LEAVING THE ROLLERCOASTER: TURKEY, STABILITY AND THE EU

Turkey looks back on a history of economic instability and recurrent crises. While the process of EU accession has the potential to fundamentally transform Turkey's economy, Turkey should not sit still and wait for the external effects of EU integration to take effect, but must tackle the sources of past instabilities. For this purpose, investor confidence is one of the critical resources Turkey needs to accumulate. Presenting the results of a survey among international bankers, this article shows up ways how this can be done.

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'Arnold Schwarzenegger's chest on Woody Allen's legs'[1] is how a French Country Risk Analyst describes the state of Turkey's economy in 2005. Indeed, the picture of Turkey's economy is very different depending on the direction you are looking. The overall growth rate is astounding, resulting at an increase of the Gross Domestic Product (GDP) at an average of eight percent since 2001, and peaking at 9.8 percent in 2004. At the same time, this period was marked by a decrease of inflation; the first time in decades that the inflation rate will be closing in single digits: 9.3 percent, in 2004. However, in the past such periods of rapid expansion have too often found abrupt endings. Periods of capital inflows, growth of GDP and output have all been followed by episodes of crisis, capital flight and recession. The last one of these *boom and bust* cycles ended 2001 in a spectacular liquidity crisis, which led to a 7.5 percent contraction of the economy. Almost inevitably, these problems still keep on reappearing. Today, foreign debt is increasingly causing concern, despite overall falling figures. As one Turkish Economist writes, "Sustainability [of the debt stock] is yet to withstand the test of currency depreciations in the future."[2]

The process of EU accession has the potential to fundamentally transform Turkey's economy. Similar to the 10 countries that entered the EU in 2005, the adoption of the *acquis communautaire* will impact and stabilize almost every aspect of the Turkish economy. Already, the country is importing stability through the close anchorage with the IMF. Further stabilizing effects are hoped for through a closer association with the European Union. Conditions for accession are laid out in the *Copenhagen Criteria*, which, beyond the political conditions, require membership-aspirants to have achieved, "…the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union" and "…the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union."[3] Despite the substantial progress Turkey has made under Recep Erdo€an, these criteria remain a significant obstacle on the way to EU accession. According to the European Commissions last Regular Report on Turkey, the country fulfils neither of the abovementioned conditions.[4] Further improvements are needed regarding the government budget, debt and inflations, terms and conditions for privatization, streamlining, and regulation. As the report on Turkey states, "Maintaining a stability-oriented economic policy is a key element [of progress towards accession]."[5] Fundamentally, Turkey is facing the chicken and egg dilemma: A continuation of the integration process is needed to further stabilize the economy to strengthen investor confidence; while increased stability is needed if integration into the EU is to continue.

[1] I owe this quote to Jean-Louis Terrier of *Credit Risk International*.
[2] "Turkey in 2005 and Beyond," *Global Policy Network,* June 2004, p.19, Document available at: www.gpn.org/data/turkey/turkey-analysis.pdf
[3] See http://europa.eu.int/comm/enlargement/intro/criteria.htm
[4] Commission of the European Communities: "2004 Regular Report on Turkey's progress towards accession," Brussels, October 2004a, Document available at: http://europa.eu.int/comm/enlargement/report_2004/pdf/rr_tr_2004_en.pdf
[5] Commission of the European Communities (2004a), p.70.

In the wake of EU accession talks, Turkey's economy is lacking strong signs of continuity and stability. If accession talks are to be successful, Turkey needs to prove that the crisis episodes are now over. Turkey should not sit still and wait for the external effects of EU integration to take effect, but tackle head-on the sources of past instabilities. In particular, Turkey needs to change the structure of its foreign exchange receipts and decrease financial vulnerability in order to increase investors' confidence. This article will give an assessment of the EU's demands regarding the Turkish economy, will show how the instabilities of the past are still haunting the economy and will discuss how they can be tackled in order to decrease vulnerability and regain confidence.

The Turkish Economy in 2005: A European Perspective

Economic turbulence is nothing new in Turkey. Turkish history is plagued with economic instability and recurrent crises. The rollercoaster ride of the past decade fundamentally undermines policymakers' and bankers' confidence in the stability of the Turkish economy and threatens to nullify the substantial economic and legal progress Turkey has made throughout the past four years. The European Commission's 2004 Regular Report on Turkey reflects these reservations. While it grants that Turkey had made "…considerable progress towards being a functioning market economy," and "should also be able to cope with competitive pressure and market forces within the Union," it quickly adds that "…in order to transform the current positive dynamics into sustained growth and stability, it is of crucial importance to continue the ongoing reform process."[6] Consequentially, demands made by the European Commission are essentially aiming toward stabilization. Among other things, the EC demands an additional reduction of fiscal imbalances, further disinflation, streamlining administrative procedures, aligning the banking sector's surveillance and prudential rules with international standards, greater privatization - especially of state-owned banks and in the construction sector, and the removal of barriers in order to allow more Foreign Direct Investment.

Turkey has already established close economic ties to the European Union. Since 1963, Turkey participated in a free trade agreement with the EEC, which was transformed into a customs union in 1996. Today, the EU has become Turkey's most important trading partner, receiving 52% of Turkey's exports in 2004. Trade in goods, therefore, is already closely integrated. Moreover, Turkey has already adopted the EU's external tariffs along with a series of other laws and administrative guidelines which facilitate fair competition, including competition and anti-trust laws. Nonetheless, "alignment with the *acquis* on free movement of goods remains incomplete," as the EC's Regular Report notes, and "there are still justified complaints regarding technical barriers to trade."[7] Nonetheless, Turkey still faces commercial barriers. Agricultural goods, which make out about 15 percent of exports, remain excluded free trade agreements. In any case, accession to the EU

[6] Ibid.
[7] Commission of the European Communities (2004a), p.78.

is likely to a have more profound impact in the service sector, which thus far has been excluded from the customs union. Beyond the financial services sector, the EC's Regular Report states that, "substantial legal restrictions exist, which exclude foreigners from the [non-financial services] market."[8] Negotiations between the EU and Turkey concerning this matter have failed due to the strong vested interests of both sides. The recent uproar caused by the *Bolkestein Directive* on free services trade within the EU-25 provides a glaring example of how politicized the subject is.

The fact remains that today many Europeans still have reservations about the accession of Turkey. Labor markets are already strained, and Western Europeans fear an inflow of Turkish migrants. Whether these concerns are substantiated remains an issue. However, looking at Turkey at a glance, 70 million inhabitants, GDP per capita of 28 percent of the EU-25 average, and a *registered* unemployment rate of 12 percent, may explain some reasons for concern. While most fears are probably unwarranted, as labor market integration will probably not take place for many years to come, they still reflect growing problems in the Turkish labor market. Overall employment is a staggering 45 percent of the population, and unemployment of young people and women is soaring. Therefore, the EC asks for "appropriate labor market policies," especially to "integrate the young population into the labor market." In turn, these measures are expected, "to reduce the pressure for migration."[9]

Capital flows between the EU and Turkey are largely liberalized. However, the legacy of Mustafa Kemal Atatürk's *Etatism*, which centered the economic power around the small elite populous, and excluded foreign capital up until the late 1960s, lingers on in the current Turkish economic environment. Many formal and informal obstacles to foreign ownership remain. Accordingly, inflows of Foreign Direct Investment (FDI) remained disappointing in the past, making up less than 0.5 percent of GDP in 2003. Meanwhile, inflows of more short-term oriented *hot money* in the equity and securities market is thriving at record levels. Rightly, the EC's Regular Report concludes, "…remaining restrictions on foreign ownership in certain sectors also seem anachronistic and unjustified, and may contribute to limiting the inflow of FDI."[10] The implementation of the institutional framework of the EU therefore is expected to boost investors' confidence to explore new market opportunities.

Supervision and regulation of the financial sector remains another area of concern for the European Commission. Engraved in chapter 28 of the *acquis* is the obligation to "give effective and equivalent protection to EC financial interests." Therefore, the EC's Regular Report requires the existence of "effective and

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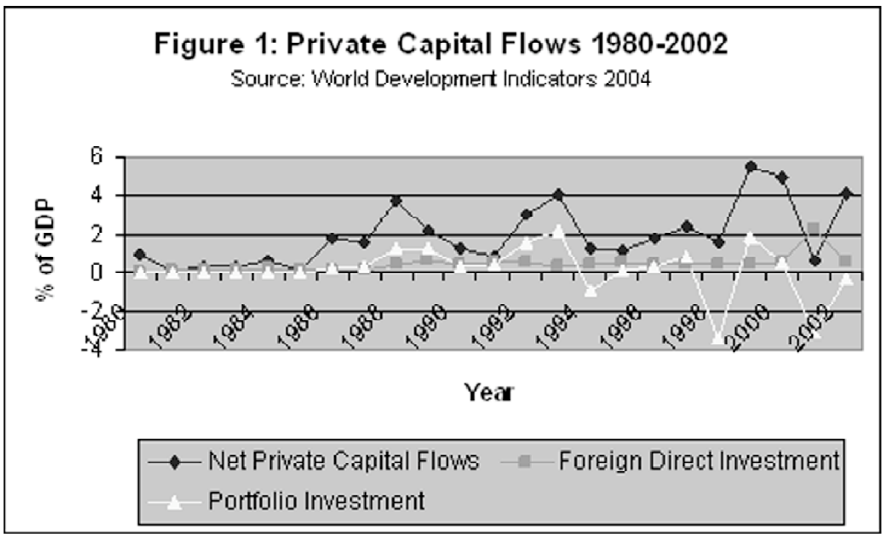
[8] Ibid., p.84.
[9] Commission of the European Communities: "Issues Arising from Turkey's Membership Perspective," October 2004b, p.16, Document available at: http://europa.eu.int/comm/enlargement/report_2004/pdf/issues_paper_en.pdf
[10] Commission of the European Communities (2004a), p.88.

transparent financial management and control systems."[11] Here, the establishment of the *Banking Regulation and Supervision Agency* (BRSA) in 2000 has been a significant improvement, but the dubious breakdown of *Imar-Bank* in July 2003 revealed that several challenges continue to persist. The EC's Regular Report deems the adoption of the *Public Financial Management and Control Law* as being "an important progress." At the same time, the report also shows concern whether "the intended integration [of financial management] can be maintained in practice."[12] Due implementation of the law, therefore, is of crucial importance.

The Confidence Trap: Past Instabilities…

Two factors have plagued economic development in Turkey throughout the last 15 years: an over-reliance on foreign short-term oriented capital, and a weak and under-regulated financial sector. Combined, these two have left Turkey's economy vulnerable to swings in investors' confidence and subsequent outflows of capital. In several cases, a sudden reversal of private capital flows has led to severe liquidity problems within banks and the economy at large. The magnitude of these swings is depicted in Figure 1.



In 1994, high foreign exchange exposures in the banking system and a devaluation of the Turkish Lira led to the breakdown of several small banks. Persistent budget deficits, sustained high inflation, and interest rate volatility eroded confidence in the Turkish Lira, and boosted dollarization. Imbalances had made speculative

[11] Ibid., p.155.
[12] Ibid., p.159.

and arbitrage activities so attractive, that net foreign liabilities added up to more than 90 percent of capital in November 1993. In this context, the downgrading of Turkish long-term debt by several credit-rating agencies was enough to trigger a sudden drop in international investors' confidence, which lead to a sharp reversal in private capital flows. Subsequent devaluation of the Turkish Lira, and weak risk management imposed high losses on banks, ultimately resulted in a bank run and the banking crisis of 1994.[13]

Over-reliance on foreign capital and an underdeveloped financial sector also played an important role in the liquidity crisis at the turn of the century. In 1999, an exchange-rate based stabilization program was initiated under the support of the IMF. The main target was to bring down inflation from an average 77 percent throughout the 1990s to below 20 percent. Under this "quasi-currency board regime"[14] the liquidity needs of the economy and external deficits were supposed to be financed entirely through inflows of international capital.[15] The program gained some initial praise, as inflation and interest rates declined and domestic demand recovered, expectedly causing the current account deficit to soar. However, Turkish banks continued to rely on arbitrage activities for a substantial part of their income and faced liquidity problems in this new, stable environment. Reflecting a loss of confidence in the entire sector, Turkish financial markets began to experience high volatility in November 1999. Only 14 months into the program, the government was forced to abandon the currency peg, as the current account deficit could not be financed anymore. Immediately, the Turkish Lira depreciated by around 30 percent. Although the market appeared to calm down after the announcement of an IMF 7.5 billion US$ emergency funding, confidence in the stabilization program could not be restored, and a second liquidity crisis emerged in February 2001 after rumors about a split of the ruling political coalition again eroded investors' confidence. This time, the already weakened banking sector crashed, and the government was forced to give up the stabilization program and float the Lira.

…And Present Repercussions

Since the 2001 crisis, two subsequent governments have undertaken substantial efforts to remedy the shortcomings of the past. Under further assistance by the IMF, the government budget deficit has not only been reduced, but turned into a net surplus that has been used to reduce government debt. A comprehensive *Banking Sector Restructuring and Rehabilitation Program* has been initiated, which strengthened private banks, initiated privatization of public banks, and developed the legal and institutional framework needed to improve supervision

[13] *IMF*: *Capital Account Liberalization and Financial Sector Stability* (Washington DC: International Monetary Fund Publishing, 2002)

[14] Emre Alper, "The Turkish Liquidity Crisis of 2000: What Went Wrong," *Russian and East European Finance and Trade,* Vol.37, No.6 (2001), pp.51-71.

[15] Under the regime, fiscal expansion needed to be covered by Central Bank assets and international capital flows were not to be sterilised. Therefore, it left no tool to the Turkish Central Bank to influence the monetary base of the economy.

and audit. The final component of this ongoing reform will be the implementation of the *Basel Committee on Banking Supervision*'s "Basel II" requirements by the end of 2007. Nonetheless, new imbalances are continually building up. Despite increasing export dynamism, imports have doubled the growth rate of exports in 2004, resulting in a current account deficit of 5.1 percent (2003: 3.7%). To finance this deficit, Turkey remains reliant on inflows of short-term capital, once more subjecting Turkey's financial stability to the hands of foreign investors.

Today, foreign capital is flooding into Turkey at unprecedented rates: the current account-statistic reveals net inflow of liquid capital in the magnitude of 10 billion US$[16] (1.6 billion in 2002). Not surprisingly, this surge of inflow of capital has significant consequences on the Turkish economy. It facilitates a boom in domestic consumption, and an increase in production on inexpensive, imported intermediary goods, resulting in economic growth. This leads to a paradoxical situation: inflows of foreign capital finance the ever-growing external financial needs that are only caused by the inflows themselves.[17] In the absence of any other significant form of foreign receipts, Turkey is running around in circles, trying to bite its own tail. Therefore, reservations about the sustainability of the current situation are increasingly being voiced.[18] Foreign currency debt not covered by foreign currency earnings is at 37 billion US$, and reserves declined to a mere 3.3 months worth of imports (5 months in 2003) in December 2004. Once again, a sudden reversal of capital flows would trigger liquidity problems.

Mirroring past events, over-reliance on inflows of easily reversible capital has led Turkish policymakers to underestimate the importance of FDI. "By not taking full advantage of FDI, Turkey has missed opportunities to create more jobs, improve productivity and competitiveness," as one World Bank Official remarks.[19] Moreover, the potential benefits continue to augment with factoring in the potential gains in term of financing external deficits. During the 1990s, FDI inflows averaged less than 0.5 percent of GDP in Turkey, while Hungary and the Czech Republic attracted more than 4 percent of GDP during the same time. UNCTAD ranked Turkey 110th out of 140 countries in its FDI performance index published in its *World Investment Report* for 2004.[20] Instability, corruption, a large black market, an unpredictable tax system, and high inflation all have contributed to discourage foreign investors. On the contrary, Turkey has furnished fabulous conditions to arbitrageurs and speculators through excessive short-term borrowing and inflation. In the summer of 2003, Turkey still offered *net rates of return* on arbitrage of 75 percent, while the US and the OECD interest rates were at 2,4 -

[16] Finance Account + Net Errors and Omissions.
[17] Erinc Yeldan, "Turkey 2001-2004: IMF Strangulation, Tightening Debt Trap, and Lopsided Recovery," Unpublished Manuscript, June 2004; Document available at: www.bilkent.edu.tr/~yeldane/Turkey_June2004.pdf
[18] See Global Policy Network (2004).
[19] Johannes Linn, quoted from a speech to the conference on "Improvement of the Investment Climate and Promotion Model for Turkey," 14 February 2002, Ankara.
[20] UNCTAD: World Investment Report 2004, (New York and Geneva: United Nations Publishing, 2004), Document available at: http://www.unctad.org/en/docs/wir2004_en.pdf

4 percent levels.[21] Clearly, it would be unrealistic to expect fixed investments to be allocated to the real sector within an economy offering such conditions for speculation.

Despite the government initiated stabilization program, the Turkish banking sector is still the *weak link* of the Turkish economy. Overexposed to interest-rate and exchange-rate risks, banks will face difficulties meeting their obligations in the event of a rising interest premium on international borrowing. A similar result would occur in the event that the Lira devaluated – an event that is becoming more and more likely in the face of the growing current account deficit. This is aggravated by banks' important maturity mismatch in between short-term customer lending, which is an important part of their funding, and their more long-term oriented liabilities. Furthermore, many banks continue to lend substantial parts of their equity to related parties (essentially shareholders) despite the prudential limit of 35 percent of total equity (25% by 2006) set out by the *Banking Regulation and Supervision Authority* (BRSA). In sum, the shortcomings of the regulatory and supervisory framework were illustrated by the dubious breakdown of *Imar Bank* in July 2003. From June 2001, the BRSA had a representative on the *Imar Bank*-board, but the representative was kept unaware of the true state of the bank until the very end.[22]

The Confidence Trap: Escaping the Cycle

In December 2004, Turkey has officially been granted the status of Candidate to EU-Accession. However, reservations about Turkey's capability of assuming EU-responsibilities persist, and the negotiation process promises to be tenacious and lengthy. Stability will be one central point of concern, and the government has undertaken huge effort to stabilize the economic system. In the past, the fate of the Turkish financial sector ultimately depended on decisions made in the financial capitals of the world, rather than in Ankara. Certainly, government policy mattered, but ultimately the decisions to pull out of Turkey were made in London, Frankfurt and New York. Given its ongoing high financial vulnerability, investor confidence is one of the critical resources Turkey needs to pursue. To get a clearer picture of this somewhat psychological resource, I conducted a small survey among international bankers working on Turkey. In total, 18 bankers were asked about perceptions on Turkey's economy.[23] Here, I will use the main findings to address three related questions of importance in this context: What are current perceptions of the Turkish financial sector, why FDI constitutes only a minuscule part of the masses of foreign capital flowing into Turkey, and further actions to take in order to increase investors' confidence?

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[21] Global Policy Network (2004), pp.9-10.

[22] Report of the "Government Commission of Inquiry into Supervisory Implications of the Failure of Imar Bank"(2004), Document available at: www.treasury.gov.tr/duyuru/basin2004/rapor_20040831.pdf

[23] Full results are available from the author upon request.

Perceptions of the Turkish Financial Sector
Globally, the bankers surveyed agreed that the situation in the banking sector is now more favorable than in the wake of the 2001 crisis. 69 percent of those polled perceived the sector as "stable" or "very stable." Improvements in supervision, regulation, and the "picking of the bad apples," (the restructuring of the sector that decreased the number of registered banks from 71 to 51) are viewed as the most important changes since 2001. Furthermore, the increased participation of foreign banks in the sector is viewed as very positive. Nevertheless, the bankers surveyed were by no means blind to the challenges remaining: the sector is still largely perceived to be under-regulated, and the recent vetoing of the new banking law by the President has again dented confidence in the resolve to pull through with reforms. Apart from regulation, the maturity mismatch between short-term customer lending and long-term liabilities is viewed as the most pressing problem of the sector.

Why FDI is flowing elsewhere
The reasons for the discrepancy between inflows of FDI, and the easily reversible capital flows are diverse. Regardless, two main trends emerge. First of all, "FDI flows where it feels welcome," as one banker bluntly put it. Indeed, bankers agree that long-term investors still encounter substantial obstacles in Turkey. "Red tape," "family-owned conglomerates," and "lack of transparency in administrative procedures" are all cited as impediments to further investment. The comparison to the Central European Economies reveals the extent of these reservations. Remarkably, 64 percent of bankers surveyed believe the investment climate to be more favorable in the CEEs. The other reason for which bankers believe that Turkey attracts so little FDI blames the "legacy of macroeconomic and political volatility." Bankers predict two possible consequences: an unpredictable future economic environment, and, given that a history of boom and bust can be highly profitable for speculators, an association with a casino rather than with a business. As one banker put it, "History matters," when making investment decisions.

What can be done to restore confidence?
For the next 12 months, bankers expect slow but steady growth. Expectations are dampened by the current account deficit, which is seen by the majority of the polled bankers as the most pressing problem of the Turkish Economy. They understand the crucial role confidence plays. As one banker so accurately states, "Market confidence is vitally important to our investment decisions in Turkey." "If a critical mass of our competitors lose confidence, our investments will be affected," stated another banker. 26 percent of bankers surveyed believe that the 2001-crisis could have been avoided altogether if international investors had had more confidence. So what can be done to restore and increase confidence in the sustainability of the Turkish Economy? Not surprisingly, a majority of bankers immediately point to the banking sector and suggest the "implementation of the new banking act" as a critical first step. Finally, 35 percent of those surveyed agree that greater amounts of foreign participation in the sector would contribute to higher rates of investor confidence.

Recommendations

As detailed above, Turkey has seen two catastrophic crises of investor confidence within the last decade. In 1994, macroeconomic imbalances contributed to an over-reliance on foreign currencies. As a result of excessive risk taking, banks, unable to meet their obligations to foreign banks, produced the effect of capital fight, along with the subsequent depreciation of the lira and liquidity shortages. In 2000/01, the interplay of a weak, risk-loving banking sector, and the over-reliance on inflows of *hot money,* left the country extremely vulnerable to a swing in confidence. Consequently, when the current account deficit soared as an (expected) repercussion of rapid adjustment, the government could not counter pressures on the Lira, and had to give up the peg.

If EU accession talks are to be successful, Turkey needs to prove that the crisis episodes are now history. Failure to do so would not only threaten to halt the process of implementation of the *acquis communitaire* that is essential for membership, it would also strengthen the lobby of accession-opponents within the EU. Turkey needs the EU as an anchor with which it can combat instability. In order to escape the "no stability without EU- no EU without stability" dilemma, Turkey must go ahead and tackle the sources of past instabilities. I identified two sources of instability which should each be addressed carefully: over-reliance on inflows of *hot money*, and the weak banking sector. Today, these two factors continue to make Turkey vulnerable to crises of investor confidence.

Reflecting the opinions gathered from international bankers and the *Commission of Inquiry into the Supervisory Implications of Failure of Imar Bank,* Turkey should immediately:

- implement the demands made under Chapter 4 of the *acquis communitaire,* in particular, accelerating efforts to improve the legal, regulatory and administrative framework for investment;
- strengthen the legal position of foreign investors in Turkey, especially regarding property rights;
- strengthen the legal, material and organizational framework of supervisory authorities of the banking sector.