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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*

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Abstract

A weakly regulated banking sector is costly notably in the context of emerging-market economies characterized by transitional financial systems. Political and institutional forces play an important role in explaining the inability to implement proper banking sector regulations over significantly time periods. The Turkish experience in the aftermath of capital account liberalization leading to the liquidity crisis of 2000 and 2001 have been utilized as a case study for highlighting the relevance of political and institutional variables in the process of bank regulation. In specific terms, the role that the banking system has played as an avenue for politically generated rent distribution has received primary emphasis. Three major dimensions of the Turkish banking sector in the 1990s have been underlined including the importance of the public banks' duty losses, politicization of new bank entry and the negligible presence of foreign banks. These characteristics are explained by a) the direct involvement of the political authority in the regulatory process; b) the absence of incentives for banks under surveillance to restructure themselves; and c) low priority attached to bank regulation on the part of the regulatory authority in the presence of multiple and conflicting objectives. Finally, attention is drawn to the key role that the external anchors play in facilitating significant regulatory reform.

JEL Classifications: F21, G21, O19

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1. Introduction

Recent episodes of financial crises in emerging markets progressively highlighted the importance of a sound and well functioning banking sector for macroeconomic stability and sustainable economic growth. The Asian crisis of 1997 in particular drew attention to the fundamental role that a deficient banking system could play in terms of generating major financial crises with devastating repercussions on the real economy and with significant possibilities of contagion in an emerging market context. The recent twin economic crises experienced by Turkey in 2000 and 2001 illustrated in a rather dramatic fashion the strong correspondence between a poorly functioning and under-regulated banking system, on the one hand, and the sudden outbreak of macroeconomic crises on the other. Indeed, the Turkish experience shows that both public and private banks can contribute significantly to the outbreak of economic crises. In retrospect, it may be argued that private commercial banks played an instrumental role in the first of the twin crises experienced in November 2000, whilst, public banks emerged as the central actors in the context of the subsequent crisis of February 2001.¹

Financial sector and capital account liberalization, in Turkey, are not novel phenomena. Indeed, financial reform involving interest rate deregulation constituted one of the earliest components of Turkey's neo-liberal experiment that dates back to January 1980. Capital account liberalization also started in 1980, proceeded in discrete stages and culminated with transition to full convertibility of the Turkish Lira in August 1989. Looking back and taking into consideration the recurrent crises in the post-1990 era, it is fair to argue that neither financial sector liberalization nor the opening up of the capital account has produced the desired outcomes in terms of creating financial deepening and a sustained growth trajectory. The deficiencies of Turkey's neo-liberal experiment have been widely discussed and documented.² Our primary concerns in this study are twofold. First we want to document the interrelation between endemic budget deficits, government ownership in the banking system and the pervasive failure to provide proper regulation of the banking system as a whole.

¹ The strong link postulated between the health of the banking sector and vulnerability to economic crises does not imply that this is the only element, which contributed to the onset of the twin economic crises in Turkey. Indeed, other influences were at work. For a comprehensive discussion of these mechanisms see Alper (2001).

² See, among others, Alper and Onis (2001), Onis (1998) and Cizre-Sakallioğlu and Yeldan (2000).

Secondly, we would like to account for the resilience of the structure described up to the point where a major economic crisis rendered a drastic change inevitable. Arguably, unless the system had reached a state of complete collapse, the forces of resistance against the parallel processes of banking and overall macroeconomic reform would have remained largely intact.

We underlined three major traits of the Turkish banking sector in the 1990s. These are 1) the negative repercussions of the public banks' duty losses which assumed special significance after the crisis and the associated stabilization program of 1994; 2) the granting of new bank licenses on the basis of political criteria and the resultant negative ramifications; and 3) the limited presence of foreign banks in the Turkish banking sector. We account for these characteristics on the basis of the following political and institutional forces. Firstly, the political authority is directly involved in the regulatory process. Secondly, the banks under surveillance lack the incentives needed to rehabilitate themselves. Thirdly, the regulatory authority places low premium on bank regulation due to the presence of multiple and conflictive objectives. Furthermore, we draw attention to the key role that the external anchors perform in facilitating significant regulatory reform.

The paper is organized as follows. The case for regulating banks taking into account the special attributes of these institutions is explored in section 2 by recourse to the theoretical literature. Implications regarding the direct and indirect presence of the state in the banking system are analyzed in section 3. This is followed in section 4 by a detailed overview of banking sector developments in Turkey in the post 1990 era. The domestic political economy of regulatory failure in the banking sector is investigated in section 5. This section highlights the complexities of constructing a regulatory state in an emerging market environment in the presence of acute distributional conflicts. Attention then shifts to the role of external actors in the process of constructing a regulatory state with special reference to the banking system in section 6. The key role played by the IMF in this process is underlined in this particular section. Concluding observations are presented in Section 7.

2. The Need for Regulation as a Precondition for Effective Banking Sector Development

A well-functioning market economy requires a certain legal and institutional infrastructure. More specifically a well-functioning banking system, which is a critical component of such a market economy since it provides liquidity insurance and monitoring services to depositors, requires a strong regulatory infrastructure. Not surprisingly, banking is one of the most regulated industries in the world. The vast literature on the desirability bank regulation provides broadly two major reasons why the banking sector should be regulated.³ The first one is the existence of systemic risk, that is, there is strong evidence suggesting that left to themselves, banks are subject to periods of instability and contagion which generally result in costly restructuring. The second reason that calls for regulation of the banking sector is the existence of asymmetric information problem and the inability of small depositors to monitor banks.

The problem of systemic risk may be illustrated as follows. Because banks provide liquidity insurance and maturity transformation service, and there exists information asymmetry about the liquidity structure of banks' assets, banks are, by definition, vulnerable to bank runs that may result as a result of pure panic or some aggregate shock. Since each bank is an integral component of the payment system and failure of one bank can bring about a domino effect on the other solvent and profitable banks. This situation may be very costly to the economy because it may lead to premature liquidation of assets and call back of loans to otherwise productive investment projects. The existence of the systemic risk may justify the existence of a lender of the last resort, generally the central bank and the existence of deposit insurance. However, these two proposed solutions bring along the problem of moral hazard. In such situations, banks may have incentive to be illiquid and take on risky projects at the expense of the tax-payers.⁴ The 1997 banking crises experienced by Asian economies vividly demonstrate the problem of systemic risk. The existence of such systemic risks clearly provides strong arguments for regulation involving liquidity and capital adequacy

³ The issues of whether or not banks should be regulated and what the optimal banking sector regulation scheme ought to look like have been explored extensively in the literature. However, there is no consensus on the answers to these issues. For a detailed analysis, see Dewatripont and Tirole (1994); for an extensive survey of literature, see Santos (2000).

⁴ Fair pricing of the deposit insurance as well as cost of borrowing from the lender of the last resort are also issues that are non-trivial.

requirements. Supervision of banks and especially timely information about the true capital position of “weak banks” are very important. Based on the supervision, the regulatory authority, at each point in time, should be able to decide whether to intervene and contain the first “domino”.

The second argument for the regulation of banks relates to the inability of the small depositors to monitor banks--also called the representation hypothesis by Dewatripont and Tirole (1994). According to this argument, the specificity of banking firms originates from the fact that small depositors or other financial institutions mainly hold their debt. The small depositors may have neither the incentive nor the competence to collect information about the asset quality, capital adequacy of the bank or intervene into the bank management. The free riding gives rise to a need for the regulatory agent to act as a public representative of depositors.

International adoption of a common measure of solvency (Cooke ratio) following the 1988 Basel Accord is a very important development for bank regulation in terms of establishing a healthy competition in banking while paying special attention to sufficient capitalization at any time. The initial Accord only considered the credit risk abstracting from market risks. Over time certain amendments were made to account for the initially unconsidered risks and financial innovation (see. Santos. 2000).⁵

Effective regulation is likely to be particularly important in the context of “transitional financial systems”. A transitional financial system may be distinguished from a heavily controlled or repressed financial system, on the one hand, and the highly developed financial systems that exist in advanced economies on the other. A key feature of such a system is that market liberalization proceeds rapidly in the absence of an effective legal and institutional infrastructure. Intermediate regimes of this kind that we typically observe in emerging market economies such as Turkey, Mexico or Argentina, in turn, are characterized by a fundamental asymmetry. Under normal conditions, the financial system, in general, or the banking sector, in particular, tends to make a limited impact on the development of the real economy. Yet, a major financial crisis induced by a series of bank failures, for example, can have a devastating negative impact on real economic performance. This fundamental asymmetry clearly

⁵ In June 1999. The Basle committee released for comment its proposal for a new capital framework which paid special attention to: three issues: minimum capital standards, a supervisory review process and the effective use of market discipline.

highlights the need to develop a strong regulatory framework for the banking sector from the point of view of both crisis avoidance and long-term economic growth.

3. Government Ownership of Banks and Its Broader Implications for Banking Sector Development

The large share of public banks constitutes one of the striking characteristics of the Turkish banking system. Prior to entering into the details of the Turkish experience, it might be instructive to explore the broader relationship between government ownership of banks and longer-term economic performance. A careful reading of the literature points towards the presence of two opposing views.

According to the first view, the government ownership of banks constitutes a favorable phenomenon. In the early stages of economic development where capital is extremely scarce, the government could play an important role in economic development by providing a big push to financial development in the first place. The underlying assumption here is that financial development is a prerequisite for successful industrialization. Government ownership of banks is important in this scenario in terms of enabling the government both to collect savings and to direct them towards strategic long-term projects. This is the kind of perspective associated with the developmentalist view as reflected in the contributions of early structuralist development economists such as Gerschenkron, Lewis and Myrdal. In fact the primary role attributed to public banks formed a component of the broader perspective emphasizing the leader role of the state in terms of overcoming market failures particularly in the early stages of economic development. In line with this broad, perspective government ownership of banks becomes particularly attractive in terms of lengthening the maturity of deposits that in turn facilitates longer-term lending for rapid development. In the absence of government ownership, and considering the risks confronting private banks and the non-bank public, deposits are likely to be characterized by short maturities with negative consequences for longer term lending.

A more recent strand of literature counterbalances the emphasis on the positive aspects of the government ownership of banks. This new strand could be classified as the neoclassical

political economy perspective and is associated with the contributions of such economists as Kornai, Shleifer and Vishny. The basic argument presented by the neoclassical political economy perspective is that government ownership of banks politicizes resource allocation, softens budget constraints and lowers economic efficiency. The logical corollary of this perspective is that government ownership of banks is undesirable since it provides perverse incentives in terms of enabling the government to finance economically inefficient but politically desirable projects.⁶

We would like to suggest the following synthesis of the two opposing perspectives. The developmentalist view is likely to be more applicable in economies in the early or take-off phase of economic development. As economies develop over time and reach a certain maturity threshold, the neoclassical political economy perspective assumes increasingly greater relevance. This synthesis in turn embodies a major policy implication, namely, privatization of public banks once a certain stage of development is reached. This is not to suggest that there is a need for complete withdrawal of the government from the banking system. What is needed is a transformation of government's role from direct ownership to indirect regulation of the banking system and the economy at large. In somewhat different terminology, this process could be described as a transition from "state capitalism" to "regulatory capitalism".

Recent empirical evidence, based on a cross-section data for a large number of countries, tends to provide a picture that is quite consistent with the neoclassical political economy perspective. The following results are rather striking and deserve emphasis: *ceteris paribus*

- the higher the government ownership of banks, the lower the subsequent financial development;
- the higher the government ownership of banks, the lower the economic growth;
- the higher the government ownership of banks, the lower the productivity growth largely implying that the government ownership of banks misallocated resources.⁷

⁶ For a comprehensive discussion of the theoretical literature on government ownership of banks and economic development and elucidation of two opposing perspectives involving the developmentalists and neoclassical political economy frameworks see La Porta et al. (2000).

The broad sets of considerations and international evidence are important in setting the Turkish experience in context. From a comparative perspective, what is also striking is that Turkey's steady deviation from the international norms. The international evidence suggests a steady decline in the share of public banks during the decade covering 1985 to 1995. The share of public banks in the Turkish context continued to prevail at the high levels established by early 1980s.⁸

4. Banking Sector Developments in Turkey in the Post-1990 Era

Banking sector developments exercised a profound influence over Turkey's macroeconomic performance during the 1990s.⁹ In fact, the relationship between distorted banking sector development and macroeconomic instability is a bi-directional phenomenon. Macroeconomic instability, in turn, has clearly aggravated the prevailing distortions in the banking sector. Rather than attempting to provide a comprehensive overview of Turkish banking sector during the period, we would like to highlight some of the key characteristics of the sector that has been instrumental in the creation of macroeconomic disequilibria. Three key elements of varying degrees of importance deserve emphasis in this respect: a) the distortions induced by the predominance of the public banks in the system; b) the dilemmas posed by "open positions" and politicization of new entry in the realm of private commercial banks; c) negligible entry of foreign banks into the sector.¹⁰ What is important for our purposes is that the underlined three broad characteristics made the system highly vulnerable to macroeconomic crises and contributed to an inefficient pattern of longer-term development at the same time.

⁷ The results reported are derived from a major empirical study conducted by La Porta et al. (2000). It is important to emphasize that the reported results are quite robust with respect to different specifications of the government ownership of banks variable as well as the inclusion of other variables in the regressions.

⁸ According to La Porta et al (2000), 1985 data reveal a striking decline in the average share of government ownership of banks in the largest 10 banks from 55.01% in 1985 to 41.74 % in 1995 (data exclude former socialist countries.) However, the corresponding figure for Turkey is 56.46% in both 1985 and 1995)

⁹ It is a well-established fact that indirect financing is of primary significance in the Turkish setting. Hence it makes sense to describe the Turkish financial system as a bank-dominated system in spite of the rapid surge in the trading activities of the stock exchange since 1986.

¹⁰ For comprehensive discussions concerning the characteristics of and distortions present in the Turkey's banking sector, see IMF Staff Country Reports (1998), Ersel (1999), Denizer et al. (2000), Akcay et al. (2001), and Alper et al. (2001).

A cursory examination of the data on the shares of public banks in total assets and deposits of the banking system portray the significant weight of public banks in Turkey in the overall banking structure. (Table 1) It is a well-established fact that public banks create major distortions in the sector notably in the aftermath of the 1994 crisis. These banks have created an uneven playing field in the banking sector due to the fact that both their borrowing and lending operations have been politicized. It is fair to argue that these institutions have emerged as major instruments of rent distribution in the political process. Indeed the reported level of the profitability reflects to a greater extent the administrative decisions as opposed to the performance of those banks conducting the market activities.¹¹ Their capitalization, liquidity and profitability have in part, been heavily undermined by directed lending at subsidized rates to favored sectors. In addition, public banks have been adversely affected through their interaction with the Treasury.

Table 1: Dominance of the Public Banks in the Turkish Banking Sector* (%)

Period Averages	1990-1994			1995-2001**		
	Public Banks	Private Banks	Foreign Banks	Public Banks	Private Banks	Foreign Banks
Share in Total						
Assets	41.28	47.32	3.46	34.68	51.91	3.75
Share in Total						
Deposits	46.38	51.72	1.92	40	51.88	2.31
Interest Payments						
on Deposits/ Total Deposits	10.9	9.1	0.3	13.2	8.2	0.5

(*) The percentages are calculated according to period averages as given above

(**) The reported data for 2001 is until August.

Source: The Banks Association of Turkey, and BRSA, available at <http://www.tbb.org.tr/english/asp/periodicals.asp> and http://www.bddk.org.tr/english/mainpage/index_eng.htm, respectively.

¹¹ Moreover, the reporting of the ratio of non-performing loans to total credits extended in public banks is also the outcome of politico-administrative decision as opposed to decision based on economic criteria.

The concept of duty losses became an increasingly fashionable term in the discourse of late 1990s. Duty losses refer to the quasi-fiscal losses incurred through directed lending which the Treasury recognizes as an obligation. The delays by the Treasury in meeting these obligations resulted in costly and heavy borrowing on the part of the public banks. This in turn helped to generate a major distortion in the system in the form of artificially high interest rates on deposits as well as interbank borrowing. The two major public banks, namely Ziraat and Halk banks, have been at the center of this process. It is important to recognize the political importance of Ziraat Bank (state agricultural bank) and Halk Bank (people's bank). Following the crisis of 1994 and the ensuing IMF program, the two major sources of rent distribution in Turkey involving the state economic enterprises and extra-budgetary funds have largely been placed under control. In retrospect, public banks emerged as the new principal avenue whereby rent distribution mechanisms have been reactivated in the post crisis era. This is not surprising in the sense that the utilization of the two major public banks allowed incumbent governments to serve large sections of the electorate. Ziraat Bank helped to channel funds towards agricultural producers whereas Halk Bank targeted small and medium sized businesses both on a heavily subsidized basis.

Moving beyond the realm of public banks, important developments could also be identified with respect to the private banking sector during the course of the 1990s, which contained significant elements of instability. Soft budget constraints underlying macroeconomic instability had exercised deep repercussions on the private banking system.

In an environment of capital account openness, all private banks, regardless of size, tried to take advantage of float income and arbitrage opportunities.¹² Indeed, the term 'open positions' became as fashionable as the term "duty losses". The term "open positions" signified borrowing foreign currencies at very high interest rates to capitalize on the opportunities provided by holding TL denominated government securities¹³. Clearly, the presence of open positions rendered the private banks extremely vulnerable to speculative attacks. In hindsight,

¹² In fact, this tendency is not unique to commercial banks but appears to be a characteristic of the corporate sector as a whole. Indeed, the annual surveys undertaken by the Istanbul Chamber of Industry concerning the performance of large industrial establishments in Turkey revealed that during 1990s an increasingly high proportion of profits were due to "non-industrial" namely, financial activities involving holding of government securities.

¹³ Foreign exchange denominated deposit accounts received net returns of 20-30% on an annual basis.

it was not surprising to observe several bank failures following the devaluations of 1994 and 2001.¹⁴

**Figure 1: Open Positions of Private Commercial Banks
(Net Foreign Exchange Assets/Total Assets)**



Source: Banking Association of Turkey

<http://www.tbb.org.tr/turkce/bulten/3%20aylik/eylul2001/grupkumule/default.asp>

Yet another disturbing characteristic involved the entry of new banks into the sector during the period on the basis of primarily political criteria. The entry of new banks in itself should not be interpreted as a negative development. However, if granting of bank licenses is determined primarily by political considerations, this is likely to generate perverse outcomes not only on the banking sector but also the economy at large. Six banks were allowed entry into the banking sector during and immediately after the elections of 1991. What is rather disconcerting is that all these six banks have subsequently failed, within a decade of their inception.

¹⁴ For detailed expositions of the problems associated with open positions and the links to the crises

Finally, attention may be drawn to the fact that the presence of foreign banks has been both negligible and counterproductive. Normally, in a well-regulated and closely supervised banking system, foreign will contribute to increasing efficiency and development of domestic financial markets. In the absence of such regulation and supervision on the other hand, only certain types of foreign banks are willing to enter the sector. These are the types of banks that are typically interested in collaborating with domestic banks in sharing excess profits originating from market imperfections.¹⁵ This in turn explains why the presence of foreign banks has been negligible, counterproductive from a social welfare perspective and yet highly profitable from a self-interest standpoint.¹⁶

5. The Difficulties of Constructing a Regulatory State in the Presence of Acute Distributional Conflicts: Domestic Political Economy Considerations

Considering the strong link postulated between the distortions present in the banking sector and recurrent macroeconomic crises in the post 1990 era, an obvious question that comes to mind concerns the inability of the authorities to undertake adequate regulatory action. The absence or at least the weakness of regulation is clearly apparent from several bank failures, which have been present in the context of the 1994 crisis and a major contributor to the 2000-2001 crises. The weakness of regulation is also vividly portrayed by the inability of the authorities to tackle effectively moral hazard problem associated with the introduction of the 100% deposit insurance scheme, since the 1994 crisis. Originally this was conceived of as a strictly temporary measure to calm the panic in the financial markets and to avoid bank runs during the 1994 crisis. What is striking for our purposes however, is that the authorities lacked political incentives to remove this apparently "temporary" measure. Weak regulation manifested itself on two additional accounts. Firstly, it was obvious that foreign banks were unwilling to participate on a meaningful scale in a system characterized by weak and uncertain regulation. Secondly, the authorities made limited or no attempt to deal with the pervasive problem of connected lending associated with strong organic links characterizing the relationship between the banks and holding companies.¹⁷ It is recognized that ceilings on

¹⁵ See Ersel (1999).

¹⁶ The superior performance of foreign banks during the 1990s is documented in Alper et al. (2001).

¹⁷ On the dominant tendency on the part of holding companies to utilize their own banks for internal financing purposes, see Denizer et al. (2000).

connected bank lending have not restrictive enough by international standards and even these levels tend to have been weakly enforced. Not surprisingly, the problem of non-performing loans has emerged as an endemic problem in the Turkish context.

One of the key characteristics that distinguish emerging market economies like Turkey, from established market economies is not the absence of rules and regulations but weak implementation of such rules and regulations in practice. Bank supervision and regulation existed in Turkey, in principle. The 1985 law on banking regulations (Banks Act No. 3182) was a landmark in this context and represented the first major attempt to regulate the banking sector. The Treasury was the principal institution responsible for bank supervision and regulation until the Banks Act No. 4389 in 1999.¹⁸ The Treasury appears to have performed its supervisory role to a reasonable degree. However, it was far from effective in terms of accomplishing a proper regulatory role. Part of the explanation of this regulatory failure on the part of the Treasury was due to inherent shortcomings of the Banks Act of 1985 itself. In retrospect the single major deficiency involved an inability on the part of the regulatory authority to take over the banks that performed in an unsatisfactory manner.

The process envisaged by the act of 1985 appeared to work in the following fashion. The Act authorized the Board of Sworn Bank Auditors associated with the Treasury to examine banks' legal compliance and their financial standing. In addition, the Central Bank was "unofficially" incorporated into the supervision process.¹⁹ If a bank was identified as performing in an unsatisfactory manner, then the next step involved reporting the case to the State Minister responsible for Economic Affairs. The Minister concerned could in principle activate a regulatory process that could empower the Treasury to take an active part in the management of the bank as a means of restructuring and facilitating an improvement in its performance.²⁰

The effectiveness of the regulatory apparatus was hampered however due to a number of interrelated influences. Firstly the process was heavily politicized due to the direct involvement of the Minister responsible. In other words, the regulatory authority lacked the kind of autonomy needed to undertake difficult decisions. What is significant is that the

¹⁸ On the evolution of the legal framework governing banking regulation in Turkey, see Canevi and Cetinkaya (2001).

¹⁹ Banks had to disclose information about their balance sheets to the Central Bank on a regular basis. This information is also useful to the Treasury in terms of monitoring liquidity, credit and interest-rate risks.

bureaucrats involved, lacked the power and the incentives needed to confront both the politicians and the banking lobbies resisting regulatory action. Their preference in this environment to adopt a course of "regulatory forbearance" or a stance of inaction considering the costs of intervention involved. From a bureaucratic point of view, an active and interventionist regulatory stance would invite direct confrontation with individual banks that could often exercise significant political influence. In a political environment characterized by a weak and fragmented party system, and unstable coalition governments, the Minister involved also lacked the power and incentives needed to initiate regulatory action.²¹ In such an environment the optimal strategy for politicians, was to delay actions leading to significant current costs in terms of generation of output and employment losses. Needless to say, this course of inaction led to significant negative repercussions on the future course of social welfare. Indeed, the political arena during the 1990s was characterized by a severe "myopic bias" in terms of implementation of macroeconomic policy. It was not surprising for policy-makers to treat the institutional structure as given in this context, given the costly nature of the transformation process.

Secondly, the designed regulatory framework offered few incentives for banks in trouble to seriously restructure themselves in the rare cases where regulatory authority was decisive enough to place them under surveillance. This paradoxical tendency may be explained by the fact that measures to rehabilitate the banks included such favorable conditions as tax breaks and exemptions from meeting the reserve requirements.²² It might even be argued that certain under-capitalized banks found it advantageous to be placed under Treasury's surveillance given the benefits involved. A key element that needs to be emphasized is that the process of being placed under Treasury's surveillance was based for obvious reasons on secrecy. Yet, negative counterpart of this scenario was the lack of any kind of transparency (aggravating the moral hazard problem, especially after 1994 when the deposits are insured by 100%) and accountability that could have induced effective regulatory action.

Thirdly, attention may be drawn to the fundamental conflict of objectives that characterized Treasury's operations. Whilst the Treasury was the primary institution responsible for banking

²⁰ The subsequent operation of the bank is governed by article 64, which empowered the minister to undertake appropriate measures to improve the condition of the bank.

²¹ For an analysis of the fragmented political environment of Turkey during the course of the 1990s, see Onis (2000).

²² For a comprehensive discussion of these perverse tendencies, see Denizer et al (2000).

sector regulation, banking sector regulation for the Treasury was a secondary function, rather than overriding objective. In fact, the principal focus of the Treasury was on budgetary financing and meeting day-to-day cash flow constraints of the government. It might be fair to argue that collecting banking regulation and budgetary financing under a unified institutional umbrella constituted the single most important distortion in the system. One may go even further and argue that this basic duality in the system resulted in the heavy politicization of banking supervision and regulation. The conflicts involving the two key objectives may be illustrated as follows.

- Possible rehabilitation of banks includes measures such as injecting liquidity through public funds, a measure that comes in direct conflict with the objective of budgetary equilibrium;
- Excessive holdings of government securities by under-capitalized banks facilitate cheaper financing of the current government deficit as well as the maturing debt. As a result, the Treasury faces few incentives to regulate the banks concerned. The fragility of the system has been accentuated further by the rapid and yet risky behavior of small-scale banks whose growth has heavily relied on disproportionate holdings of government securities.

Table 2: Domestic Borrowing by Buyers (Treasury Bills + Government Bonds) (USD million)

	Banks		Public Sector		Private sector		Households		Total
	Amount	%	Amount	%	Amount	%	Amount	%	Amount
1998	39,234	86,8	3,634	8,0	1,763	3,9	572	1,3	45,203
1999	42,382	85,3	5,566	11,2	1,044	2,1	667	1,3	49,659
2000*	36,586	75,9	9,790	20,3	1,839	3,8	0	0,0	48,215
2001*	107,653	74,5	32,028	22,2	2,121	1,5	2,774	1,9	144,577

(*) Provisional

Source: Treasury, available at <http://www.treasury.gov.tr/stat7icborc.htm#2>

It might be useful at this point to turn our attention to the kind of motives underlying the behavior of both large and small banks involving resistance to regulation. Large private commercial banks have typically complained by uneven competition induced by the failure to

institute regulation over public banks. The distortions created by the significantly higher rates of interest on time deposits offered by the public banks such as Ziraat Bank generated a significant degree of resentment on the part of such large private banks.²³ Small banks, on the other hand, displayed a natural tendency towards resistance of regulation because of their single-minded commitment to asset size growth at all costs. The growth in asset size could only be achieved by high-risk high-return strategy, which would not be allowed in a proper regulatory environment. Added to this was the assumption that they would be bailed out in case of a possible collapse due to the built-in elements of insurance in the system.

Finally, we may highlight some of the strategy games involving large and small players in the system. The myopic bias that appeared to have characterized the behavior of public actors was equally applicable to the case of private actors. Even large private commercial banks appeared to have severely underestimated or simply ignored the increase in systemic risks due to the heavy exposure of banks to government securities. Capitalizing on the failures of small banks, in the event of a crisis, in order to establish greater market share and reduced competition might have constituted another implicit motive underlying the strategic behavior of some of the larger banks.

The Demirbank is an illuminating case in terms of highlighting some of the major dimensions, discussed earlier in this section, pertaining to the political economy of bank regulation in Turkey during the period concerned. Demirbank is a private commercial bank with a long history. It was originally founded in 1953. However its rapid growth is an extremely recent, post-1994 phenomenon. Clear indication of this rapid recent growth is portrayed by a cursory examination involving the share of the bank in the total deposits and assets of private commercial banks as a whole. Demirbank's share of total deposits was 0.8% in 1990, 0.9% in 1994 and 5% in 1999. Similarly its share of total assets was 1.3%, 1.8% and 4.5%, respectively. It is also striking to observe the dramatic increase in the asset size of the bank during the course of the decade. The size of its total assets increased from USD 0.313 billion in 1990 to USD 2.986 billion signifying an increase of more than eighth-fold within a decade.²⁴ The bank managed to accomplish this unusual growth. Looking back at the behavior of the bank during 2000, one can get significant insight into the dynamics of its aggressive

²³ The interest rates reached at certain instances to some 20 percentage points higher than the average rate offered by the privately owned commercial banks.

growth strategy. Elements of this strategy are clearly portrayed in Table 3, which highlights some key financial indicators of Demirbank with two leading private commercial banks Akbank and Garanti Bank taken as benchmarks for comparison.

Table 3: Demirbank’s Performance In Comparative Perspective, 1999- (in USD million)

	Demirbank			
	1999	1999	2000	2000
Government Securities	473	1,133	863	282
Repo Transactions	2,466	344	599	597
Share Equity and	416	288	1,610	1,086
Total Assets	2,986	8,061	10,953	9,839

Source: s In Turkey 2000.”

What is clearly evident from Table 3 as well as from detailed accounts of November 2000 crisis experienced by Turkey, is that Demirbank chose an extremely risky strategy for growth by heavy recourse to purchasing long-maturity government securities and financing them in the overnight repo markets.²⁵ This was clearly the type of behavior that most other private commercial banks did not pursue during a period characterized by the implementation of IMF supported stabilization program (and associated fall in expected interest rates at least during the initial phases).

In retrospect, the Demirbank episode is interesting in terms of understanding the reactions of other banks in the system as well as the contours of regulatory failure on the part of the public authorities. 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 actually occurred. The underlying explanations of this regulatory failure have already been provided

²⁴ The relevant data are obtained from the Banks in Turkey publication of the Turkish Banks Association. The information is available at <http://www.tbb.org.tr/english/asp/2000.asp>.
²⁵ On the technicalities of the November 2000 crisis, see Alper (2001).

above in rather general terms. Two additional factors render the Demirbank case rather unique. The Demirbank case illustrated the obvious conflict of interest between the two primary objectives of the Treasury namely, cheap financing of the public sector borrowing requirement on the hand and bank regulation on the other. With its large portfolio of government securities (approximately half of which is purchased in the year 2000), Demirbank implicitly helped the Treasury to attain its primary goal. Perhaps, it is for this very reason that the authorities decided to pursue a policy of regulatory inaction.²⁶ It may also be the case that this bank more than any other small bank, through its unusually rapid growth trajectory, posed a serious threat to major actors in the private commercial banking system. Indeed, during the onset of the initial crisis in November 2000, large banks, notably Akbank and Garanti Bank, shut down their credit lines to Demirbank which was experiencing severe liquidity problems at the time.²⁷ Finally, towards the end of the liquidity crisis of November 2000, Demirbank was transferred to the Savings Deposit Insurance Fund (SDIF) on December 6, 2000.

If the failure to regulate private banks was the prime cause of November 2000 crisis, "under regulation" of the public banks was the prime contributor to the subsequent liquidity crisis of February 2001, which effectively put an end to the stabilization program of 2000. Under regulation in this context has a specific meaning. It refers to the abuse of public banks by the Treasury. Stated somewhat differently, the Treasury failed to take full responsibility of the stock of duty losses of the public banks. Consequently, the public banks were forced to borrow from the inter-bank market to finance their day-to-day liquidity needs. Clearly, this inherent deficiency rendered the system extremely vulnerable to an exogenously generated shock. The detrimental effects of this shock might manifest themselves in a striking fashion, if the shock leads to a sudden stop in capital inflow or even worse, to a sudden capital outflow. Table 4 displays information on the amount of duty losses that the Treasury had to take responsibility of before and after the crisis. It is instructive in indicating the dimensions of the level of under-regulation prevailing in public banks. This might also be interpreted as a

²⁶ A qualification is called for in the sense that the Treasury in formal terms ceased to be the key regulatory agency following the formation of the Banking Regulation and Supervision Agency (BRSA) in conjunction with the new Banks Act No. 4389. However, the full operation of BRSA could not take place until beginning of September 2000.

²⁷ There may be a problem of identification here. The primary motive for shutting down the credit lines to Demirbank might have been to cover themselves against the risk of non-payment. This might have been a move with an economic rationale (other than eliminating a potential threat) considering the unhealthy state of Demirbank and the fact that unlike deposits, interbank loans are uninsured.

measure of the magnitude of rent distribution undertaken by public authorities by recourse to public banks since the stabilization program of 1994.

Table 4: Securities Issued for the Duty Losses of State Banks				(TL Trillion)
	Ziraat Bank	Halk Bank	Emlak Bank	Total
2000 Year-end	2,034	863	-	2,897
2001 January ^(*)	2,333	2,167	-	4,500
February	-	1,000	-	1,000
March	550	1,750	-	2,300
April	4,500	1,750	-	6,250
May	4,730	4,130	45	8,905
2001 Total	12,113	10,797	45	22,955
TOTAL	14,148	11,659	45	25,852

^(*) USD 750 million securities denominated in foreign currencies were converted by the CBRT exchange rate of issuing day, January 3, 2001.

Source: Banking Sector Restructuring Program: Progress Report. BRSA, 08.11.2001

6. External Actors and The Construction of Regulatory State: IMF and Its Role in Banking Sector Regulation

Domestic political environment of Turkey provided few incentives for a smooth transition to a regulatory state both in general terms and with specific reference to the banking sector. In fact, the primary impetus for regulatory reform originated from external sources. However, the role that external actors played, has been a highly discontinuous process. Indeed, discrete steps, taken in the direction of regulatory reform, have only been possible when the autonomous sphere of action of domestic political actors have been substantially undermined following the outbreak of significant economic crises.

The World Bank and the IMF have been the primary external actors responsible for the implementation of regulatory reforms in the economic sphere. The EU may also be considered as a central actor involved in the process of regulatory reform since part of the Copenhagen criteria relate explicitly to the economic sphere. Compared with her fundamental role as an instigator of reform in the social and political realms, the impact of the EU on

regulatory reform has been of secondary importance. The possibility of EU membership has, nonetheless, provided an additional impetus for reform especially in the more recent context. What is significant for our purposes is that in contrast to its major Latin American counterparts, Turkey faced a double external anchor pushing for regulatory reform during the recent era.

Turning our attention specifically to the case of the banking sector, two major regulatory waves may be identified. Both of these waves represented natural reactions to previous financial crises involving bank failures. In both cases, the key multilateral agencies were heavily involved as the primary actors in the process of instituting regulatory reform. Looking back at the 1980s, the Banks Act No. 3821 of 1985 represented a clear response to the bank failures of 1982. These constituted the very first wave of bank failures in the Turkish setting following the initial round of liberalization measures of 1980 in the context of which the World Bank and the IMF were also heavily involved.²⁸

What is striking, however, is that once the legal infrastructure of reform had been introduced, the external actors had little power to push the implementation of these reforms. A clear example concerning the relative impotence of external actors under normal conditions relates to the early attempts to institute an independent regulatory agency such as BRSA during the late 1980s. It appears that the IMF, the World Bank and leading officials of the Central Bank all favored the formation of BRSA. Yet, in the absence of an explicit crisis until 1994, these agencies did not possess the autonomy and power needed to overcome acute domestic political pressures that would have rendered the formation of BRSA at a significantly earlier stage in Turkey's reform trajectory. The 1994 crisis itself represents somewhat of an anomaly in the evolution of externally directed regulatory reforms with respect to the banking sector. It is surprising to observe that in spite of explicit bank failures in the context of the 1994 crisis, bank regulation did not form a key component of the ensuing stabilization program.

It is undoubtedly the case that the Banks Act of 1999 represented a fundamental turning point in the evolution of bank regulation in Turkey. Needless to say, the IMF was once again heavily involved. In retrospect, the Asian Crisis of 1997 had resulted in a radical rethinking of IMF policies. The organization had been subjected to severe criticism following its

²⁸ On the dynamics and sequencing of the reform process in the 1980s see Onis (1998). Concerning the details of the first wave of bank failures in Turkey and its associated costs see Denizer et al. (2000).

misdiagnosis of the Asian crisis in which bank failures seem to have played a fundamental role. With a certain time lag, IMF responded to these criticisms and started to assign a fundamental role to banking sector regulation in its quest for stabilization and regulatory reform.²⁹ An equally important consideration that augmented the power of the IMF in the Turkish context in 1999 concerned the growing realization on the part of the politicians and the public at large of an impending fiscal and financial crisis. Hence, the IMF, through its promise of financial assistance to avert a possible financial crisis, regained the upper hand to accelerate the momentum of bank regulation in 1999 as part of a broader package of stabilization and reform.³⁰

The Banks Act No. 4389 was put into operation in 1999 immediately after the formation of the new coalition government. In hindsight, the formation of BSRA constituted the single most important element of the Banks Act of 1999. The formation of the new agency represented a clear improvement over the previous regime in at least two key respects. First, the single-minded objective of the new institution was to rehabilitate and improve the performance of the banking sector. Hence, by definition, the new organization did not face the kind of dilemmas that the Treasury had been confronted with in the previous era due to the presence of multiple and conflicting objectives. Second, the ability of domestic politicians to involve the process of bank formation and their capacity to resist the process of bank regulation was severely circumscribed in the presence of the new institution.³¹ In the past, the Minister responsible could exercise direct influence over the actions of the Treasury with respect to the banking sector. The system was clearly open to abuse a clear example of which

²⁹ The recognition of the significance of banking sector reforms is evident in the Turkish context from IMF (1998).

³⁰ The Letter of Intent signed with the IMF identified strengthening the banking sector and bank regulation as one of the major areas of reform. The letter clearly highlighted the urgency of instituting an independent supervisory and regulatory agency such as BRSA. The Letter of Intent of December 9, 1999 can be accessed at <http://www.imf.org/external/np/loi/1999/120999.htm>

³¹ Resistance to banking reforms in general and the formation of the BRSA as an independent actor in particular manifested itself at an early stage. As a result of powerful pressures stemming from banking lobbies, vital provisions have been left out from the Act of 4389. Six months later, the Banks Act was amended by Act Number 4491 to remove the loopholes present in the earlier piece of legislation. Perhaps the most significant amendment embodied in Act No. 4491 involved the granting to the BRSA the right to issue new banking permits, which until then had been a political decision left to the domain of the Council of Ministers. Political pressures also manifested themselves as delays in the formation of the BRSA board. The IMF clearly played a vital role in this process. The appointment of the Board was actually a "structural performance criterion" as stated in the letter of intent of December 9, 1999. The Article number 53 of the Letter of Intent (can be accessed at <http://www.imf.org/external/np/loi/1999/120999.htm>) stated that the BRSA was expected to be in full operation by end-August 2000. It is interesting to note that the appointment of the Board did not take place until the last day before the completion of the deadline. For a detailed examination of the legal dynamics of bank regulation and its political background in the context of 1999-2000, see Canevi and Cetinkaya (2001).

was granting of bank licenses on the basis of political criteria. In the new environment political pressures could still operate but in a rather indirect fashion. It is fair to say that the formation of BSRA reduced by a significant margin the ability of politicians to distort the process of bank regulation. BSRA as an institution also reduced the scope for banking lobbies to resist regulation by recourse to the political process.

The events following the passing of the Banks Act of 1999 clearly illustrated the fact that there are still major challenges facing the construction of a proper regulation of the banking system in Turkey. Indeed, the full operation of BRSA could only be initiated with a pronounced time lag, signifying the reluctance or resistance against reform in the Turkish political arena. Once the organization became operative, it became quite apparent that it is not totally immune to political interference. Political pressures may be more limited compared with the previous era, but indirect avenues for exerting political influence certainly exist. Clearly the appointment of the Chairman and the members of the Governing Board is a political decision that rests with the political authority. The Council of Ministers can, in principle, influence the decisions of BRSA through their impact on the selection of the Board members. Indeed, they have used this power in practice through the appointment of the initial Board, an action that has elicited significant subsequent reaction on the part of the IMF. This raises the question of whether it is possibly to institute a truly autonomous regulatory agency in Turkey in practice. Apart from the issue involving independence from political pressures, attention might be drawn to another fundamental dilemma, concerning the representativeness of the institution in practice. It is quite possible to visualize situations where a Board can satisfy the criterion of autonomy but may not be representative of the various stakeholders involved.

This essentially political dilemma may create significant conflicts in the economic realm. If the Board is autonomous and unrepresentative, it is perfectly possible that its primary focus will be on capital adequacy; hence it will place a low premium on the objectives of high growth and high employment. To be more precise, rigid insistence on capital adequacy criteria may imply a restriction of credit to small and medium size enterprises leading to a loss momentum in their growth performance. The danger however is that a Board which is highly representative but lacks autonomy may end up in the other extreme by placing excessive premium on the growth objective and not paying any attention to the capital adequacy criterion in the process. Our view on this matter is that an autonomous Board is desirable.

Since the growth objective is the primary concern of other institutions such as the Treasury. A process of compromise involving these key institutions may achieve the appropriate policy mix in this scenario.³²

Hitherto we have drawn attention to the positive role that external agencies such as the IMF have played in the process of introducing key banking sector reforms. For a balanced perspective, however, we should also highlight some of the mistakes resulting from their actions. It might be argued, for example, that the actions of the IMF concerning the choice of BRSA board members appeared to have undermined the legitimacy and credibility of the institution from the outset. The IMF's active intervention in facilitating the dismissal and replacement of board members following the February crisis of 2001 raised serious question marks in the public eye concerning the true credibility of BRSA.³³ Indeed, this point draws attention to a broader political problem implicit in the actions of key external agencies in their quest to advance the course of regulatory reform pertaining to issues of national sovereignty and popular political support. One may pose the following question: is it possible to institute an effective regulatory agency if that agency is perceived in the public mind as autonomous from domestic politics and an agency of the IMF at the same time?

At a purely economic level, the IMF is also open to criticism of displaying a rather myopic bias in its approach to reform. In spite of the growing attached to banking sector reform, perhaps it was not the fundamental issue in terms of the organization's immediate priorities. Stated somewhat differently, the IMF appears to have placed far more emphasis on correcting the fiscal disequilibrium as opposed to undertaking bank restructuring and regulation. An *ex-post* appraisal would suggest that a different sequencing of reforms with banking sector reform receiving immediate priority in the December 1999 program might have helped to avert the subsequent financial crises.³⁴ Yet another criticism that can be levelled against the

³² Similar logic may apply to the independence of the Central Bank. A highly independent central bank may be able to focus single-mindedly on the inflation control objective. The appropriate mix of growth, inflation and bank regulation could then emerge through a process of compromise involving the three principal bureaucratic agencies.

³³ In fact one could also criticize the IMF on the grounds of inconsistent behavior in this respect. The IMF was quite passive in the initial stages when the first set of board members was selected. Yet, it adopted an interventionist approach in the subsequent stages and participated actively in the dismissal of the first set of board members and its replacement by a new group.

³⁴ The issue involving the appropriate mix and sequencing of reforms is not a trivial issue. For example, if the Treasury had assumed the duty loss stock of the public banks at the onset of the program, the problem of short-term financing of public banks but would have been solved. Yet, the issue of fiscal sustainability might have

IMF in the purely economic realm is the following. The design of the stabilization program did not put enough emphasis on the fragility or vulnerability of the banking sector in practice. This design failure manifested itself as excessive restrictions in the Central Bank's ability to avert a possible liquidity crisis. Indeed, the crises of November 2000 as well as February 2001 reflected, to a certain extent, these design failures.³⁵

All these considerations suggest that external actors have played a central role in pushing through radical banking sector reform in Turkey. It would be misleading however, to treat the contributions of external actors as unambiguously positive, in this context. We have identified a number of instances where the role performed by the IMF proved to be rather counterproductive as judged by the initial objectives formulated. Nevertheless, we may safely argue that rather controversial changes involving banking sector legislation and regulation would not have been feasible without the active involvement of key multilateral agencies and to a lesser extent the existence of the EU anchor.

7. Conclusion

The performance of the banking system is of primary significance for crisis avoidance and sustained economic growth. Our vital premise is that a proper regulation of the banking system is essential for the performance of the sector and the economy as a whole. Our central objective has been to identify and document the key institutional and political forces responsible for the severe under-regulation of the Turkish banking system that has proved to be rather costly in the era of capital account openness.

Attention has been drawn to the endemic problems by the existence of a large budget deficit and the associated perverse incentives arising from the need to finance these deficits. These deficits reflect the existence of powerful pressures for rent distribution as a major element of

arisen earlier and the initial optimism could have been undermined and the initial support from the external private actors would not have taken place.

³⁵ Alper (2001) discusses the incentives inherent in the stabilization program, which induced private banks to take higher risks in return for higher capital gains. On the other hand, there is another dimension that requires some emphasis. While bank deposits are insured to avoid bank runs, no similar direct mechanism existed for interbank deposits. Prior to the implementation of the program, the Central Bank, being the "Lender of the Last Resort" constituted the implicit insurance mechanism against systemic risks involving interbank deposits. The

Turkey's political economy in recent decades. What is interesting for our purposes is that mechanisms of rent distribution transform over time. This is particularly the case where certain avenues of rent distribution become no longer available due to the actions of external agencies. Specifically, in the present context, duty losses of the public banks have replaced SEEs and Extra Budgetary Funds as the principal avenues for rent distribution since the crisis and the associated stabilization program of 1994. In retrospect, this proved to be a main contributor to the liquidity crisis of 2001.

Looking back to the 1990s from the perspective of the liquidity crises of 2000 and 2001 and their associated consequences, other than the emergence of the public banks' duty losses after 1994, two other salient characteristics of the Turkish Banking System stand out. Firstly, entry by new banks to the sector has been determined primarily by political criteria, hence making these banks particularly vulnerable to subsequent collapse. Secondly, the Turkish banking sector failed to benefit from the presence of foreign banks whose participation proved to be both peripheral and rent oriented.

The next step in our analysis has involved an explanation of regulatory failure, which has been primarily responsible for the three characteristics that we have identified above. We have highlighted the importance of politicization of the regulatory process due to the direct involvement of the political authority. We have also drawn attention to the absence of sufficient incentives for banks placed under surveillance to restructure themselves. Finally, we have underlined the conflict of objectives that characterized the operations of the Treasury, the main regulatory body as a consequence of which banking regulation failed to receive enough emphasis. The relevance of these concerns is illustrated in detail by recourse to specific examples of the public and private banks that had been at the hearth of the liquidity crises of 2000 and 2001.

Our analysis points out to the possibility of significant transformation in the presence of pervasive political constraints. What is striking however is that change is driven primarily by external actors and manifests itself as a discontinuous process. This discontinuity, in turn, is explained by the fact that the power of the external actors increases and the autonomous sphere of actions of domestic actors shrinks in periods of economic crises.

specific program introduced by the IMF, however, eliminated the Central Bank's ability to implement this

From a broader comparative perspective, the Turkish experience highlights the complexities involved in the construction of an effective regulatory state in the presence of acute distributional pressures. Clearly, external agencies like the IMF are open to criticism in that they focus their attention single-mindedly on the regulatory role of the state and underestimate the income distribution consequences of reforms in the process. We would predict that in societies characterized by both low per capita incomes and high inequality, the construction of effective regulatory state is unlikely to proceed in a smooth and linear manner even in the presence of powerful external anchors.

implicit insurance mechanism by specifying a ceiling on its Net Domestic Assets.

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