# The Economic and Financial Stability in Turkey: A Historical Perspective

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**Abstract:** Since gaining independence in 1923 until the 2000s when the Republic of Turkey applied for membership in the European Union, volatile trends were recorded in the country in terms of both economic growth and financial performance. In the early stages, lack of human capital and hard currency reserves prevented rapid economic growth and creation of welfare. The priority was given to institutional reforms in order to achieve sustainable growth under low inflation and financial stability. Heightened political unrest in Europe leading to WWII forced the Young Republic to rely on a "mixed" system of etatism for sustainable growth and financial stability. Private ownership and greater participation of private capital in economic activity were given additional incentives during the 1950s, whereas an import-substitution growth strategy was initiated quite successfully during the 1960s when the Turkish economy experienced the best growth performance during 80 years of its existence. The oil crisis of the 1970s took away all the resources and prevented the emergence of strong private banks. The accumulated capital was wiped out by the balance of payment crises. The second half of the 1980s was the period when private banks began winning a market share. The 1990s, which may best be described as the "lost decade" in terms of banking and financial stability, ended with a huge financial crisis in 2001. After 2002, Turkish economy managed to achieve a very high level of growth that came with low and decreasing rate of inflation. The Republic of Turkey is now facing the challenging task of increasing domestic savings to support sustainable growth under low and stable inflation and managing its way through the complications of global financial crises that still clouds the air and threatens the economic and financial stability all around the world.

**Keywords**: Banking, financial stability, economic growth.

**JEL Code:** G1, G21, O4

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# 1. Introduction

Economic and financial stability has always attracted strong interest from academicians and practitioners. Economic stability may best be defined as an economic environment without excessive fluctuations or extreme volatility in the macro-economic variables. When the economy grows at a fair rate under low and stable inflation, it is considered to be economically stable. On the other hand, volatile recessions, business cycles in very short horizons, unsustainable balance of payment aggregates, high foreign exchange volatility, sharp ups and downs in fiscal balances, persistently high or volatile inflation leading to financial stability concerns are all signs of economic instability, which may increase uncertainty and discourage investment, slow down economic growth and decrease social welfare. When economic instability is minimised, the economic system can increase the quality of life by promoting living standards through heightened productivity and efficiency that will lead to sustainable employment levels.

The definition of financial stability is a complex matter and different approaches were taken by different authors in an attempt to find the most adequate definition. On the final analysis, it can be portrayed as a conjuncture where  the financial system efficiently performs its key economic functions in terms of efficient allocation of resources, spreading risk as well as settling payments under all type of stress situations including structural changes and paradigm shifts (Bundesbank, 2003; Padoa-Schioppa, 2003; Wellink, 2002; Schinasi, 2004). In other words, financial stability may best be described as the joint stability of the key financial institutions operating within financial markets and the stability of these markets, where economic entities can feel secure that their financial transactions will be executed timely and securely (Schinasi, 2003).

The financial instability is also a situation in which economic performance is potentially impaired by fluctuations in the price of financial assets or by an inability of financial institutions to meet their contractual obligations (Crockett, 1997; Chant et al, 2003). Similarly, Mishkin (1999) defines financial instability as the occurrence of shocks to the financial system, which interfere with the information flow, disabling the financial system from performing its job of channelling funds to those with productive investment opportunities. In addition, financial instability can also be characterized by significant deviation (either below or above) in aggregate spending which is also likely to harm the economy’s potential to produce (Ferguson, 2002). Thus, financial instability is caused by financial imbalances that put great risks on the intermediaries’ balance sheets to the extent that the financial system can no longer allocate funds efficiently (Moenjak et al, 2004). Financial instability is therefore a sequence of events entailing heightened risk of financial crisis, where financial crisis is seen, in turn, as a major and contagious collapse of the financial system, entailing inability to provide payment services or to allocate funds for investment (Davis, 1999). In this paper, we prefer these definitions of economic and financial stability and the terms will be used in this context from now.

Throughout the history, different countries, from the Romans to the Americans, captured high growth rates with strong social welfare creation. Ottoman Empire was one of those successful economic models that created strong economic growth ending in long-lasting sustainable welfare creation that lasted for more than 500 years. Common characteristics of these models may be counted as the rule of law including property rights, a strong feeling of justice and equal treatment of citizens, efficient resource allocation, incentives for technological innovation, an open mind for reforms when change is needed and a flexible approach to re-organisation and re-structuring to adapt to fast changing global conditions. The fall of the Ottoman Empire was caused by the loss of these prerequisites for sustainable development which enhance economic stability.

In the early years of the Young Turkish Republic, there were indeed no economic or financial stability concerns. The priority in the early years was hunger prevention in order to keep the social law and order after many years of global and national conflicts that destroyed the majority of human capital. The already scarce resources to finance a new development initiative were wiped out by the lack of social rule of law. After all, the main heritage of the Empire, one of the main losers of the First World War, was a huge external debt.

The Turkish Republic was struggling for survival in the early years. Approximately 77% of the population, which is about 13 million, lived in villages in the 1920's. 82% of the working population was engaged in agriculture, 6% in industry, 5% in trade and 7% in the service sector. Industry's share in the national income was only 10%, and the share of agriculture was 67%. However, agricultural production was very primitive and involved very few technological innovations. In the Republic's early year, there were only around 220 tractors in the country. Industry met only the most basic needs of the population that was experiencing extreme shortage of basic foodstuffs.

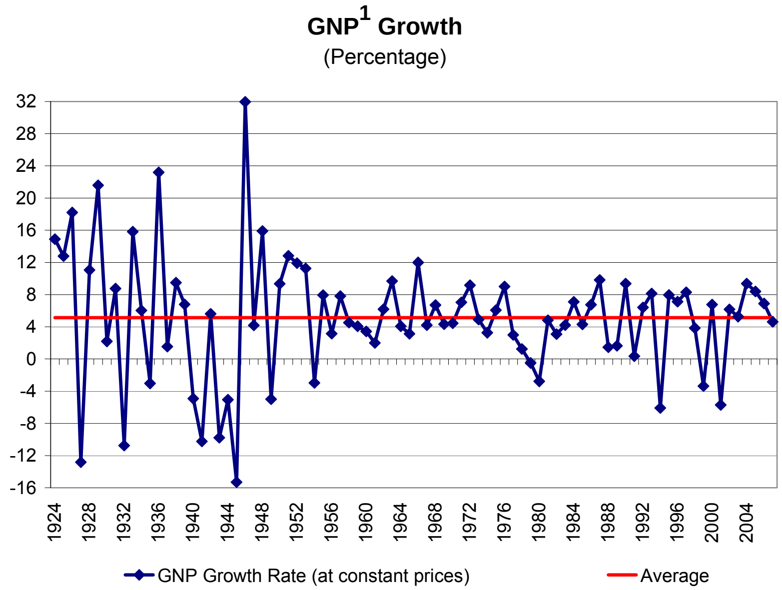
It was not only the lack of resources on the national level that created hurdles for economic welfare creation for Turkey in those early years: Global conditions did not help either. The 1929 economic collapse in the US increased the cost of external funding as well, and once that turmoil ended, came the heightened social unrest in Europe leading to the World War II. National and global conditions did not allow jump-starting a proper economic and financial stability progress in the early decades.

One may argue that the 1950s were the first decade in which Turkey had a proper chance of welfare creation. Unfortunately, a military coup disrupted the strong economic recovery for a short period of time. During the planned economy of the 1960s a certain amount of capital was accumulated to trigger a long-lasting economic and financial stability. However, the first and second oil price shocks of the 1970s once again increased dependence on external funding for sustainable growth.

The 1980 reforms to downgrade the import-substitution based development strategy in order to upgrade an export-led growth helped to catch a high growth platform for a couple of years but such a high level of re-structuring had its own drawbacks and financial liberalisation policies created a banking crisis in 1983. However, the recovery was fast and Turkey experienced strong growth plato for another decade. Financial liberalisation also brought new diseases to potential growth, such as dolarisation. International financial institutions, such as the International Monetary Fund (IMF), were familiar visitors in those years but this did not prevent another heavy banking crisis in 1994. The 1990s are generally been accepted as lost years not only because of the 1998 earthquake but also because of the global financial spill over, such as the Russian and the Far-East crises. The decade ended with a deep economic crisis in 2001 and the Turkish Economy has been undergoing in-debth re-structuring and reforms ever since.

The overall economic growth performance of Turkey since 1923 is shown in the chart below. High volatility in the early years reflects the dominance of agriculture and the impact of good and bad weather conditions. Average growth rate during the period was 5.12 percent.

Chart 1




Source: Turkstat.

The rest of the paper is structured as follows: The early years of the Young Republic from an economic and financial stability point of view will be summarised in the next section. The early liberalisation period from 1945 to 1960 will be followed by a summary of the planned economy of the 1960s. Then we will explore the second initiative for liberalisation in the 1980s, which will be followed by the lost years of the 1990s. The paper will conclude with the re-structuring and reforms periods of the final decade after the destructive economic crisis of 2001.

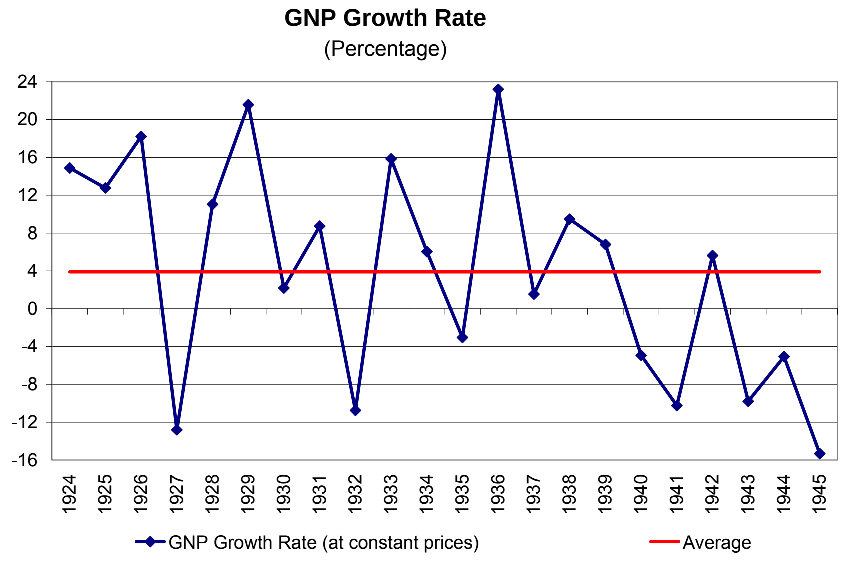
## 2. Institutional infrastructure period (1923-1945)

It may be argued that the major impact of the collapse of the Ottoman Empire on the Young Turkish Republic was a huge debt burden. Almost the final 50 years of the Empire were lost through wars that ended with border losses and devastating destruction of an already scarce infrastructure. The extremely costly defence of Dardanelles in Çanakkale and the First World War destroyed the human capital and an additional burden of domestic conflicts increased this destruction in the years that followed. Compared to neighbouring countries, Minor Asia infrastructure was insufficient and under-developed. It lacked the basic infrastructure for railways, roads, schools, while basic health services

[1] New series GDP data were used after year 1999.

were adequate. The industry or manufacturing was a fantasy word as the share of agriculture in the national economy was dominant, and as the next chart exhibits, there were sharp fluctuations in growth rates determined by weather conditions:

Chart 2




Source: Turkstat.

Until 1936, economic growth rate fluctuated sharply, falling by more than 10 percent in some years and growing by more than 15 percent in others. Although Turkey did not enter the Second World War, the state defence costs increased fast and these expenses negatively affected economic development efforts and lowered the average growth rate. During the war years between 1940 and 1945, GNP growth was negative except in 1942. Inflation was under control and the value of TRY against the U.S. dollar followed a steady course especially after the year 1934.

Table 1

**Selected Economic Indicators**

| | CPI Inflation (%)[1,4] | Trade Balance (Million US Dollar)[1] | Domestic Debt (Million US Dollar, Year End)[3,5] | Exchange Rate (TL/US Dollar)[1] | Highest Short Term Interest Rate (%,Year End)[1] | 3 months Bank Deposit Rates[1] | Export (Million US Dollar)[3,1] | Import (Million US Dollar)[3,1] | Budget Deficit / GNP[3] (%) |
|---|---|---|---|---|---|---|---|---|---|
| 1923 | | -36 | | 1.67 | | | 51 | 87 | -0.6 |
| 1924 | 16.4 | -18 | | 1.93 | | | 82 | 100 | -0.6 |
| 1925 | 7.9 | -26 | | 1.87 | | | 103 | 129 | 2.0 |
| 1926 | 1.7 | -25 | | 1.93 | | | 96 | 121 | -0.5 |
| 1927 | -12.2 | -27 | | 1.96 | | | 81 | 108 | -0.2 |
| 1928 | -0.4 | -25 | | 1.97 | | | 88 | 114 | -1.3 |
| 1929 | 6.3 | -49 | | 2.07 | | | 75 | 124 | -0,5 |
| 1930 | -7.8 | 2 | | 2.12 | | | 71 | 70 | -0.5 |
| 1931 | -5.5 | 0 | | 2.11 | | | 60 | 60 | 1.2 |
| 1932 | -2.5 | 7 | | 2.11 | 7.00 | | 48 | 41 | 2.2 |
| 1933 | -10.7 | 13 | 117.0 | 1.66 | 5.50 | | 58 | 45 | 0.0 |
| 1934 | -1.6 | 4 | 165.4 | 1.26 | 5.50 | 5.00 | 73 | 69 | 1.8 |
| 1935 | -7.1 | 6 | 190.5 | 1.26 | 5.50 | 5.00 | 76 | 71 | 2.2 |
| 1936 | 0.4 | 20 | 198.4 | 1.25 | 5.50 | 4.50 | 94 | 74 | -1.1 |
| 1937 | 1.5 | 19 | 238.1 | 1.26 | 5.50 | 4.50 | 109 | 91 | -1.5 |
| 1938 | -0.4 | -4 | 273.4 | 1.26 | 4.00 | 4.50 | 115 | 119 | -1.0 |
| 1939 | 2.2 | 7 | 289.9 | 1.28 | 4.00 | 4.50 | 100 | 93 | -0.1 |
| 1940 | 8.4 | 31 | 378.8 | 1.38 | 4.00 | 4.00 | 81 | 50 | -0.6 |
| 1941 | 19.6 | 36 | 545.5 | 1.35 | 4.00 | 4.00 | 91 | 55 | -2.5 |
| 1942 | 66.8 | 13 | 732.8 | 1.31 | 4.00 | 4.00 | 126 | 113 | -1.5 |
| 1943 | 45.7 | 41 | 786.3 | 1.31 | 4.00 | 4.00 | 197 | 155 | -0.1 |
| 1944 | 2.5 | 52 | 824.4 | 1.31 | 4.00 | 4.00 | 179 | 127 | 0.9 |
| 1945 | 0.9 | 71 | 839.7 | 1.30 | 4.00 | 4.00 | 168 | 97 | -1.1 |
| Average | 6.0 | 5 | 429.0 | 1.61 | 4.75 | 4.33 | 96.6 | 91.9 | -0.13 |

Source: 1-The Central Bank of Turkey;
2-Turkstat;
3- Pakdemirli E., 1991 ‘Ekonomimizin 1923’den 1990’a Sayısal Görünümü’;
4- Doğruel F., ‘Türkiye’de Enflasyonun Tarihi’;
5- Undersecretariat of Treasury of Turkey.

After 1930, the country's foreign trade was in surplus. Especially in the first half of 1940s, trade balance surpluses dominated the external trade indicatiors. Consumer Price Inflation (CPI) was –12.2 percent in 1927 and 66.8 percent in 1942. Because of the nature of the preferred regime, exchange rates were relatively stable.

From 1923 to 1945, financial stability was never disrupted thanks to rational policies to manage hightenned stress. First of all, the Central Bank of the Ottoman Empire was given an extended license to sustain monetary stability. This has prevented a total collapse of monetary values and created certain barriers to a possible devastation of the already scarce wealth. Banking, money or capital markets were all underdeveloped but there were some incentives to shape up the national banking system despite enormous challenges. There was a non-monetary base in trade and transactions, implying existence of barter economy. State support and the country's economic conditions led to the establishment of a monopolistic banking: As an almost closed economy without national central bank in an environment in which credit was channelled mainly by foreign banks and credit powers over a long period, there was no chance for private banks to emerge (Görmez, 2008).

The primitive agricultural production base and underdeveloped market structure prevailed in an underdeveloped socio-economic framework. There was only one state bank, 14 foreign banks and 8 domestic banks in Turkey in 1923. In six years, 24 privately owned domestic banks joined the financial system by 1929[2]. Escaping from the financial crises while still learning banking in the early years, and even resisting the effect of the United State’s Great Depression of 1929 with almost perfect fiscal discipline, enabled the emergence of a mixed private-public banking system that eased the burden of a financial re-development and re-structuring. Between 1923 and 1932, more than 20 local banks were gone bust mostly because of the Great Depression (Görmez, 2008).

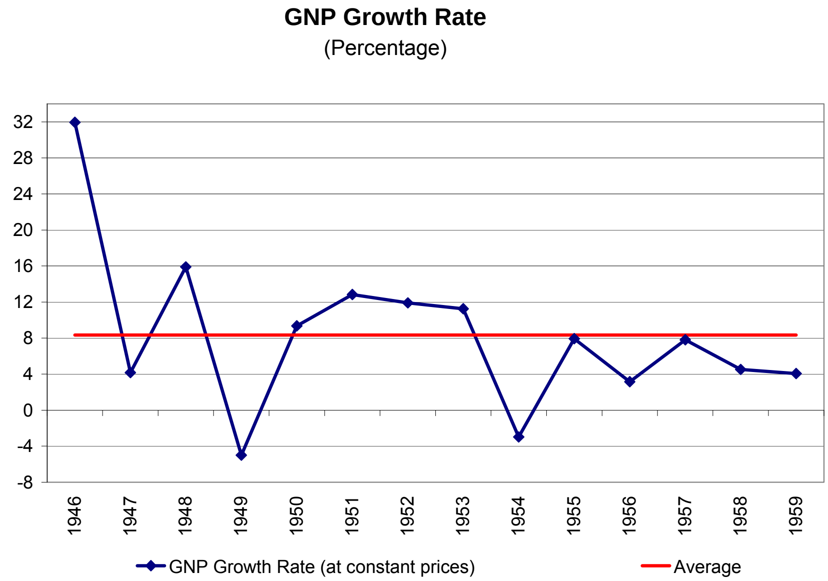
A major development for the financial system of the country was the establishment of the Central Bank of Turkey in 1932 . With the emergence of private banks which followed the creation of the central bank, basic financial architecture was almost complete. However, as a damage control strategy, the main efforts between 1939 and 1945 were focussed on keeping the impact of World War II as low as possible. It may be suggested that in view of the global economic and financial conditions, the approach to economic and financial stability applied in this period, should be considered successful. It was constructive to stay away from the war and rationally use scarce resources, and at the same time, accumulate some capital rather than spend it all on the defence. Turkey was kept in the right positioning for the re-structuring and re-development strategies of the post-war economic policies.

## 3. Moving towards an open economy (1946-1959)

The preference of a common public and private ownership model of development in the early period was not a choice of good will but a forced alternative since, lacking capital accumulation, there was no private wealth creation potential. As soon as the destructive impact of the Second World War ended in mid 1940s, strong subsidies were allocated to support the joint ownership model of public and private enterprises. Heavy state involvement in economic activity was relaxed and private entrepreneurs were given incentives to apply aggressive investment strategies. As the next chart shows, average growth rate during the period came as high as 8,35 percent thanks to the extreme performance in 1946.

[2] Silier O. 1975, 1920’lerde Türkiye’de Milli Bankacılığın Genel Görünümü, Türkiye İktisat Tarihi Semineri, Hacettepe.

Chart 3




Source: Turkstat.

During the period observed, CPI was moderate and fluctuated from –6.6 percent to 7.7 percent until 1955, but the second half of the 1950s had a bad track record in this respect. During that period there was no pressure or no crowding out of the private by the public sector through unsustainable budget deficits. Exchange rate regime favoured the fixed rates rather than a competitive devaluation in the second half of the 1940s before joining the Bretton-Woods. In search for a realistic currency value, the TRY was devaluated against the U.S. dollar by 50% on 7 September 1946. One of the weaknesses of such an arrangement appeared as a chronic current account deficit, especially during the second half of the 1950s.

Table 2

**Selected Economic Indicators**

| | CPI Inflation (%)[1,2] | Domestic Debt (Million US Dollar, Year End)[3,5] | Budget Deficit / GNP[3] | Exchange Rate (TL/US Dollar)[1] | Highest Short Term Interest Rate (%,Year End)[1] | Current Account Balance (Million US Dollar)[3] |
|---|---|---|---|---|---|---|
| 1946 | 4.3 | 607.7 | -0.3 | 1.81 | 4.00 | 7 |
| 1947 | -6.6 | 354.6 | -0.7 | 2.82 | 4.00 | -14 |
| 1948 | 5.4 | 569.4 | -0.7 | 2.81 | 4.00 | -149 |
| 1949 | 6.4 | 496.5 | -0.6 | 2.82 | 4.00 | -93 |
| 1950 | -3.1 | 642.9 | 0,5 | 2.80 | 4.00 | -50 |
| 1951 | 2.5 | 714.3 | -0,5 | 2.80 | 3.00 | -94 |
| 1952 | 4.5 | 750.0 | 0,1 | 2.80 | 3.00 | -198 |
| 1953 | 2.9 | 821.4 | 0,1 | 2.80 | 3.00 | -164 |
| 1954 | 7.7 | 857.1 | 1.1 | 2.80 | 3.00 | -177 |
| 1955 | 18.6 | 928.6 | 0,8 | 2.80 | 4.50 | -177 |
| 1956 | 2.7 | 964.3 | 0.8 | 2.80 | 4.50 | -75 |
| 1957 | 13.5 | 1142.9 | 0,7 | 2.80 | 4.50 | -64 |
| 1958 | 20.5 | 1285.7 | 0,4 | 2.80 | 4.50 | -64 |
| 1959 | 28.5 | 1285.7 | 0.8 | 2.80 | 4.50 | -145 |
| Average | 7.7 | 831.8 | 0,2 | 2.73 | 3.89 | -104.1 |

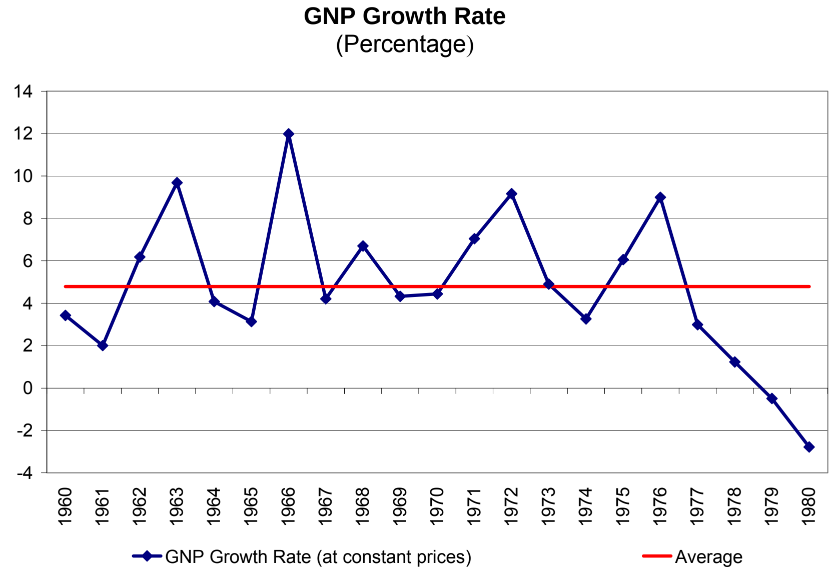
Source: 1-The Central Bank of Turkey;
2-Turkstat;
3- Pakdemirli E., 1991 'Ekonomimizin 1923'den 1990'a Sayısal Görünümü';
4- Doğruel F., 'Türkiye'de Enflasyonun Tarihi';
5- Undersecretariat of Treasury of Turkey.

On the road to a small open economy, financial stability in Turkey in the second half of the 1950s did not have a bad track record. Private banking had a licence to expand fast when public banks gave some space to them. The then decision makers favoured liberalisation and market economy principles, and development zones reached inner Anatolia with increasing investment in infrastructure. Middle and upper classes took a breath and private wealth accumulation rate reached the highest levels. Even under controlled deposit and credit interest rates, number of private banks increased sharply. Another characteristic of this period was the enhancement of branch banking. There was a rapid increase in the number of branches of banks between 1945-1960 in Turkey. Thirty new banks were established (including bank mergers) and the number of banks reached 59 compared to 42 in 1944.

## 4. Planned economy and oil price shocks (1960-1980)

After trying a liberal approach to the development strategies in the 1950s, the tactic was changed in the 1960s, and if the first half of the 1950s may be called the first "golden years" of Turkey in terms of growth, the second "golden years" were in the 1960s.

Chart 4




Source: Turkstat.

The development paradigm during this period was shifted in favour of import substitution based growth. The framework was quite transparent: There was a 5 year plan prepared by wise guys in the State Planning Organisation and approved by the elected decision makers: The end result was a long period of sustainable growth of around 5 percent. During this period, extremely detailed plans captured every level of priorities regarding the production and distribution channels in the economy. The role of the public sector increased in the conduct of economic activity.

Table 3

**Selected Economic Indicators**

| | CPI Inflation (%) [1,4] | Domestic Debt (Million US Dollar, Year End) [3,5] | Budget Deficit / GNP[3] | Exchange Rate (TL/US Dollar)[1] | Highest Short Term Interest Rate (%,Year End)[1] | Interest Rate, Saving Deposits[1] | Current Account Balance (Million US Dollar)[3,1] |
|---|---|---|---|---|---|---|---|
| 1960 | 2.3 | 849.8 | 0.8 | 5.11 | 4.5 | | -139 |
| 1961 | -0.7 | 988.9 | 0.9 | 9.0 | 7.5 | | -170 |
| 1962 | 2.6 | 1,122.2 | 0.2 | 9.0 | 7.5 | | -242 |
| 1963 | 3.2 | 1,255.6 | 0.0 | 9.0 | 7.5 | | -300 |
| 1964 | 1.7 | 1,311.1 | 0.9 | 9.0 | 7.5 | | -109 |
| 1965 | 5.9 | 1,388.9 | 1.2 | 9.0 | 7.5 | | -78 |
| 1966 | 4.4 | 1,766.7 | 0.8 | 9.0 | 7.5 | | -164 |
| 1967 | 6.7 | 2,022.2 | 0.0 | 9.0 | 7.5 | | -115 |
| 1968 | 0.4 | 2,277.8 | 0.6 | 9.0 | 7.5 | | -224 |
| 1969 | 6.5 | 2,511.1 | 1.5 | 9.0 | 7.5 | | -220 |
| 1970 | 8.1 | 2,195.8 | 0.0 | 11.3 | 9.0 | 9.0 | -171 |
| 1971 | 16.3 | 1,969.3 | 2.9 | 14.8 | 9.0 | 9.0 | -109 |
| 1972 | 12.9 | 2,357.1 | 0.0 | 14.0 | 9.0 | 9.0 | -8 |
| 1973 | 16.6 | 2,750.0 | 0.9 | 14.0 | 8.8 | 7.0 | 484 |
| 1974 | 18.7 | 3,129.5 | 1.0 | 13.8 | 9.0 | 9.0 | -718 |
| 1975 | 20.1 | 4,612.2 | 0.3 | 14.3 | 9.0 | 9.0 | -1,648 |
| 1976 | 15.3 | 6,116.0 | 0.6 | 15.9 | 9.0 | 9.0 | -2,029 |
| 1977 | 28.3 | 7,515.4 | 5.0 | 17.8 | 9.0 | 9.0 | -3,140 |
| 1978 | 49.6 | 7,436.6 | 1.9 | 24.0 | 10.0 | 12.0 | -1,265 |
| 1979 | 56.5 | 11,051.9 | 3.0 | 30.8 | 10.8 | 20.0 | -1,413 |
| 1980 | 116.6 | 6,957.8 | 3.6 | 75.1 | 26.0 | 33.0 | -3,408 |
| Average | 18.7 | 3,409.0 | 1.2 | 15.8 | 9.1 | 12.3 | -723.0 |

Source: 1-The Central Bank of Turkey;
2-Turkstat;
3- Pakdemirli E., 1991 ‘Ekonomimizin 1923’den 1990’a Sayısal Görünümü’;
4- Doğruel F., ‘Türkiye’de Enflasyonun Tarihi’;
5- Undersecretariat of Treasury of Turkey.

In the 1960s, CPI was low and stable; there were no major fiscal imbalances and the exchange rate was rather stable. There were no balance of payment imbalances either. It was almost a magical economic performance and income distribution gained some breathing space allowing it to, at least partially, repair the inequalities.

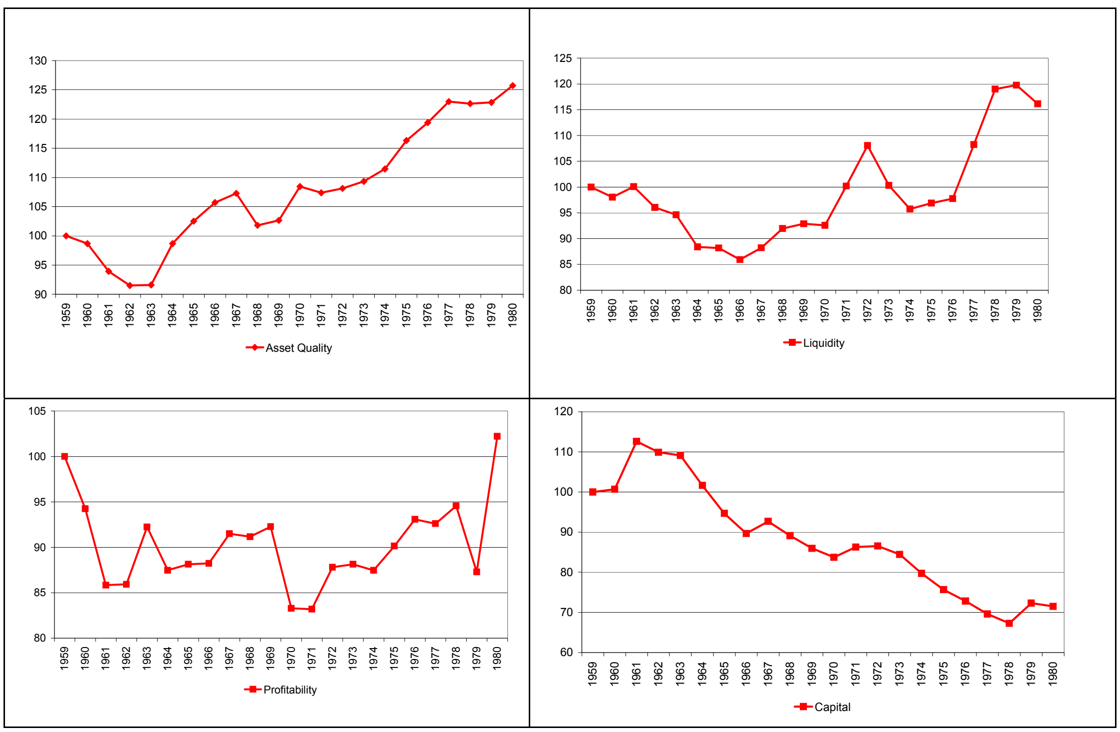
This picture changed rapidly in the 1970s and a hidden fragility of the 1960s came to the scene: Dependence on energy imports. As oil prices increased sharply, not only once but twice, the economy failed to adapt to high-energy prices and the economic policy makers lost sight of the medium and long run but rather concentrated on short-term solutions. Foreign exchange rate guarantees increased contingent liabilities of the public sector and advances to the Treasury from the Central Bank printing machines created a persistently high and volatile inflation. During this period, Turkey fell into a double-digit inflation trap. Instead of having a multi-party coalition implement medium and long-term economic and financial stability programs for a couple of years, domestic conflicts among social groups increased the cost of solutions to the crises and Turkey ended 1980s with an inflation rate of above 100 percent. Fixed exchange rate regime became unsustainable because of the black market rates, while public sector borrowing requirements increased to such high levels that crowding out became a norm in the years that followed. External account imbalances only created additional problems and did nothing to help decrease the pressure.

As expected, there were no catastrophic problems on the financial stability front. The reason was being the lack of market influence on deposit and credit interest rates in addition to negative interest rates imposed on the banking system by the regulators. Central bank independence was a far away dream and nobody talked about it when the economic activity collapsed so badly due to a shortage of raw materials for the production of basic goods, including energy. Advances to the Treasury were regularly granted and public banks increased their dominance in the financial sector because of the critical importance of credit to the private sector.

Financial stability during this period may also be explained by the lack of an in-depth financial market or "bankisation". Financial markets were quite shallow. Banks' asset quality, liquidity and profitability improved steadily whereas capital adequacy deteriorated as shown in the chart below:

Chart 5

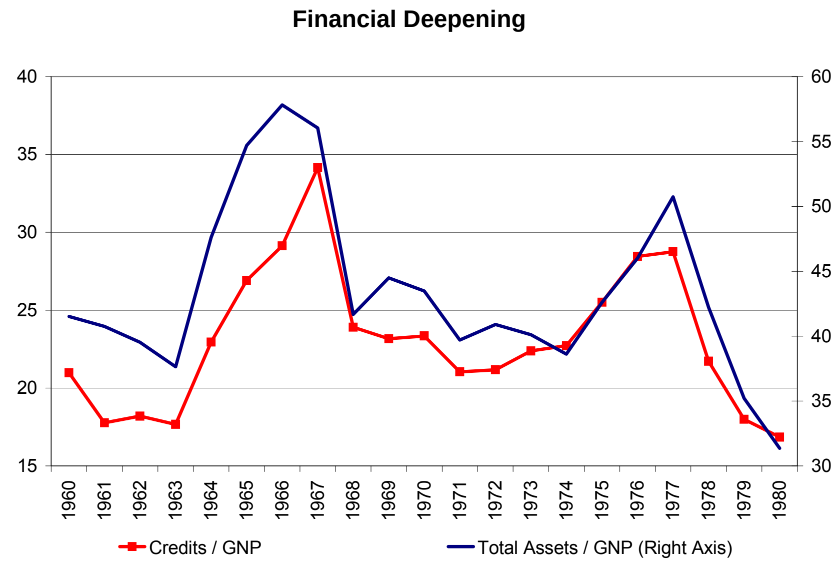
**Financial Strength Sub-Indices**




Source The Banks Association of Turkey.

As expected, early 1960s experienced a sharp financial deepening when credit to GNP ratios more than doubled. Total assets to GNP ratio also displayed a similar trend. However, as explained earlier, oil price shocks discouraged this tendency and financial deepening eroded sharply so that the levels recorded at the end of period were almost identical to those at the beginning of the period. This period was generally regarded as the root-cause of institutionalised short-sighted monetary and fiscal policy implementation failures. One may also argue that the 1970s were the maturing period of the lost decades in Turkey in terms of economic and financial stability.

Chart 6




Source: The Banks' Association of Turkey (BAT)

## 5. Marketisation and liberalism (1981-1990)

The first half of 1980s saw a surprise external debt crisis of the Latin American countries, and with the help of the 1980 reform agenda, Turkish economy managed to record a decent pace of growth:

Chart 7


Source:Turkstat.

The average growth rate during the period was more than 5 percent, while the 1987 rate was close to 10 percent. The 1980 stability program primarily aimed to change the course of import substitution based development strategy in favour of an export-led growth. Chronic hard currency shortages surrounding the economy since 1972 were given a structural response so that the economy could create its own hard currency inflow through trade and never face balance of payment bottlenecks again. Marketisation was a critical part of this strategy and credit and deposit rate settlement was left to market forces. At the same time, the Central Bank was equipped with open market operations tools that could be actively used. A proper domestic borrowing mechanism was declared in addition to the establishment of over-night money markets within the Central Bank. This was followed by the emergence of a foreign exchange market, gold market and a department in charge of active reserve management. A stock exchange in Istanbul was also established at that time.

Table 4

**Selected Economic Indicators**

| | CPI Inflation (%)[1,4] | Domestic Debt (Million US Dollar, Year End)[3,5] | PSBR / GDP[1] | Exchange Rate (TL/US Dollar)[1] | Highest Short Term Interest Rate (%,Year End)[1] | Interest Rate, Saving Deposits[1] | Current Account Balance (Million US Dollar)[3,1] |
|---|---|---|---|---|---|---|---|
| 1981 | 35.9 | 7,713 | 3.00 | 110 | 31.5 | 35.0 | -1,919 |
| 1982 | 27.1 | 8,910 | 2.70 | 161 | 31.5 | 50.0 | -935 |
| 1983 | 30.9 | 14,288 | 3.70 | 224 | 48.5 | 45.0 | -1,828 |
| 1984 | 48.5 | 11,575 | 4.00 | 364 | 52.0 | 45.0 | -1,439 |
| 1985 | 50.4 | 13,448 | 2.70 | 520 | 52.0 | 55.0 | -1,013 |
| 1986 | 37.0 | 15,714 | 2.70 | 669 | 48.0 | 48.0 | -1,465 |
| 1987 | 39.6 | 20,127 | 4.50 | 856 | 45.0 | 58.0 | -806 |
| 1988 | 71.7 | 20,094 | 3.60 | 1,426 | 54.0 | 83.9 | 1,596 |
| 1989 | 63.7 | 18,753 | 4.00 | 2,121 | 54.0 | 58.8 | 938 |
| 1990 | 62.2 | 20,109 | 5.50 | 2,606 | 45.0 | 59.4 | -2,625 |
| Average | 46.7 | 15,073 | 3.64 | 906 | 46.2 | 53.8 | -950 |

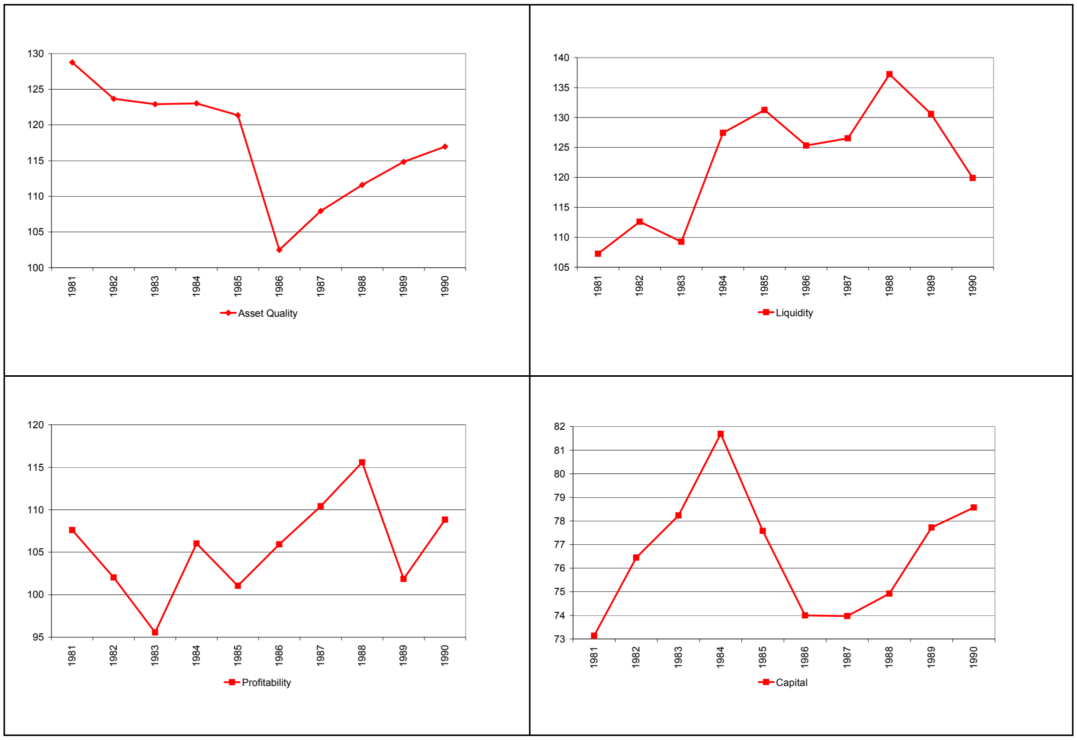
Source: 1-The Central Bank of Turkey;
2-Turkstat;
3- Pakdemirli E., 1991 ‘Ekonomimizin 1923’den 1990’a Sayısal Görünümü’;
4- Doğruel F., ‘Türkiye’de Enflasyonun Tarihi’;
5- Undersecretariat of Treasury of Turkey.

The main problem that was addressed properly during this period was inflation. Although it declined to 27 percent in 1982, inflation remained persistent and never fell back to single digits for another two decades. At the same time, chronic public deficits crowded out the private sector in almost every year and the burden increased annually. Balance of payment imbalances only increased the problems of the fragile economic stability.

On the financial stability front, the first shock were bank bankruptcies of the early 1980s. Obviously, those bankers constructed individual ponzi games. The banks that collapsed were forced to merge with public banks, which was the early misuse of public banks. that in the decades that followed. The reform agenda of the 1980 failed to achieve a high level of regulatory and supervisory quality, while lax approach to market economy led to the accumulation of certain pressures that were carried over into the following decades. Managing the change was a difficult task and financial market infrastructure needed a better oversight, which the Turkish economy learned later on at a heavy price. Under high and volatile inflation, performance of the banking sector was not terribly bad, but the banks were not gaining regular power either. Shortening of deposit terms and increased pressure of dollarisation added extra pressure on the banks. In mid-1980s, banks were allowed to collect foreign exchange deposits and dollarisation was institutionalised.

Chart 8

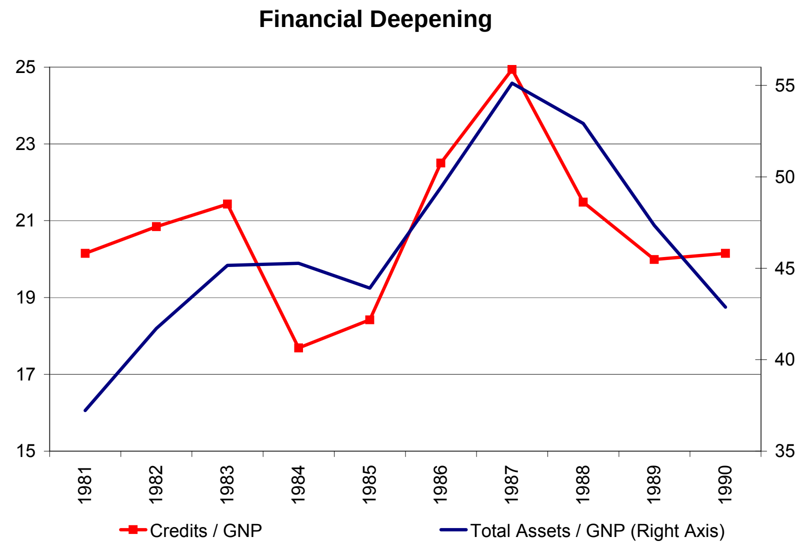
**Financial Strength Sub-Indices**




Source: The Banks Association of Turkey.

In the 1980s, the pace of financial deepening increased thanks to the marketisation initiatives. However, data for end of the period were not much different from those recorded at its beginning. As the persistence of inflation supported inefficiencies in the financial service provision, short term gains were eventually lost. The credit to GNP ratio increased from 20 percent to above 25 percent before falling to 20 percent again. Total financial assets to GNP ratio also fluctuated between 35 percent and 55 percent of GNP. One interesting development during this period was the increasing interest of foreign banks in the Turkish financial markets.

Chart 9



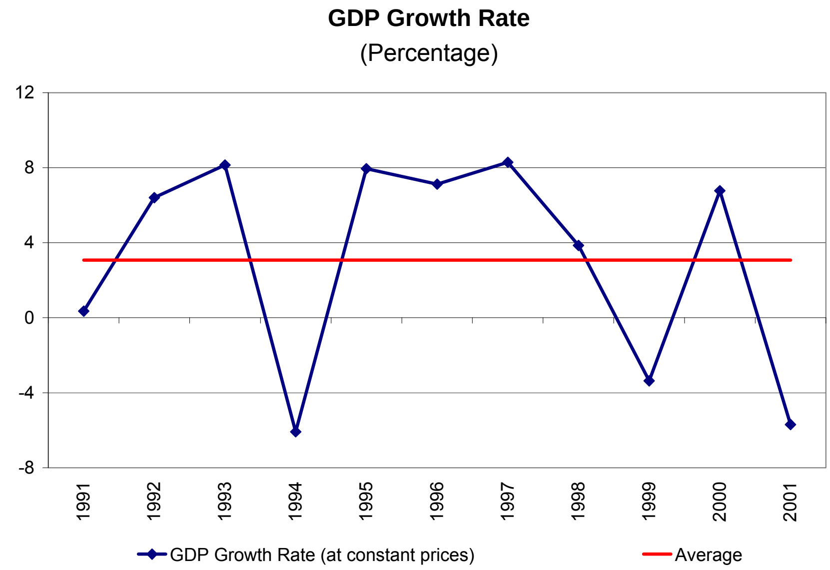

Source: BAT.

The financial liberalization process proved costly in the years that followed, but still, without those measures, it would have been more costly to stabilize the economy, both in terms of internal and external accounts. The 1970s already proved unsustainable with import substitution based development strategy because of the external account bottlenecks for the import of basic needs. International crises did not help the Turkish economy in those years either. Europe and the US were trying to solve their inflation problems by following extremely high interest rate polices. Brazil, Mexico and Argentina debt crises placed additional burden on the Turkish economy and Europe was struggling to create its own single currency. In this conjuncture, once the priority of low and stable inflation was delayed in favour of increasing infrastructural investment, internal account balance deteriorated each year and all types of well known costs of high inflation engulfed the economy step by step.

## 6. Lost years (1991-2001)

The worst economic performance of Turkey was recorded in the 1990s, which is generally accepted as a lost decade by the academicians and practitioners. However, it was surprising that though inflation was high and volatile since 1972, hyper-inflation never became an issue. Average growth performance, on the other hand, was the worst ever, reaching less than 4 percent, which is below the performance during the 1930s.

Chart 10




Source: Turkstat.

One possible explanation for the persistent high inflation short of hyperinflation may be the lack of financial deepening under capital controls and allowing the asset and liability dolarisation after capital controls were abolished. Public banks were also used excessively in order to cover up temporary bottlenecks. Another argument may be that unofficial economy blocked all hyperinflation risks by providing flexibility under stress.

In this period, average inflation was 76 percent at its highest and the current account balance produced structural deficits. Domestic debt stock increased regularly as the public sector borrowing never fell below 3,7 percent and the period average was realised at above 7 percent.

Table 5

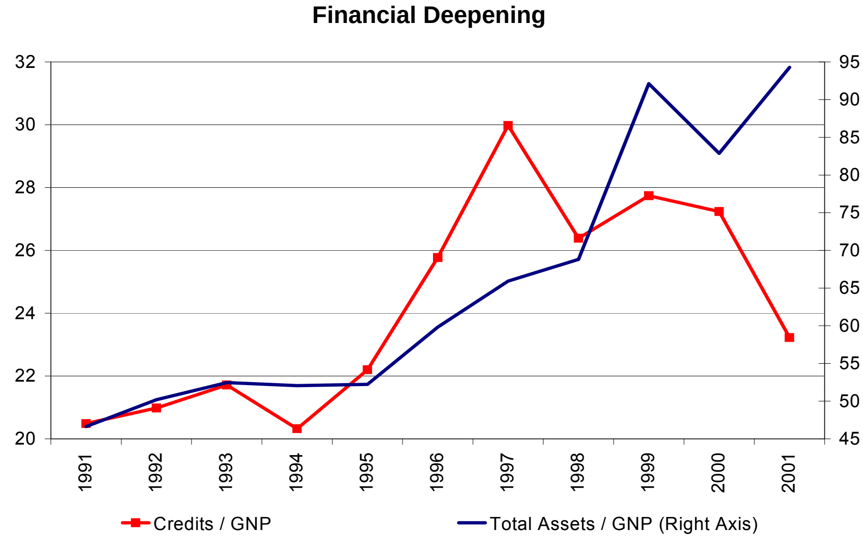
**Selected Economic Indicators**

| | CPI Inflation (%)[1,4] | Domestic Debt (Million US Dollar, Year End)[3,5] | PSBR / GDP[1] | Exchange Rate (TL/US Dollar)[1] | Central Bank Discount Rate (%)[1] | Interest Rate, Saving Deposits[1] | Current Account Balance (Million US Dollar)[3,1] |
|---|---|---|---|---|---|---|---|
| 1991 | 68.7 | 23,387 | 7.6 | 4,175 | 56.0 | 72.7 | 250 |
| 1992 | 77.1 | 28,255 | 7.9 | 6,874 | 56.0 | 74.2 | -974 |
| 1993 | 68.0 | 32,381 | 7.7 | 11,036 | 56.0 | 74.8 | -6,433 |
| 1994 | 104.4 | 26,833 | 4.6 | 29,788 | 55.0 | 95.6 | 2,631 |
| 1995 | 88.0 | 29,756 | 3.7 | 45,739 | 50.0 | 92.3 | -2,339 |
| 1996 | 80.7 | 38,692 | 6.5 | 81,386 | 50.0 | 93.8 | -2,437 |
| 1997 | 88.3 | 41,319 | 5.8 | 152,071 | 67.0 | 96.6 | -2,638 |
| 1998 | 85.4 | 44,498 | 7.1 | 260,974 | 67.0 | 94.8 | 2,000 |
| 1999 | 68.2 | 54,555 | 11.7 | 420,126 | 60.0 | 46.7 | -925 |
| 2000 | 56.3 | 58,394 | 8.9 | 623,704 | 60.0 | 45.6 | -9,920 |
| 2001 | 54.3 | 99,687 | 12.1 | 1,225,412 | 60.0 | 62.5 | 3,760 |
| Average | 76.3 | 43,433 | 7.6 | 260,117 | 58.0 | 77.2 | -1,548 |

Source: 1-The Central Bank of Turkey;
2-Turkstat;
3- Pakdemirli E., 1991 ‘Ekonomimizin 1923’den 1990’a Sayısal Görünümü’;
4- Doğruel F., ‘Türkiye’de Enflasyonun Tarihi’;
5- Undersecretariat of Treasury of Turkey.

One particular event during this period was the 1994 financial crisis: Because of unsustainable fiscal balance and insufficient primary surplus to counter-balance external deficit fragilities, the economy fell into the traps of twin deficits. Constantly delayed stabilisation program shattered the nerves of financial market participants, and in January 1994, Turkish lira faced sharp depreciation after more than a decade. Because of the timing of local elections, desperately needed economic package came three months later, and at one point, the Treasury had to sell bonds with a maturity of three months at an interest rate of 50 percent. These shock rates helped ease the unbearable levels of volatility and a new deal with the IMF helped to turn expectations into the positive realm. However, one way or another, the IMF deal was not implemented properly in the years that followed and the terrible earthquake in the second half of the 1990s further diminished any hope of a sustainable recovery.

Chart 11




Source: BAT.

During the lost years of the 1990s, financial deepening was mainly shaped by credit expansion through public banks and creative credit expansion tactics of banks using instruments such as back-to-back credits. Structural problems of the economy that were accumulating since 1972 waited for a reform agenda in order to decrease high and volatile inflation and bring the economy to a sustainable growth path at least close to its potential. With this aim in mind, an exchange rate based stabilization program was signed with the IMF in 1999 implying reforms such as establishing an independent supervisory and regulatory banking authority to increase the quality of financial stability. Privatisation was put on the high alert agenda, which was a dramatic story because Turkey started its privatisation calendar before the fall of the Berlin Wall. However, while countries like the Czech Republic and Hungary completed their privatisation programs, Turkey's performance fell far below the cost of privatisation itself. With the privatisation of the Turkish Telecom and the lack of any value assessment whatsoever came the early signs of financial markets stress in November 2000. An additional financial aid package from the IMF was not sufficient to prevent the worst ever economic crisis in Turkey. Exchange rate based stabilisation program collapsed and foreign exchange rate regime was changed overnight in favour of the floating exchange rate regime, which led to a sharp depreciation of the Turkish lira. The number of banks facing bankruptcy was increasing gradually since August 2000 and peaked after the depreciation of the Turkish lira. The overnight interest rates increased to 5 digits, which was quite uncommon in literature. The devastating impact of the economic crisis left no alternative other than signing of another IMF deal.

Chart 12

**Financial Strength Sub-Indices**

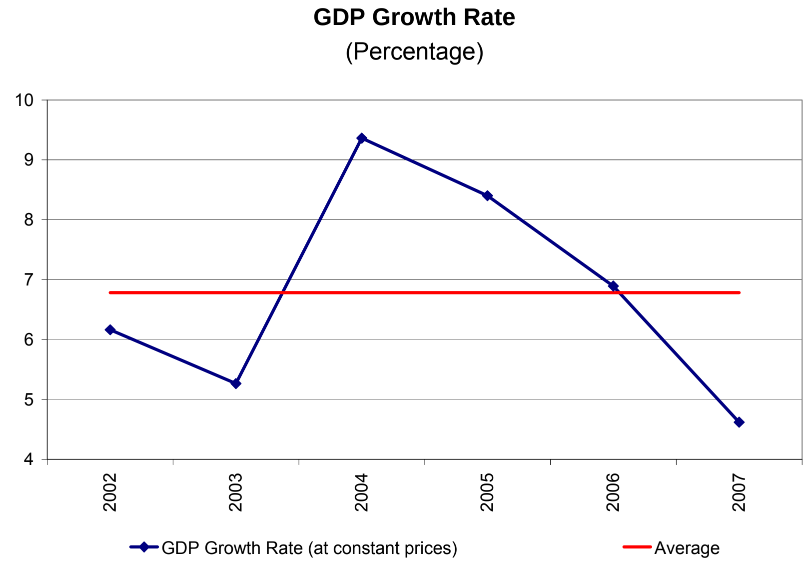

Source: BAT and The Central Bank of Turkey.

Performance of the financial stability indicators was at their lowest during the period reviewed. All indicators including asset quality, profitability and capital adequacy deteriorated to a certain extent. It may be worth mentioning that the banking regulation and supervision performed terribly as many banks were taking excessive risks without managing the counter party, credit or exchange rate risks properly. The licensing was alo loose. The lost years of the 1990s ended not only with the worst economic crisis, but with the worst and most costly financial crisis, too.

## 7. Reforms, restructuring and the road to EU (2001- 2008)

The European Union officials have lately declared Turkey as a “proper functioning marker economy”. This achievement was the result of the well-balanced stabilisation program that has been implemented since 2002. The end result was an average growth rate of more than 6 percent, which is almost the highest compared to any decade’s performance:

Chart 13




Source: Turkstat.

There are two main pillars of the new stabilisation program: Inflation targeting and floating exchange rate regime. Inflation targeting was implemented implicitly until 2005 when explicit targeting took the role. One among so many critical reforms was that the independence of the Central Bank of Turkey, where short-term advances to the Treasury were forbidden, was incorporated into the Law including a ban on the purchase and sale of Treasury bonds and bills in the primary market. A Monetary Policy Committee was established for the purposes of interest rate setting, while credibility and transparency of the Central Bank are guaranteed by the new memorandum of understanding.

Table 6

**Selected Economic Indicators**

| | CPI Inflation (%)[1,2] | Domestic Debt (Million US Dollar, Year End) [3,5] | PSBR / GDP [1] | Exchange Rate (TL[3]/US Dollar)[1] | Central Bank Discount Rate (%)[1] | Interest Rate, Saving Deposits[1] | Current Account Balance (Million US Dollar)[3,1] |
|---|---|---|---|---|---|---|---|
| 2002 | 43.1 | 99,526 | 10.0 | 1,505,840 | 55.0 | 48.2 | -626 |
| 2003 | 22.9 | 130,193 | 7.3 | 1,493,068 | 43.0 | 28.6 | -7,515 |
| 2004 | 9.4 | 157,826 | 3.6 | 1,422,341 | 38.0 | 22.1 | -14,431 |
| 2005 | 7.7 | 182,565 | -0.3 | 1,340,790 | 23.0 | 20.4 | -22,088 |
| 2006 | 9.7 | 187,433 | -2.0 | 1,431,110 | 27.0 | 23.7 | -32,051 |
| 2007 | 8.4 | 209,923 | 0.1 | 1,301,510 | 25.0 | 22.6 | -38,219 |
| 2008 | 10.1 | 222,555 | 0.8 | 1,292,910 | 25.0 | 22.9 | -41,416 |
| Average | 15.9 | 170,003 | 2.8 | 1,398,224 | 33.7 | 26.9 | -22,335 |

Source: 1-The Central Bank of Turkey
2-Turkstat
3- Pakdemirli E., 1991 'Ekonomimizin 1923'den 1990'a Sayısal Görünümü'
4- Doğruel F., 'Türkiye'de Enflasyonun Tarihi'
5- Undersecretariat of Treasury of Turkey

The successful implementation of the stabilisation program may not have been possible without the full commitment to the fiscal discipline that was defined as 6.5 percent primary surplus. Owing to this commitment, public sector borrowing requirement fell from 10 percent to the negative zone in some years. One of the main achievements of the program was the fall in inflation to single digits, unprecedented since the 1970s. Exchange rate volatility also eased and some years even saw appreciation of the exchange rate.

It may be argued that global liquidity squeeze should have helped in this conjuncture and the argument is well taken. However, without full commitment, which may be confirmed with the successful completion of a Stand-by agreement with the IMF, a case never seen before, the targets of the program may not have been reached, as has been the case with the early deals with the IMF since 1960.

Successful implementation of the privatisation scheme also helped ease the cost of crowding-out. Once the Treasury started to collect the revenues from sold assets, debt rollover ratio was reduced significantly and cash balances increased sharply to decrease the risk premium. The Central Bank also gained credibility by achieving the inflation targets and when this was not the case, by explaining successfully the reasons for the under/overshooting of the targets.

There was one side effect of all these achievements: The delayed investment during the turmoil years increased the need for external funding, which was also supported by the low level of domestic saving rates. Balance of payment imbalances increased their impact towards the end of the period. It may be worth mentioning that when six zeros were dropped from the Turkish lira, de facto

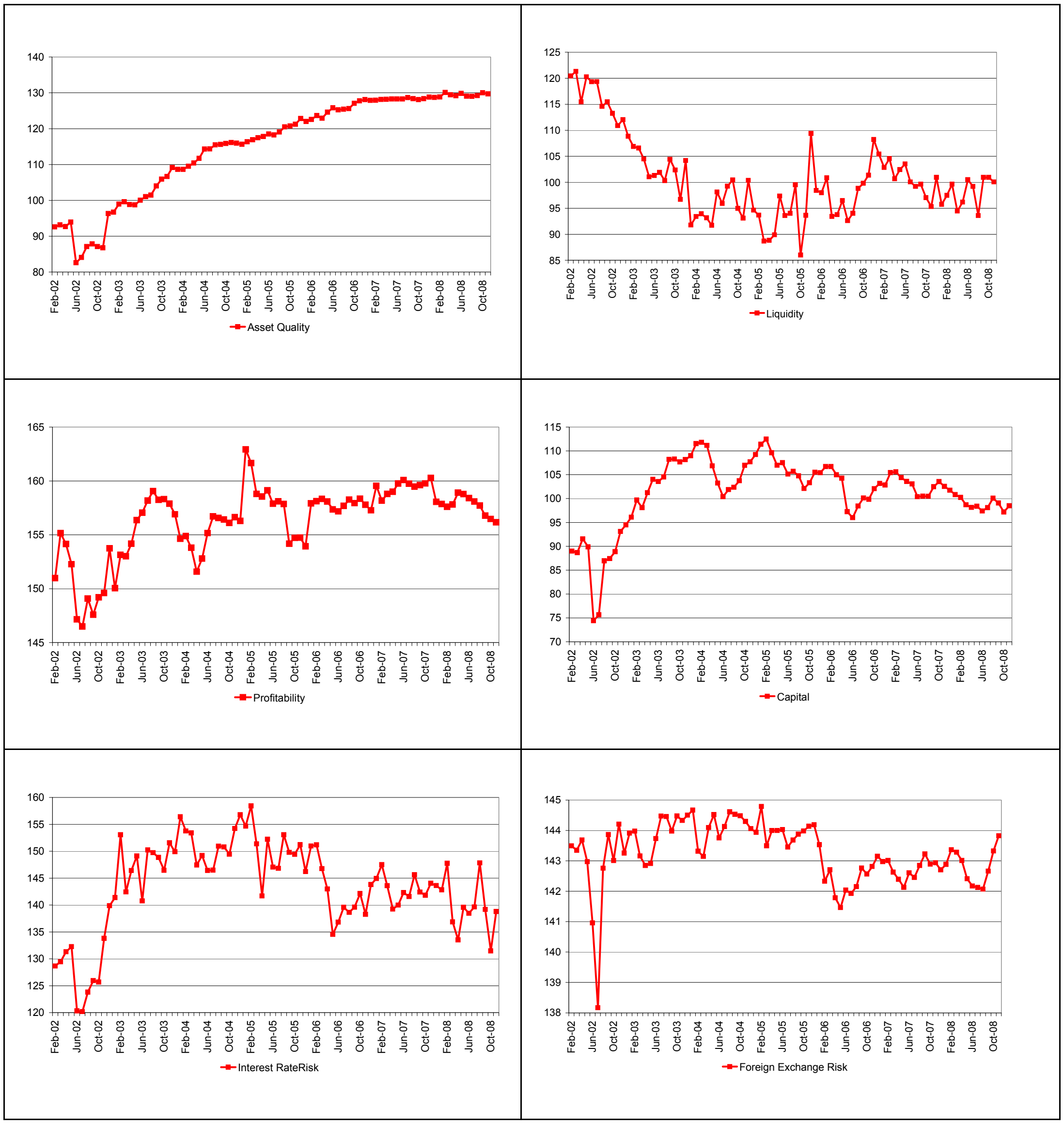
[3] At the beginning of 2005, six zeros have been dropped from the Turkish lira.

convertibility was also gained as confirmed by the issuance of TRY bonds by international financial institutions.

Banking sector increased its performance in every year during this period. Credit and deposit rates decreased to levels never seen in the last three decades and re-structuring and re-capitalisation after the 2001 crisis paid back well as the vulnerabilities of the sector disappeared one by one. Asset quality and profitability rose to unimaginable levels and there was a heightened interest from international banks to buy a bank or to look for opportunities for mergers and acquisitions. Banking sector capital adequacy ratio increased regularly as well. Public banks' burden on the system diminished after the re-organisation. Financial Stability Report was produced to give an independent assessment of the financial system. Together with the Inflation Report, which was introduced a couple of years earlier, the Central Banks communication set was completed.

Chart 14

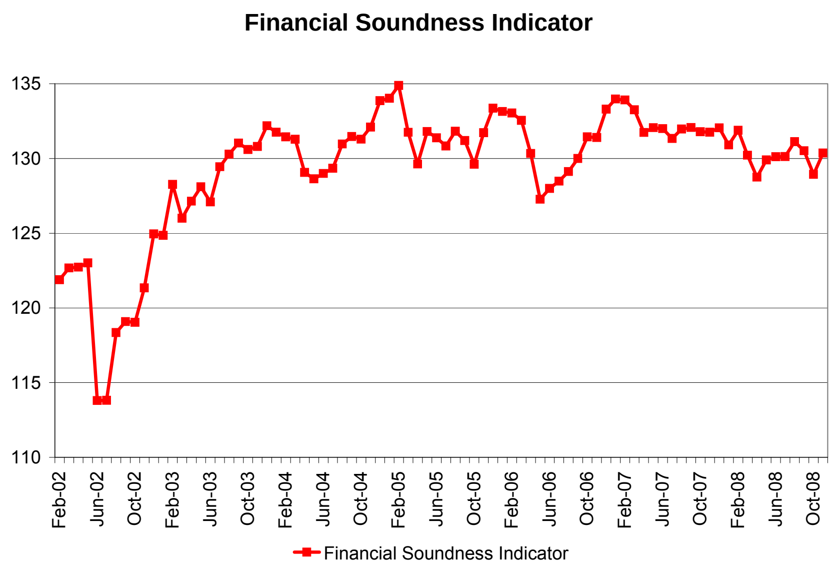
**Financial Strength Sub-Indices**




Source: The Central Bank of Turkey

The Turkish economic and financial stability struggle was in for a turbulent road from the1920s to 2008. However, the current performance of the economy is quite strong. It is believed that the successful implementation of the 2002 stabilisation program was the main factor behind such achievement . Financial stability in Turkey is quite resilient to the current global crises as the next chart exhibits and Turkish banks have been quite profitably even during the last two turbulent years. Now, the challenge is to adapt to the European Union standards.

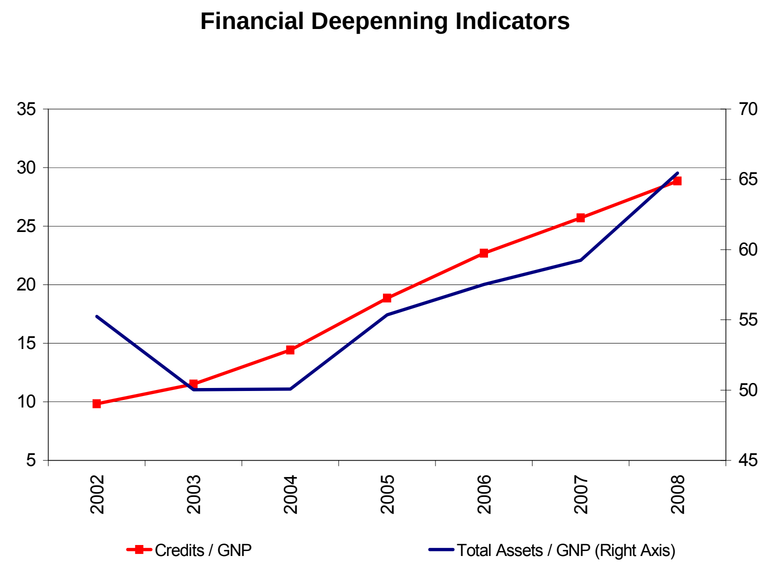
Chart 15




Source: The Central Bank of Turkey

One of these challanges is to strengthen the credit channel in Turkey. In order to achieve this target, the financial deepening needs an additional acceleration. Compared to the EU countries, the figures are quite low both in terms of total assets to GNP and credit to GNP ratios. Turkish banking system has proved very resilient to the current global crises. Once the destructive impact of the crisis eases in the years to come, banks will be well positioned to close this financial deepenning gap and increase their share in the economic activity. It may be argued that a stronger banking system will decrease the cost of adaption to the EU standards.

Chart 16




Source: The Central Bank of Turkey

## 8. Conclusion

The independence of the Republic of Turkey was declared in 1923. Initial conditions after the collapse of the Ottoman Empire were not ideal for a jump-start of economic activity that would lead to strong growth rates without structural reforms and re-structuring. There was no hard currency inherited and operating capital was so scarce that central banking was outsourced to French bankers. The basic element for sustainable growth, human capital, was insufficient and inefficient because of long wars and conflicts that led to destruction of productive human capital.

In the early decades after Independence, the priority was given to institutional reforms for a sustainable growth path under low inflation and financial stability. To this end, the rational approach of the Young Republic to the finance and banking managed the risk of a banking or a financial crisis carefully and confronted the total collapse of already scarce capital accumulation potential.

Heightened political unrest in Europe leading to the World War II forced the Young Republic to rely on a "mixed" system for sustainable growth and financial stability. On one hand, private investment and ownership were given incentives including direct capital injection for the production and/or distribution of basic consumption goods. On the other hand, the State invested in sectors that were strategically important for poverty and hunger reduction. The mixed economic system of development did not provoke high inflation rates or lead to financial chaos even under extreme global risk perception during those difficult years.

The end of decades of global wars and conflicts provided new opportunities for a new paradigm to sustain growth and financial stability. Private ownership and greater participation of private capital in economic activity were given additional incentives. Private banking developed fast with the emergence of new banks. Marshall aid package also provided a new capital base for infrastructural investment. Turkey experienced high levels of growth and strong total factor productivity in the 1950s. There was no serious pressure on financial stability other than small-scale balance of payment difficulties leading to devaluations. Even with strengthened policy towards liberalisation during 1950s, public banks extended their leading role in the financial system because of the general shortage of capital.

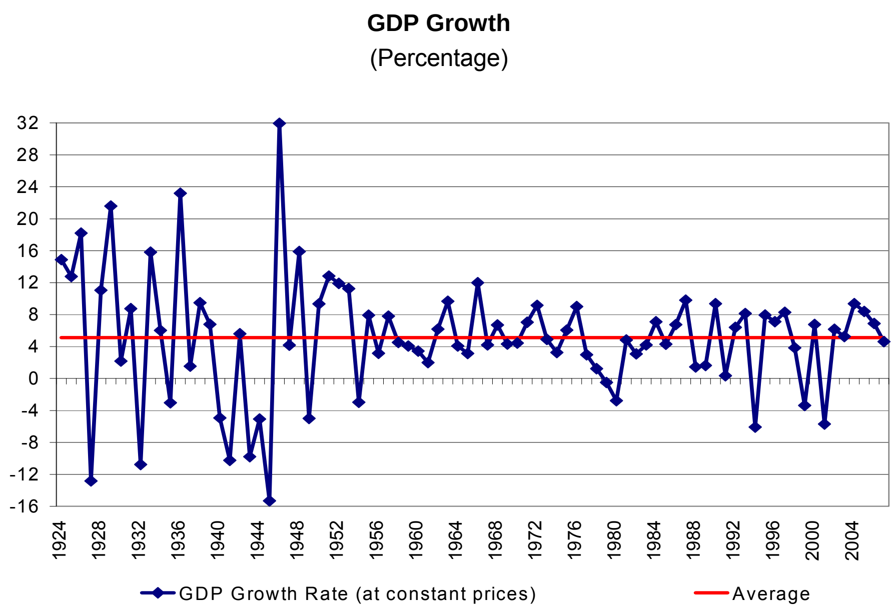
After the military coup in the 1960, an import-substitution growth strategy was initiated quite successfully and the Turkish economy experienced the best growth performance of its short existence. A semi-socialist planning strategy successfully dominated the Turkish economy with "five-year plans" influencing banking and finance as well. A clear list of strategically important sectors was announced and supported through all kinds of incentives, from tax exemptions to project finance credits or ease of access to credit through guarantees. In the early phase of its implementation, the program based development strategy provided high growth rates under low inflation rates.

With heavily regulated interest and foreign exchange rates, branch banking became a norm without any pressure of competition in the 1960s. Private entrepreneurs relied on "holding banking"[4], which was also encouraged by tax incentives. Industrial holding companies wanted to have a bank in order to finance their potential investments as most of the deposit base of the financial system was strictly channelled to "planned" or "programmed" prioritised investment projects. Then came the oil crisis of the 1970s and took away all the resources for the emergence of strong private banks. The capital accumulated in the last decade was wiped out by the balance of payment crises. The 1970s may best be defined as lost years partly because of shortsighted monetary and fiscal policies but also because of the increased political tension within the society. Lack of sufficient hard currency reserves quite often led to devaluations and a strategic mistake to dollarise the central bank balance sheet sharpened the destructive effects of the turbulence. Average growth rate for the decade fell sharply.

After the balance of payment crises and serial depreciations in the second half of the 1970's, a liberalisation initiative triggered free setting of deposit and credit rates to support market discipline. The second half of 1980s was the period when private banks began winning a market share. Following the strong growth performance of the 1960s, a new period of strong development began, but unlike during the 1960s, high and volatile inflation turned out to be persistent as well. The chart below exhibits the annual growth rates from 1923 onward:

[4] The term refers to priorising irrationally a group (holding) company in credit allocation.

Chart 17




Source: Turkstat.

Accumulation of capital in this decade came at a price: The bankers crisis in 1983, which had emerged as a ponzi game, wiped out certain gains in this area. Sustainable growth with low and stable inflation remained a distant dream.

The 1990s may be described as another "lost decade" in terms of banking and financial stability. The 1994 banking crises played a critical role in this definition. However, due to the lack of dedication to social welfare and economic re-structuring, fiscal deficits crowded out so much that the whole banking system fell into another crisis in 2001. Replacing the import-substitution growth strategy of the 1960s with export-led growth strategies required a competitive exchange rate policy that came at a price: Exchange rate pass-through created a vicious-circle of devaluations followed by heightened inflation persistence. Growth rate volatility increased sharply and both economic and financial stability became an unreachable targets without external aid. The IMF agreements came one by one and none was followed by successful implementation. The liberalisation of capital account to eliminate all controls and to declare "de jure" convertibility was ill-prepared in 1990 without financial reforms and high quality supervision and regulation.  Financial system failed to adapt to the new paradigm and banks were often bailed out through nationalisation.

Since the 1994 banking crisis, the Turkish economy in general, and banking system in particular, relied heavily on IMF agreements for both credibility gains and external balance sustainability. An exchange rate based stability program in 2000 failed to give a boost to economic stability and the 2001 financial crisis wiped out another round of capital accumulations.

After 2002, Turkish economy experienced a very high level of growth that came with low and decreasing level of inflation. A very long list of reforms and re-structuring programs, including banking and finance, supported this paradigm shift. As a candidate economy to the European Union, Turkey has been declared a market economy and the current challenging target is to adapt the productivity and efficiency to the European levels. The global crisis that has been dominating the world since August 2007 has made free access to external finance even more difficult. Turkish economy is now facing the challenging task of increasing domestic savings to support sustainable growth under low and stable inflation and support domestic demand to get rid of the risk of recession without increasing the risk premium.

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