Banking Reform of 1999, there occurred some delays in the appointment of BRSA's Board[46] and personnel due to the political intervention.[47] According to the Banking Law No. 4389, dated June 1999, the Board of BRSA should have been appointed by the end of September 1999 and the BRSA should have commenced its operations by the end of 1999. However, the BRSA could not commence its operations until September 2000, creating a period of regulatory forbearance. As BRSA started its activities on 31 August 2000, it became operational too late to prevent the banking crisis from erupting in November 2000 and February 2001. The time lag to appoint BRSA's Board clearly showed the reluctance for or even resistance to reform in the domestic political sphere. As the appointment of the Board was a 'structural performance criterion' of the IMF programme, which had to be met to receive IMF financial assistance (named 'tranche'), the appointments were finally announced, just one day before the IMF deadline.

Hence, domestic political and institutional factors seem to outweigh the external factors in explaining the degree of implementation failures. The IMF pressure to adopt and implement best practice regulatory frameworks as part of conditionality of IMF packages has been successful only after the severe crises in 2000 and 2001.

Conclusion

The question why politicians delay enhancing prudential regulatory and supervisory frameworks of the banking system, while being well aware of the large costs of a probable financial crisis, is an important one. This question is searched for the Turkish case on the basis of the fact that weaknesses of the banking sector were quite obvious from various bank failures following the crises of 1982, 1994, 2000 and 2001. A detailed examination of the banking sector reforms in the 1980s and 1990s reveals that pervasive implementation failures have been the major problem in the 1980s and 1990s in Turkey, leading to excessive risk taking of the banks that mostly laid the basis of financial crises in the 1990s. More specifically, the authorities involved in the regulatory and supervisory bodies did not take timely and adequate regulatory action.

Various political economy factors help explain why prudential regulation was weakly enforced. Easier application of financial liberalization as compared to banking regulation and supervision, governance incapabilities of the government, ability of certain interest groups to block reforms, politically subordinate supervisory institutions, direct involvement of the political authority in the regulatory process and regulatory forbearance can be cited among the political reasons. Among these, the direct involvement of the political authority in the regulatory process and supervisory process as well as the low priority attached to bank regulation on the part of the regulatory authority in the presence of multiple and conflicting objectives seem to have played a prominent role for

the implementation failures of the rules and regulations in the Turkish banking system.

On the other side, although the role of external actors in establishing the legal framework have been strong in the Turkish experience, impact of external pressures to bring about effective implementation of the reforms has been limited until the major Turkish crises of 2000 and 2001. In the face of the Turkish crises of 2000 and 2001, the dominance of domestic actors is undermined, as the influence of the external actors becomes stronger. Hence, improvements to prudential regulation and supervision generally follow crises, as governments may come under pressure to raise prudential standards. Overall, domestic political factors and institutional weaknesses outweigh the external factors in explaining the degree of implementation of banking regulatory and supervisory reforms in Turkey.

Dr Aytül Ganioğlu is an economist at the Research Department of the Central Bank of Turkey and a part-time lecturer in economics at Bilkent University.

Address for correspondence: Research Department, The Central Bank of Turkey, İstiklal Cad. No. 10, 06100 Ulus, Ankara, Turkey.
E-mail: aytul.ganioglu@tcmb.gov.tr

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