Edited by
José M. Fanelli and Rohinton Medhora

FINANCIAL REFORM IN DEVELOPING COUNTRIES

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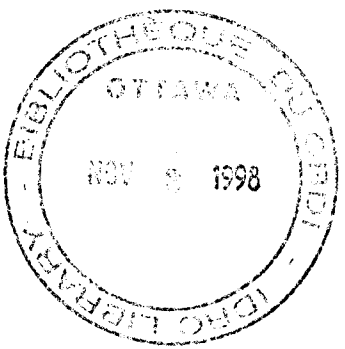

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To my wife

José M. Fanelli

To my parents

Rohinton Medhora

Contents

List of Tables ix

List of Figures xi

Foreword by Lance Taylor xiii

Preface xv

Acknowledgments xix

List of Abbreviations xx

Notes on the Contributors xxiii

PART I INTRODUCTION

1 Financial Reform in Developing Countries: An Overview 3
José M. Fanelli and Rohinton Medhora

PART II COUNTRY CASE STUDIES

2 Argentina 31
José M. Fanelli, Guillermo Rozenwurcel and Lucio M. Simpson

3 India 57
Kunal Sen and Rajendra R. Vaidya

4 Nigeria 90
Melvin D. Ayogu, Chidozie Emenuga and Charles C. Soludo

5 Turkey 129
Erol M. Balkan and A. Erinc Yeldan

6 Uruguay 156
Nelson Noya, Carlos Casacuberta and Fernando Lorenzo

PART III THEMATIC ISSUES

7 Micro- and Macro-Level Financial Reform in Canada 197
James Powell

8 The 'Unforgiving' Market and the *Tequilazo* 220
Guillermo A. Calvo

9 'Big Bang' versus 'Go Slow': Indonesia and Malaysia 245
Anwar Nasution

10 Banking on the Transition 296
Rodney Schmidt

11 Microeconomic Elements and Perspectives from Finance Theory 328
Varouj A. Aivazian

Index 353

List of Tables

2.1	Argentina: main macroeconomic indicators	34
2.2	Argentina: IV. 1991 financial matrix	36
2.3	Argentina: III. 1995 financial matrix	37
2.4	Argentina: leverage	40
2.5	Argentina: short-run debt/total debt	41
2.6	Argentina: dollar debt/total debt	41
2.7	Argentina: interest rates and financial spread: annual interest rates on 30-day deposits and loans	50
2.8	Argentina: non-performing loans net of provisions as proportion of net worth	51
3.1	India: selected macroeconomic indicators	62
3.2	India: distribution of assets, banking and financial institutions	64
3.3	India: financial surplus or deficit by sector	65
3.4	India: non-financial sectors' sources of external funds	66
3.5	India: uses of funds by non-financial sectors	67
3.6	India: financing of large, non-financial enterprises in the private sector	69
3.7	India: structure of bank lending rates	74
3.8	India: institution-wise details of financial assistance to the industrial sector	76
3.9	India: foreign investment inflows	83
3.10	India: India's balance of payments	83
4.1	Nigeria: key reform measures and main outcomes	97
4.2	Nigeria: growth profile in the financial services industry	103
4.3	Nigeria: flow of loanable funds in the reform period	111
4.4	Nigeria: dynamics of corporate financing profile	112
4.5	Nigeria: dynamics of domestic national debt financing and external debt burden	117
5.1	Turkey: main economic indicators	135
5.2	Turkey: financial assets and monetary indicators	136
5.3	Turkey: public sector balances	141
5.4	Turkey: speculative short-term capital (hot money) flows and financial indicators	144
5.5	Turkey: main indicators in securities markets	149

5.6	Turkey: interest rates on deposit and government debt instruments	150
6.1	Uruguay: main macroeconomic indicators	159
6.2	Uruguay: credit to firms and deposits from households	162
6.3	Uruguay: structure of financial system	166
6.4	Uruguay: main macroeconomic policy orientations after financial liberalization	182
9.1	Malaysia and Indonesia: key macroeconomic indicators	248
9.2	Malaysia and Indonesia: structure of the financial sectors	251
9.3	Malaysia and Indonesia: financial ratios	254
9.4	Indonesia: reform in the banking industry	259
9.5	Malaysia: reform in the banking industry	262
9.6	Indonesia: Herfindahl index of banking industries	265
9.7	Malaysia: concentration in the commercial banks	267
9.8	Malaysia and Indonesia: money market instruments	279
10.1	Central and Eastern Europe: deposits and claims of the commercial banking system	300
10.2	Poland, Hungary and the Czech Republic: non-performing loans of the banking system	302
10.3	Poland, Hungary and the Czech Republic: sources of investment finance in enterprises	302
10.4	Czech Republic and Poland: share of loss-making enterprises	310
10.5	Czechoslovakia, Czech Republic, Slovakia, Hungary and Poland: government expenditures, subsidies, and arrears	319
11.1	Various countries: tax advantage of investment income relative to equity income.	337

List of Figures

3.1	India: commercial bank real lending rate and spread between lending and deposit rates	73
3.2	India: real effective exchange rate – trade-weighted	85
4.1	Nigeria: financial reforms key performance indicators	109
4.2	Nigeria: real interest rate and financial savings	112
4.3	Nigeria: growth in private and public sector credit	113
4.4	Nigeria: financial reform and economic growth	114
4.5	Nigeria: net (public and private) capital flows through formal channels	119
4.A1	Nigeria: structure of the financial system	125
5.1	Turkey: short-term net capital inflows and central bank reserves	147
5.2	Turkey: speculative hot money inflows and ISE index	148
6.1	Uruguay: households assets in foreign currency	161
6.2	Uruguay: private banking offshore activity	167
6.3	Uruguay: banking spread on domestic currency	170
6.4	Uruguay: banking spread on dollars	171
6.5	Uruguay: long-run determinants – investment rate	179
6.6	Uruguay: spread between domestic and foreign assets	185
6.7	Uruguay: degree of dollarization	186
6.8	Uruguay: premium over national currency deposits	187
8.1	Uruguay: Krugman crisis	227
9.1	Malaysia and Indonesia: components of monetary base	283
9.2	Malaysia and Indonesia: developments of interest rates	284
9.3	Malaysia: market exchange rate, nominal exchange rate and real effective exchange rate	285
9.4	Indonesia: real effective exchange rate	287

5 Turkey

Erol M. Balkan and A. Erinc Yeldan

5.1 INTRODUCTION

Integration of the developing national economies into the evolving world financial system has been achieved by a series of policies aimed at liberalizing their financial sectors. The motive behind liberalization was to restore growth and stability by raising savings and improving economic efficiency. A major consequence, however, has been the exposure of these economies to short-term capital movements, which have increased financial instability and caused a series of financial crises in the developing countries.

Integration was further deepened by the dollarization of these economies when they became reliant on foreign capital for their privatization programmes. Such a reliance became inevitable when governments were unable to implement credible anti-inflationary policies while at the same time demanding access to foreign currency. In many cases, inflows of short-term capital were used not to create new productive investments that would generate growth, but instead simply created new dollar obligations for which there was no clear source of repayment. The existence of a currency board in Argentina, for example, provided short-term stability, but the fact remains that the current exchange rate of the Argentine peso against the dollar has been financed with offshore debt and privatizations. As such, this policy is unsustainable.

Financial liberalization, by way of reliance on short-term capital inflows, intensified the already existing problems such as budget deficits, monetary instability and market distortions. The problems were the consequence of the very nature of these flows, because they created instabilities in exchange rates, interest rates and financial asset prices. Because most developing country stock markets are in their infancy, they display a high degree of volatility. From 1982 to 1985, share prices (in US dollars) on the Brazilian stock market rose fivefold. Two years later, they fell more than 28 per cent of their 1985 value. In the first nine months of 1987, share prices on the Mexican stock market rose six-fold. Following the October crash, however, prices fell to a tenth of their previous level (Singh, 1992). In Turkey between 1992 and 1993, share prices rose four-fold. The next

year they fell by 50 per cent. This link between short-term capital flows and stock markets increased the potential for further crisis. Because the return on investments depends largely on the movements of the exchange rate, serious shocks experienced by these countries that caused a devaluation in their currency triggered a sharp decline in equity prices and an outflow of capital (Akyüz, 1995).

Short-term capital flows are now considered the double-edged sword of economic development. On the one hand, they tend to create an environment that enhances and increases the efficiency of the domestic financial markets via intensified competition. On the other, however, evidence also suggests that short-term capital speeds in and out of developing countries for reasons not always related to their discretionary monetary policies. As a result, countering positive expectations such as increased efficiency in financial markets, short-term capital flows are likely to result in a number of equally detrimental consequences. First, they tend to increase financial fragility. Second, they increase the interest rates and inflate financial asset prices, causing stock market bubbles to emerge. Third, they create contractions in the real economy that have real consequences for employment. Fourth, they worsen the income distribution. Fifth, they reduce a government's ability to conduct monetary policy.

The Turkish economy experienced its first major financial crisis in the first quarter of 1994. One of the best-performing emerging stock markets in 1993, the Turkish stock market suffered huge dollar losses during this period, owing to a 65 per cent devaluation in the Turkish lira. The Istanbul Stock Exchange Composite Index fell 50 per cent in dollar terms as volatility of capital markets and political instability further reduced confidence in the lira, despite efforts to reduce Turkey's current account, budget, and trade deficits. The currency crisis led to implementation of an austerity programme in April 1994, the aim of which was to restore confidence in the Turkish lira and establish a clear commitment to reducing fiscal and external imbalances by reducing government spending and slowing down rapid inflation. Several unpopular measures were adopted, including higher taxes and state-controlled prices, a speed-up of the privatization programme, and a further devaluation in the lira. The central bank intervened in the foreign exchange market, and between January and 5 April it used over $3 billion (about half of its year-end 1993 reserves) to support the lira. Between the end of 1993 and the end of April 1994, the value of the lira fell by 60 per cent in nominal terms against the US dollar.

In part, the currency crisis was a result of deteriorating macroeconomic fundamentals that were rooted in public sector imbalances, but to a large

extent the crisis can be traced to unsustainable growth in current account deficits as a result of short-term capital inflows.

The main objective of this chapter is to analyse the determinants of speculative short-term capital flows and their consequences on various aspects of the Turkish economy during the recent financial liberalization experience. First, in Section 5.2, we briefly examine the main motivation behind attempts at liberalization by returning to the structure of the economy prior to liberalization. Then we discuss the evolution of the financial sector in Section 5.3, by looking at various aspects of the system. In Section 5.4 we highlight some of the consequences of financial liberalization, concentrating on the effects of short-term capital flows into the economy. In our conclusion, Section 5.5, we pull together the main characteristics of the liberalization period that led to the present financial instability.

5.2 FINANCIAL LIBERALIZATION IN TURKEY: A BRIEF HISTORY

Turkey's attempts at liberalizing its financial system began along with the structural adjustment reform programme initiated in 1980. Before then, the system revealed all the attributes of 'financial repression', with negative real interest rates, a high tax burden on financial earnings, and high liquidity and reserve requirement ratios. Overall, financial markets suffered from a highly regulated and inefficient banking system, with consequent low-quality portfolio management. Given the underdeveloped and fragmented nature of the capital and stock exchange markets, corporations had to over-rely on banking credits rather than issuing stocks to finance their working capital balances (OECD, 1988). The fiscal deficits were mostly financed by direct monetization through the central bank.

On January 1980, with the introduction of a comprehensive stabilization programme, the overall development strategy was reoriented from a highly regulated, inward-looking economy to that of an outward-oriented, open economy operating under market incentives. The major elements of the reform programme were the switch to a pegged exchange regime of continuous adjustments, elimination of price controls and phasing out of subsidies, and the gradual removal of trade restrictions towards full commodity trade liberalization. Many aspects of the Turkish structural adjustment have been well documented in Rodrik (1991), Nas and Odedokun (1988) and Aricanli and Rodrik (1990).

In retrospect, it can be stated that the mode and pace of financial reforms have progressed in leaps and bounds, mostly following pragmatic,

on-site solutions to the emerging problems. In the beginning, the major aim of the reforms had been the deregulation of the financial system, which had naïvely been expected to be sufficient to create a competitive financial structure more efficient over the previous one (Ersel, 1991). The first action undertaken was the removal of legal ceilings on deposit interest rates, which led to a fierce struggle among the banks and the broker institutions to attract funds from the public. This bonanza of fake 'Switzerlandization' was short-lived, however, and came to a halt with the emergence of the 1982 financial crisis.

The foreign exchange regime was liberalized early in 1984. Banks were allowed to accept foreign currency deposits from citizens and to engage in foreign transactions. Deregulation of restrictions on foreign exchange led to enormous pressures towards currency substitution. Such influences led to very high real rates of interest throughout the reform period, because the monetary authorities tried to defend the Turkish lira by increasing the real interest rate to improve the capital account. With full liberalization of the capital account, and the recognition of full convertibility of the lira in 1989, however, there has been a massive inflow of short-term capital into the domestic economy (Boratav *et al.*, 1995). Even though there was no officially stated exchange rate management policy during this period, the government seemed to use the exchange rate as the nominal anchor in trying to control the inflationary expectations. This policy led to an annual depreciation of the exchange rate below the inflation rate. For example, the extent of the real appreciation ranged from 33 per cent in 1990 to 2 per cent in 1992. In 1995, real appreciation was 15 per cent. Much as in the Southern Cone experience, however, this use of the exchange rate to attain the inflationary targets led to significant fluctuations in the real economy and was severely deflationary (see Dornbush, 1982; Diaz-Alejandro, 1985; Fanelli and Frenkel, 1993).

In the credit market, the central bank's control over commercial banks was simplified with a revision of the liquidity and reserve requirement system. An interbank money market for short-term borrowing facilities was enacted in 1986. In 1987, the central bank diversified its monetary instruments by starting open market operations. And in October 1989 it abandoned the use of rediscount facilities as an instrument of selective credit policy.[1] Finally, in early 1990 the central bank announced a new monetary program based on a new concept of controlling the stock of its balance sheet on both the assets and the liabilities sides, formulated as central bank money (CBM). To restrain the growth of CBM, the central bank signed a protocol with the Treasury to limit public sector borrowing requirements and monetization of the fiscal deficit.

In order to regulate and supervise the capital market, a Capital Market Board was established, and initiated the reopening of the Istanbul Stock Exchange (ISE) in 1986. To encourage equity financing, significant tax incentives were granted and, since 1986, all dividends and capital gains have been exempted from personal taxation.

The adjustment experience of the real sector to financial liberalization had been one of boom-and-bust cycles. As documented in Table 5.1, the post-1988 performance of gross domestic product revealed intensified short-term business cycles, with rates of annual growth ranging between 8 per cent in 1993 and –5.5 per cent in 1994. Following the production cycle, both consumption and investment demand fluctuated sharply over the same period. Similarly the external economy was in turbulence, with the balance on current account suffering from severe fluctuations between –$6.4 billions in 1993, and $2.6 billions in 1994, and again –$2.3 billions in 1995. The domestic rate of inflation reached the plateau of 70 per cent to 80 per cent per annum and displayed strong resistance at this threshold.

Given the Turkish experience, one can easily trace out the drastic impacts of the reform measures on the domestic financial markets and the ongoing trend towards financial deepening. Contrary to expectations, however, the public sector share in financial markets remained high. The financing behaviour of corporations did not show significant change, and credit financing from the banking sector and inter-firm borrowing continued. Furthermore, the share of private sector securities in total financial assets fell. Thus, the observed upward trend of the proportion of direct securities to GNP originated from the direct new issues of public sector securities and treasury bills. Because the commercial banking system has been the major customer of such securities, however, the share of aggregate security instruments fell in private portfolios. In fact, with the implementation of positive interest rates, and the new possibility of foreign exchange accounts, the advance of financial deepening for the private households has meant increased foreign exchange deposits with vigourous currency substitution. Thus, it can be stated that the 'pioneers of financial deepening' in Turkey in the 1980s have been public sector securities and foreign exchange deposits. As Akyüz (1990) attests, from this observation, Turkish experience did not conform to the McKinnon–Shaw hypothesis of financial deepening, with a shift of portfolio selection from 'unproductive' assets to those favouring fixed capital formation.

The process of financial deepening had matured by 1990. Total deposits in the banking system had risen from 18.6 per cent of the GNP in 1980, to 30 per cent by 1988 and have been relatively stable since then (Table 5.2). Signs of tension, however, were visible after 1990, when the degree of

monetization of the domestic economy was under scrutiny. Ratios of monetary aggregates M1 and M2 were found to be on a declining trend, whereas that of M2Y increased.[2] We observed that while the ratio of M2 to GNP had decreased from 21.1 per cent in 1988 to 16.6 per cent in 1995, that of M2Y had increased from 28.4 per cent to 34.3 per cent during the same period. This development hints at the decreased confidence on the domestic currency, and reveals the increased threat of currency substitution, which, combined with the threat of international speculative capital flows (hot money), would be the prime cause of the vicious cycle of high real interest rates along with currency appreciation.

The process of financial deepening was shaped directly by the financing needs of the public sector. Table 5.2 documents this episode. The new issues of securities by the state increased from 6.9 per cent of the GNP in 1988 to 20.3 per cent in 1995. On the other hand, issues by the private sector stood at 2.2 per cent of the GNP as of 1995. The state granted a series of incentives to the banking sector for holding its government debt instruments (GDIs). GDIs could be used as collateral and be held against the liquidity requirements. This process led to three important consequences: first and foremost, it substituted fiscal policy for monetary policy and hindered the central bank's capacity to conduct monetary policy; second, it enabled the Treasury to assume a monopoly power to regulate the distribution of domestic credit and crowded out the private sector; third, as a result of the sudden and unexpected changes in the issues of the GDIs through captive methods of liquidity requirements, it led to a highly volatile money multiplier.

5.3 STRUCTURE AND EVOLUTION OF THE FINANCIAL SYSTEM

The structure of the financial system prior to the liberalization episode can be summarized briefly by highlighting several of the main characteristics. First, there were ceilings on the interest rates for deposits and credits, and real interest rates were negative. This encouraged corporations to use excessive leverage, but to a large extent it caused the financial sector to shrink in real terms. Second, the reserve requirement ratios were relatively high, resulting in increased costs of bank intermediation. Third, there were no institutionalized capital markets. Fourth, public sector deficits were primarily financed through monetization. Because the money markets and government securities markets were not developed, the CB could not utilize financial market instruments for the

Table 5.1 Turkey: main economic indicators

	1988	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
Annual change (%)								
GDP	2.7	1.2	7.9	1.1	5.9	8.0	–5.5	7.4
Consumption								
Private	1.2	–1.0	13.1	1.9	3.3	8.4	–7.5	11.8
Public	–1.1	0.8	7.9	4.5	3.8	2.3	–7.6	9.5
Fixed capital formation								
Private	12.6	1.7	19.4	0.9	4.3	44.1	–22.2	16.5
Public	–20.2	3.2	8.9	1.8	4.3	12.1	–31.6	–2.4
Exports (million US$)	11 929	11 780	13 026	13 667	14 891	15 611	18 390	21 975
Imports (million US$)	14 335	15 792	22 302	21 047	22 871	29 428	23 270	35 709
Current account (million US$)	1596	961	–2625	250	–974	–6433	2631	–2339
GNP per capita (US$)	1684	1959	2682	2655	2744	3056	2161	2732
Inflation rate (CPI, %)	75.4	64.3	60.4	71.1	66.1	71.1	125.5	78.9

Source: SPO main economic indicators. Central Bank of the Republic of Turkey, *Annual Report* (Ankara) various years. Undersecretariat of Foreign Trade and Treasury, *Main Economic Indicators* (Ankara) various years.

Table 5.2 Turkey: financial assets and monetary indicators (% of GNP)

	1988	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
I. Securities by issuing sectors								
Public Sector	6.9	7.7	5.4	7.6	12.9	16.8	22.9	20.3
Government bonds	3.0	3.9	3.1	1.9	5.6	7.5	5.1	4.5
Treasury bills	4.0	3.3	2.1	5.4	6.9	9.0	16.7	15.8
Private Sector	0.9	1.0	1.0	0.9	2.0	3.5	2.2	2.2
Shares	0.3	0.4	0.5	0.6	0.4	0.4	1.0	0.6
Private bonds	0.2	0.3	0.2	0.1	0.1	0.0	0.0	0.0
Assets backed securities	0.0	0.0	0.0	0.0	1.3	2.6	1.1	1.5
General total	7.8	8.7	6.4	8.5	14.9	20.3	25.1	22.5
II. Monetary indicators								
Currency in circulation	3.5	3.7	7.2	6.9	3.4	3.2	3.1	2.9
M1	8.8	8.5	7.9	7.4	7.1	6.5	5.9	5.2
M2	21.1	20.5	18.0	18.5	17.3	14.1	16.2	16.6
M2Y	28.4	26.6	23.5	26.5	26.6	23.7	30.7	34.3
Total deposits	30.3	27.8	24.7	27.4	27.8	24.5	31.7	28.9
Sight deposits	6.1	5.5	5.0	4.6	4.3	3.9	3.3	2.6
Time deposits	12.3	12.0	10.1	11.1	10.2	7.7	10.3	11.2
FX deposits	7.4	6.1	5.5	8.0	9.4	9.5	14.5	15.0
Reserve money	9.4	9.0	7.2	6.9	7.0	6.5	7.3	4.4
Volume of domestic credit	22.5	18.9	18.8	20.6	22.1	22.7	19.9	23.1

Sources: Central Bank, *Annual Report*; Treasury main economic indicators.
Undersecretariat of Foreign Trade and Treasury, *Main Economic Indicators* (Ankara) various years.

purpose of monetary control. Fifth, there were restrictions on the entry of foreign and domestic banks into the banking sector. Sixth, foreign exchange operations were significantly restricted. And finally, corporate financing was achieved through borrowing rather than equity financing. Commercial banks were the dominant financial institutions, and bank loans were the main instrument of financing. Under these structural conditions, liberalization measures were introduced to correct the balance of payments problems in an attempt to end financial repression and stimulate real economic growth.

The multiple aims of the 1980 Stabilization Programme were to reconstruct the economy by moving towards more of a market orientation, which would allow a far more efficient allocation of resources, so as to control the chronically high inflation rate, to improve the balance of payments problems through the reduction of current account deficit, to implement an investment policy to increase capacity utilization and the efficient allocation of resources, to establish a more realistic exchange rate policy to promote exports, to promote foreign investment and the inflow of foreign capital, and to have a credible public finance policy to increase tax revenues. To meet these goals, import substitution was replaced by export promotion, opening the economy to foreign capital flows.

During the same period, financial reform measures were introduced in an effort to promote financial market development through deregulation and competition. The strategy was to make entry into the banking sector easier, so as to increase the role of the financial system in promoting growth. Significant structural changes in the financial system followed from the these measures, especially during the second half of the 1980s.

The Banking System

The banking system, generally, viewed the implementation of the financial liberalization programme as benign, and made an effort to accommodate its measures. Banks began to modernize themselves, by adopting new technologies in their operations. The liberalization of interest rates and the foreign exchange regime, along with the entry of new domestic and foreign banks, increased competition in the banking sector. In this new environment, efficient supervision became an important issue in the maintainance of the safety and soundness of the banking system. Some measures pertaining to the adequacy of capital were introduced to strengthen banks' capital structures. The minimum amount of a bank's required capital was raised from 25 million to 5 billion Turkish lira in 1988. In addition to the minimum capital requirement, a capital adequacy ratio was

established to minimize the risks of a bank's assets. In 1992, the capital adequacy ratio was increased to 8 per cent, by using BIS guidelines to determine primary and secondary capitals and risk weights. Firms with low equity/debt ratios were unable to pay their debts, resulting in an accumulation of non performing loans in the banks' portfolios. Because there were no legal obligations, the classification and provisioning of non-performing loans were at the discretion of the banks. In 1986, through an amendment to the Banking Law, the government issued a decree for provisioning, requiring banks to keep specific loan loss reserves as well as general reserves for their loan portfolios. Although the practice was not in accord with international practices, this can be seen as a first attempt to require banks to classify and keep reserves for their past due loans. The rates for provisions were very low. In May 1988, a new decree on loan classification and provisioning was put into effect, based primarily on the creditworthiness of the borrowers.

After the initial implementation of the financial liberalization measures, in addition to on-site examinations, the establishment of an effective off-site supervision system became an important objective of the regulatory authorities. Therefore, all banks were required to use a uniform chart of accounts. Another important measure of supervision of the banking system was the independent auditing of banks. Reports from independent auditors were evaluated to assess banks' strengths and weaknesses.

All these measures were aimed at increasing the efficiency of supervision and led to more transparency of banks' financial statements.

In 1983, to protect depositors against possible bank failures and to increase the public's confidence in the financial system, the Savings Deposit Insurance Fund was established. The coverage of insurance was limited to saving deposits only. The law authorized the Treasury to liquidate or rehabilitate problem banks.

Developments in the banking sector throughout the liberalization period can be summarized as follows (Akkurt *et al.*, 1992):

(1) The banking system was strengthened by establishing prudential regulations in line with international practices and guidelines. The standards for loan classification and loan-loss provisioning helped in identifying and classifying non-performing loans. Besides these standards, the banks have been required to fulfill the risk-weighted capital adequacy ratio, which was 8 per cent in 1992.
(2) The soundness of the system was also enhanced by improving the on- and off-site supervision, establishing an independent auditing mechanism, and making uniform accounting practices.

(3) The banking system has developed as a result of the introduction of new markets such as the foreign exchange and gold markets; and improvements in capital markets through refined instruments, liberalization of the foreign exchange regime and interest rates, reduction in the volume of preferential credits and more effective taxation of financial intermediation. The liberalization of the foreign exchange regime created an opportunity for the banks to increase their profitability by mobilizing foreign exchange funds while increasing the tendency for currency substitution.
(4) The central bank played a leading role in the reduction of the volume of preferential credits that had created an obstacle to increasing the efficiency of the banking system. The rediscount facilities for preferential credits were terminated, and the banks have been allowed to use the discount window only for their liquidity requirements at a rate determined by the CB.
(5) Distortions in the efficiency of the banking system, caused by high taxation on financial intermediation, were reduced to some extent by lowering the reserve requirement ratios.[3]
(6) Despite the rapid growth of non-financial economic institutions throughout the liberalization period, the banking sector remained as the main contributor to fund mobilization.
(7) Owing to their rapid growth, most of the new financial instruments were introduced by these institutions.[4]
(8) The share of banks in the secondary markets of these instruments amounts to 90 per cent. Additionally, the predominant financial instruments are bank deposits and government securities.

A closer examination of developments in the banking system, however, reveals that its growth was neither smooth nor completely in line with the liberalization programme.[5] There was a decline in concentration measured by the share of the five largest banks in total assets. For example, concentration for the five largest banks declined from 69 per cent in 1980 to 52 per cent in 1995. Similarly, the concentration for the largest ten banks also declined from 88 per cent in 1980 to 76 per cent in 1995. During the same period, the share of government securities in the banks' portfolios increased.[6] There also was an increase in the banks' capitalization. And as a result of opening the economy, commercial banks' share of claims on and liabilities to non-residents increased after 1986. Since then, total domestic credit as a percentage of GNP declined while banks' profitability increased. After 1986, the role of foreign banks in promoting competition in the banking sector was negligible.

Capital Markets

The liberalization process was initiated by the creation of legal framework for the enactment of the Capital Market Law in 1981. This was followed immediately by the establishment of the Capital Market Board in 1982 as the supervisory and regulatory authority to ensure the functioning of the market.[7] Besides the supervisory and regulatory functions, the Board was also given the authority to develop the markets themselves. The distinguishing feature was that the Board had the authority to set the framework and then to amend its regulations according to changing market conditions.

Between 1982 and 1986, the infrastructure of the markets was almost completed. The main principles for the financial intermediaries and for the scope of their operations were set, the instruments were defined and the rules for issuing securities were specified.

A new law was enacted in 1992 to lay the foundation for a market-determined financial innovations process. The scope of authority of the Board was enlarged and financial innovations were made easier in terms of the development of new instruments and institutions by the market itself.[8] The principal measures that were taken can be summarized as follows (Sak, 1995):

(1) Instruments of direct finance were defined by the Board. Disclosure requirements were set and conditions required from the issuers of securities were defined,[9] while merit regulation principles were adopted.[10]
(2) The roles of banks and non-bank financial intermediaries in the securities markets were specified, leading to an acceptance of the universal banking system. Banks were allowed to undertake all kinds of financial market activities without requiring any additional licensing.
(3) The Istanbul Stock Exchange (ISE) was established in 1985 as the secondary market of securities and became operational in 1986. Fiscal incentives were granted to bring all trading on corporate stocks under the auspices of the ISE. After 1989 the ISE became large enough to attract foreign investors and to absorb the issue of shares of large SEEs for privatization purposes.[11] The Board has acted not only as a regulatory authority but also as a leading innovator for the whole industry, with a special emphasis on investor protection.

5.4 DETERIORATION OF THE FISCAL BALANCES OF THE STATE

The post-1980 period witnessed the rapid deterioration of the fiscal position of the state. As Table 5.3 documents, the major breakdown has

Table 5.3 Turkey: public sector balances (real 1987 prices, billions TL)[a]

	1988	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
Tax revenues	10 455.0	11 702.6	13 255.3	13 078.0	14 543.4	15 647.6	14 313.5	13 589.5
Direct	4 037.6	5 076.7	5 625.7	5 621.9	6 110.2	6 346.2	6 165.4	5 172.5
Indirect	6 417.3	6 625.6	7 629.6	1 134.0	8 433.1	9 301.4	8 148.1	8 417.0
Factor revenues	4 675.6	3 959.8	2 690.4	512.8	–66.1	570.2	696.5	1 745.5
Current transfers	–6 160.8	–6 167.9	–5 629.2	–4 925.0	–5 666.6	–8 150.7	–8 044.8	–8 911.7
Public disposable income	10 001.1	10 499.0	11 517.5	9 497.0	9 559.8	8 489.8	7 015.9	7368.4
Public savings	5 038.8	3 742.5	2 871.5	347.7	–849.1	–2 444.3	–1 267.3	–283.0
Public investment	6 232.0	5 885.8	7 502.4	6 029.0	5 509.5	6 207.5	3 179.3	3023.6
Public saving – investment balance	–1 193.3	–1 796.0	–4 630.9	–5 675.6	–6 358.6	–8 651.8	–4 446.5	–3 306.6
Ratios to GNP (%)								
PSBR	4.6	5.2	7.4	10.3	10.6	12.1	7.5	5.4
Budget deficit	3.0	3.3	3.1	5.3	4.3	6.9	3.5	4.2
Non-interest primary budget	–0.4	0.6	0.5	–1.5	–0.6	–0.9	3.8	3.4
Interest payments on:	3.7	3.6	3.5	3.8	3.7	5.8	7.7	7.5
Domestic debt	2.4	2.2	2.4	2.7	2.8	4.6	6.0	6.2
Foreign debt	1.4	1.4	1.1	1.1	0.9	1.2	1.7	1.3
Personnel expenditures	3.8	5.4	6.7	7.8	8.5	8.5	7.0	6.5

[a] Deflated by the CPI.

Sources: Treasury main economic indicators.

Boratav, Turel and Yeldan (1995, Table 11).
CBRT, *Annual Report* (Ankara) various years.
State Planning Organization, *Main Economic Indicators* (Ankara) various issues.

occurred in the flow of factor revenues generated by the state economic enterprise system and in the rapid rise of the transfer expenditures. Factor revenues declined by 4.6 trillions TL in real 1987 values in a period of four years from 1988 to 1992. Even though there had been modest improvements in tax revenues, the surge in transfer expenditures overran such gains. Likewise, the capacity of the public sector to generate savings was eroded severely and turned negative after 1992. The aggregate disposable income of the public sector fell by 30 per cent in real terms between 1988 and 1995 and the savings – investment gap widened nearly four-fold.

All these developments led to a sharp increase in the public sector borrowing requirement (PSBR), which increased to as much as 12.1 per cent of the GNP in 1993, just before the outbreak of the 1994 economic crisis. The state has resorted to a massive operation of domestic debt financing by way of new issues of debt instruments. As a result, the stock of domestic debt grew rapidly, to reach 20 per cent of the GNP by the end of 1995. The interest payments on domestic debt increased from 2.4 per cent in 1990 to 6.2 per cent of the GNP in 1995, and as a result constituted an important mechanism of income transfer within the domestic economy. In this way, the Treasury assumed a regulatory role in redistributing the economic surplus in favour of financial rentiers, a phenomenon discussed more extensively in Yeldan (1995).

Another mode of finance for the state's fiscal operations has been the opening up of the domestic financial sector to speculative short-term foreign capital flows. Turkey completed the liberalization of its capital account in 1989 by deregulating all its capital movements in its balance of payments transactions. Since then, such flows have effectively displayed very high sensitivity to the net differential between the domestic and foreign interest rate and the rate of currency depreciation. In this situation, the central bank has lost its overall control over these two instruments; they have practically turned into exogenous variables controlled by the external financial markets. From the view of the domestic financial markets, liberalization of the capital account necessitated a higher rate of return on domestic assets, as compared with foreign currency (as given by the rate of nominal depreciation). The rationale for this link can be traced directly to the *threat of currency* substitution (dollarization and/or D-markization) of the domestic liquidity markets. Given this threat, the monetary authority had to assume a passive role against excessively high real rates of interest on domestic assets, coupled with an overvalued exchange rate. It is actually a misnomer to refer to the foreign exchange rate regime as one of *overvaluation*. In fact, it is the balance of payments accounts that yield such an equilibrium in the first place, because liberalization of

the capital account in the short-term capital transactions requires a commitment to high real rates of domestic interest exceeding the rate of currency depreciation. As this commitment stimulates more direct portfolio investments, domestic currency appreciates, inviting an even higher level of hot money inflows to the domestic economy.

All of these connections help to create an extremely unpredictable environment. The 1989–93 experience shows the serious problems confronting a developing economy than decides to move into full external and internal deregulation in the financial system under conditions of high inflation. 'The spectre of capital flight' becomes the dominant motive in policy-making and creates commitment to high interest rates and expectations for cheap foreign exchange. The links between these two policy variables and the real sphere of the economy, that is, investment in physical capital and the current account balance of payments, are deeply severed. When adverse impacts on the current account balance become excessively destabilizing, real depreciation seems imminent, which, however, needs to be matched by further upward adjustment in the rate of interest if currency substitution or capital flight is to be restrained. Even with all the necessary adjustments, the country may experience capital flight for reasons beyond its control. Instability in the rates of foreign exchange and also in interest rates creates feedbacks that lead the economy into further instability.

The elements of this process are displayed in Table 5.4. We report the net return on hot money in column 1. This return is calculated as the rate of difference between the highest nominal interest offered in the domestic economy and the rate of nominal depreciation of the TL. It yields a net return to a foreign investor who switches into TL, captures the interest income offered in the domestic economy and switches back to the foreign currency at the end-of-period exchange rate. The difference between the interest earned and the loss due to currency depreciation is the net earnings appropriated by the investor.

The returns on such speculative transactions are contrasted with the alternative international yields, summarized by LIBOR, in the second column. The inflows show high sensitivity to whether or not the domestic rate of return compares favourably with the LIBOR. Except for 1990 values, the net flows are observed to be of the expected sign. Net flows fluctuated widely, especially between 1993 and 1995, and caused drastic business cycles, with 1994 the worst economic crisis in the postwar republic's history.

Note, though, that one has to be aware of the *gross* magnitudes of such flows, rather than *net* amounts, because it is here that the destabilizing consequences of speculative short-term capital movements prevail. In

Table 5.4 Turkey: speculative short-term capital (hot money) flows and financial indicators (millions US$)

	Hot money flows[b]						*ISE Index*[c]					
	Return on Hot money[a]	*LIBOR*	*(1) Inflows*	*(2) Outflows*	*(3) BOP (1 – 2) + (3) Errors & omission*	*Aggregate net flows*	*TL base*	*US$ base*	*Inflation rate(%)*	*Annual depreciations rate ($, %)*	*Current account balance*	*Reserve at CB*
1988	–0.073	0.077			515	–1 766.00	374	120	75.4	66.1	1 596	2 307
1989	0.236	0.091			971	2 646.00	2 218	561	64.3	49.2	961	4 831
1990	0.293	0.082			–468	1 627.00	3 256	643	60.4	22.9	–2 625	5 972
1991	–0.038	0.058	57 116	56 633	948	1 431.00	4 369	502	71.1	59.9	250	4 918
1992	0.154	0.039	81 389	76 885	–1 190	3 314.00	4 004	273	66.1	64.7	–974	6 116
1993	0.045	0.034	142 501	134 282	–2 222	5 997.00	20 683	833	71.1	59.9	–6 433	6 213
1994	–0.316	0.051	97 892	103 575	1 769	–3 914.00	27 257	413	125.5	170.4	2 631	7 112
1995	0.199	0.066	101 190	97 766	2 275	5 699.00	40 025	383	78.9	53.8	–2 339	12 390

[a] $[1 + R)/(1 + c) - 1]$; where R: the highest rate offered by the banking system or government debt instruments (Boratav *et al.*, 1995); E: rate of depreciation of the nominal exchange rate.
[b] Flows of portfolio investments, FX credits of the banking system.
[c] ISE index (1986 = 100).

Sources: Boratav *et al.* (1995, Table 11); CB balance of payments statistics, May 1995, SPO, *Main Economic Indicators*.
Capital Market Board (1995) *Annual Report* SPO (1996) *Main Economic Indicators* (Ankara) (April).

columns 3 and 4 of Table 5.4 we report the gross inflows and outflows of hot money to the domestic financial markets for the post 1991 period (unfortunately such detailed data were not available for the previous period at the time of writing.) For our purposes, we define hot money as (1) the flows of portfolio investments; (2) the FX deposits of non-residents; (3) the FX credits brought by the banking system; and (4) the net errors and omissions from the balance of payments statistics (mostly to account for the so-called 'unrecorded' transactions).

We can see that the gross inflows grew rapidly from $50 billion in 1991 to reach $165 billion in 1995. This difference is almost the size of the overall Turkish GNP! Clearly, the domestic financial system is under severe pressure from the international speculative centres and is no longer in a position to generate an independent monetary and foreign exchange policy. Furthermore, those centres constituted the major reason for the short-termism and volatility of the real business cycles, led to increased fragility of the financial and the external position of the domestic economy and resulted in worsening the distribution of income. We now study these issues in more detail.

Short-Term Capital Flows Restrict the Independence of the Central Bank

With the opening up of the domestic economy to speculative foreign transactions, the monetary authority is bound to a passive role. Two of the most important tools of the central bank, rates of interest and foreign exchange, fall under the exclusive directives of the external centres, and, consequently, the domestic economy is trapped in the vicious cycle of high real interest rates and an overvalued domestic currency. To accommodate this process, the central bank is pushed into a passive role of foreign reserve administration and is forced to hold significant foreign exchange. Indeed, one of the most direct consequences of the hot money inflows was the massive buildup of international reserves of the central bank. Figure 5.1 depicts this relation using monthly data. On the right-hand scale of Figure 5.1, we display the movements of hot money inflows; on the left-hand scale, we trace the monthly position of the international reserves of the central bank. With a proper adjustment of the vertical scale, one can easily observe the striking comovement of the two variables over time. Rather than financing productive investments in the real sector, short-term capital inflows lead to a rapid buildup of the reserves of the monetary authority. This presents a serious contrast to the orthodox expectations, prognosticating a complementarity between

financial liberalization and the expansion of investment funds in the domestic economy. In this setting, the only proper role that remains for the monetary authority becomes that of monetary sterilization, so that the surge in the M2Y value of money supply is checked by restricting the *domestic* component, with a consequent rise in the domestic interest rates, and a recommencement of the cycle.

Short-Term Capital Flows Disassociate the Financial and the Real Sectors and Create Bubbles in the Stock Exchange Market

Another direct consequence of the speculative hot money flows pertains to the links between the real and the financial spheres of the domestic economy. Speculative flows, given their sheer size and volatility, lead to artificial bubbles in the stock markets than have no real foundation and end up inflating the stock prices. In theory, stock prices have to depend on the productive performance of the corporations. In principle, a well-functioning stock market should help the economic development process through (a) the growth of savings, (b) the efficient allocation of investment resources and (c) better utilization of existing resources, through the pricing process (Singh, 1992). Nevertheless, with the inflows and outflows of speculative capital that are almost the size of the national product, all financial returns are inflated and an artificial burst on nominal values is created. Figure 5.2 portrays this process succinctly, where we plot the monthly *gross* speculative inflows on the left-hand scale and plot the Istanbul Stock Exchange Index (ISE, 1986=100) on the right-hand axis. The evolution of the bubble is clearly visible, starting from March 1993, where the ISE Index accelerates along with the intensification of hot money flows. Such bubble–burst–bubble performance of the stock market is clearly dissociated from the real production capacity of the economy. Rather than enhancing the aggregate credit volume, it reveals itself as the major cause of the economic crisis.

The analysis showing that short-term hot money flows have destabilizing consequences for the process of financial deepening can also be augmented by an analysis of the volume of securities market transactions (Table 5.5). In 1995 aggregate volume of trading in ISE market reached $52.3 billion of which $16.5 billion were government securities. Thus, with this volume, the stock market stood very shallow, given the magnitude of hot money flows. The secondary market transactions volume, on the other hand, can be observed to be have been more vivid, totalling $410 billion. Almost 98 per cent of such securities traded belonged to the public sector. Thus the episode of hot money inflows should be interpreted, in the

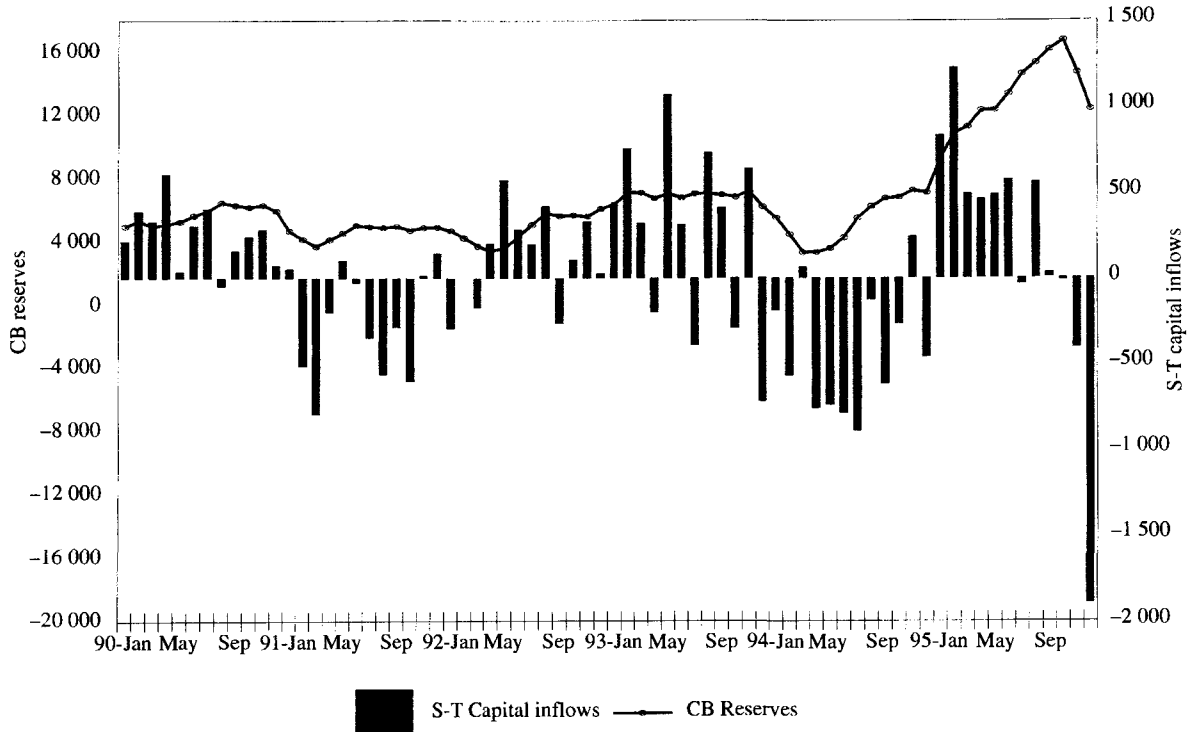

Figure 5.1 Turkey: short-term net capital inflows and central bank reserves (million US$)

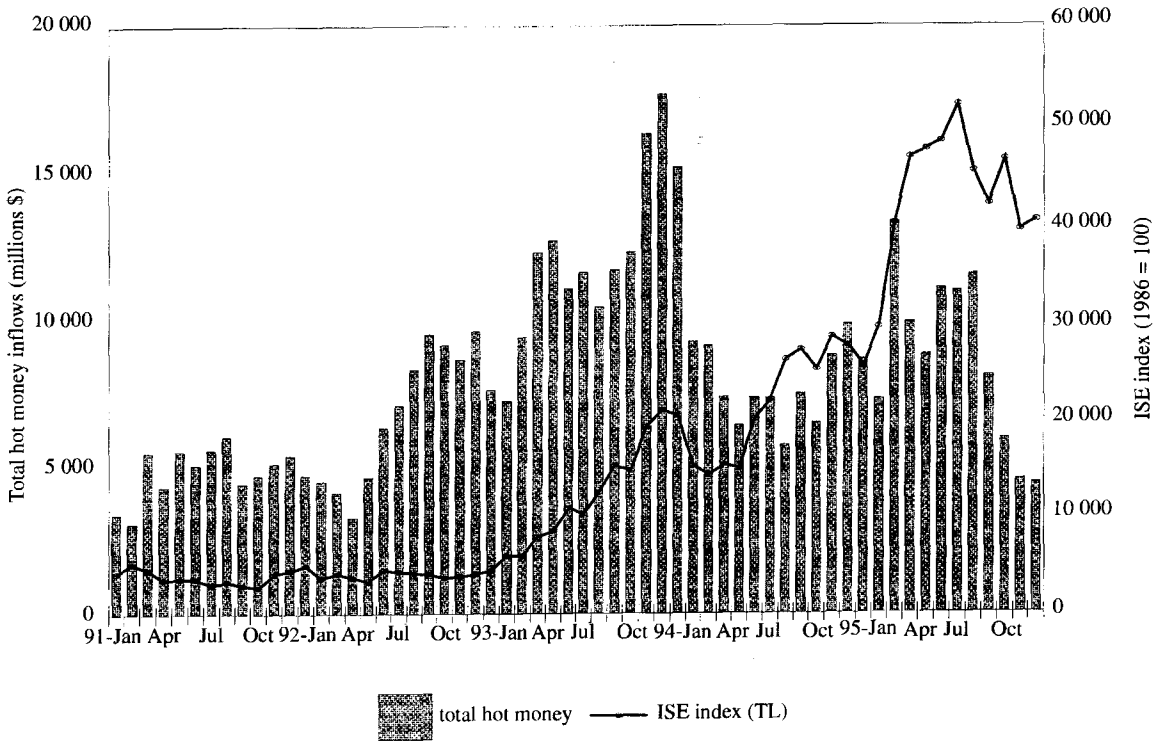

Figure 5.2 Turkey: speculative hot money inflows and ISE index

Turkish context, as the long arm of fiscal policy, overcoming the credit and monetary constraints of the monetary authority.

The availability of such funds enabled the fiscal authority to postpone any adjustment in its revenue-enhancing capabilities, such as the implementation of added taxes on capital earnings and the reduction of evasions on taxable corporate earnings. Yeldan (1995) discusses this stance in terms of a discretionary surplus redistribution strategy on the part of the state via its fiscal policy. Through the availability of short-term borrowable funds, the state has become a viable apparatus to generate an economic surplus for corporate incomes by way of a lax attitude towards tax evasion and the consequent deficits.

Acting in this way, the Treasury offered market yields on its instruments and thereby became the dominant agent in the financial economy. Table 5.6 contrasts returns on deposits and GDIs of different maturities. GDI yield returns are seen to be more favourable in most instances.

Short-Term Capital Flows Increase External Fragility and Lower Creditworthiness

Another consequence of hot money flows concerns the creditworthiness of the recipient country. Although the composition of external borrowing has

Table 5.5 Turkey: main indicators in securities markets (million US$)

		Istanbul Stock Exchange trading volume		*Secondary market transaction volume*		
	Number of firms	*Total*	*Government securities*	*Private*	*Public*	*Repo[a] rev-repo[b] trading volume*
1988	79	115		1 075	7 295	
1989	76	773		2 001	15 210	
1990	110	5 854		7 359	37 000	
1991	134	8 502	312	3 139	66 873	
1992	145	8 567	2 403	2 305	88 771	
1993	160	21 771	10 717	3 719	157 861	4 794
1994	176	23 202	8 828	4 941	180 587	23 704
1995	193	52 357	16 509	6 003	404 643	123 254

[a] Repurchase
[b] Reverse Repurchase

Sources: Capital Market Board, 1995; SPO, *Main Economic Indicators*, April 1996.

Table 5.6 Turkey: interest rates on deposits and government debt instruments

	Deposit interest rates				*Treasury bills*			*Government bonds*
	1 month	*3 months*	*6 months*	*12 months*	*3 months*	*6 months*	*9 months*	*1 year*
1991	58	69.6	64.8	72.7	68.4	66.8	68.9	68.8
1992	57.6	69.1	69.5	74.2	74.4	73.9	73.3	75.4
1993	52.9	64	69.1	74.7	69.8	73.3	80.1	86.3
1994	61.8	77.3	81.1	95.6	101.3	111.9	84.9	117.0
1995	83.7	83.9	84.4	92.3	68.4	102.1	83.2	99.8

Source: SPO, *Main Economic Indicators*, various issues.

changed dramatically relative to the debt crisis period, several creditworthiness indicators show that foreign investors have been continuously lowering Turkey's creditworthiness. This is associated with the unstable economic environment caused by continuous speculative capital flows.

Creditworthiness is associated mainly with balance of payments problems, the likelihood of devaluation, and overall economic and political stability. All of these indicators have been extremely volatile in the 1990s. Looking at total debt outstanding as a percentage of export earnings, it is clear that this indicator was extremely high for Turkey during 1988–95. Just to make a comparison, at the height of the debt crisis, in 1982, Mexico's ratio of debt outstanding to exports was around 236 per cent, while during the same period the same ratio for Turkey was around 200 per cent. In 1993, this ratio for Turkey was 431 per cent.

The volatility in the current account balance is another indicator of creditworthiness and fragility. Table 5.1 shows that the current account balance for 1993 was –$6433 million, for 1994 $2631 million, and for 1995 it stood at –$2339. Another interesting indicator is the ratio of short-term debt to total debt. In 1993, short-term debt was around 28 per cent of total debt. In the following year, it fell to 17 per cent and in 1995 it rose to 27 per cent in 1995. These fluctuations were exclusively the result of short-term capital flows that led to intensified financial instability in the domestic economy.

Short-Term Capital Flows Increase the Volatility of Business Cycles and Worsen the Income Distribution

With disassociation of the financial from the real economy, hot money inflows lead to more intensified fluctuations in real output in a shorter time span. The post-1993 experience is indicative of this observation. The fourth quarter of 1993 saw conditions in Turkey at their most fragile, with currency appreciation and the consequent current account reaching unprecedented levels. With the sudden drainage of short-term funds at the beginning of January 1994, the production capacity contracted. Industrial output fell continuously throughout that year. Together with this contraction, the post-1993 crisis management has given rise to significant shifts in the income distribution and intensified the ongoing transfers of economic surplus from wage-earners and industrial/real sectors towards the financial sectors. Real wages fell rapidly to 25 per cent in just two years. Likewise, dollar-denominated wage costs decreased and enabled export earnings to rise. In this manner, Turkey once again has switched its mode of surplus extraction from the domestic economy back to the exporting sectors.

5.5 CONCLUSIONS

The integration of the Turkish economy into the global financial system through financial liberalization and privatization has been a mixed blessing. Even though the main motive behind financial liberalization was to restore growth and maintain stability through increased efficiency and savings, it created financial instability. The inflows of short-term capital were not used to create new and productive investments, but instead simply created new dollar obligations for which there is no clear source of repayment. It has also intensified the already existing problems such as budget deficits, monetary instability and market distortions. In short, relying on short-term capital flows proved to be detrimental to the health of the economy.

The 1989–95 experience shows the serious problems confronting a developing economy that moves into full external and internal deregulation of its financial system under conditions of high inflation. The spectre of capital flight became the dominant motive in policy-making and created unsustainable commitment to high real interest rates and expectations of cheap foreign exchange. Meanwhile, links between the financial sector and the real sector have been severed. Instability in the rates of interest and foreign exchange created feedbacks that led the economy further into instability.

During the same period the fiscal position of the state deteriorated rapidly as factor revenues declined. Likewise, the capacity of the public sector to generate saving was eroded. The state has resorted to a massive operation of domestic debt financing by issuing new debt instruments. As a result, the stock of domestic debt has grown very rapidly. The interest payments on domestic debt also reached high levels during the same period and constituted an important mechanism of income transfer within the domestic economy.

The threat of currency substitution surfaces with the liberalization of the capital account, necessitating a higher rate of return on domestic assets as compared with foreign currency. As a result, the monetary authority has had to assume a passive role against excessively high real interest rates on domestic assets coupled with an overvalued currency.

The overall Turkish experience also showed the problems and limits of financial liberalization by relying on the exchange rate as a nominal anchor and riding on short-term capital inflows to finance deficits. Such a stabilization programme is often attractive for governments, because it avoids politically unpopular and painful measures. Its chances of success

are also high in the short run, because financial markets tend to be short-sighted. The issue is not whether capital flows are good or bad, but rather the challenge they pose to the state's ability to make sound and credible macro and micro policy that would ensure that such capital flows are directed toward the promotion of long-term growth, economic development and social equity.

Notes

1. To implement monetary policy, the central bank started to construct a programme and set monetary targets for the first time in 1986. The monetary programme continued to be implemented in 1987 and 1988, but the targets were exceeded by substantial margins. In 1990 a new programme was announced in which the targeted variable was the lira liabilities of the bank, also known as central bank money.
2. As is known, M1 and M2 measure supply of money in domestic assets, whereas M2Y includes foreign exchange deposits.
3. Zaim (1995) shows that there have been increases in both technical and allocative efficiency in the banking sector.
4. These instruments include corporate bonds, commercial paper, profit and loss sharing certificates and equity stock.
5. See Atiyas, and Ersel (1994).
6. Banks' obligations to hold government securities against high liquidity requirements created a large market for government securities. In addition, public securities offered very high yields, which made them highly attractive.
7. The financial crisis in 1982 gave an impetus to create the Capital Markets Board.
8. New institutions, such as real estate investment companies, rating agencies, clearing and depository institutions, mortgage backed securities centre, were being regulated. Short sale, margin trading and repo became available by securities intermediaries.
9. This was the first attempt to define the contractual rights in the securities markets. Obligations were defined in the Commercial Code for corporate shares and bonds only. However, obligations in terms of disclosure requirements were first entered into the legislation during the reform process (Sak, 1995.)
10. Merit regulation leads the regulatory authority to specify interest rates at the end. However, after the financial crisis in 1982 there was serious concern about investor protection. The absence of rating agencies, independent auditing institutions, accounting standards and so on were considered imperative in accepting a system of merit regulation. In 1992 the Capital Markets Law was amended and disclosure regulation defined.
11. The capital market, however, has been dominated by public sector securities, because the financing of the deficits has been done largely by auctioning treasury bills and government bonds.

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