Financial reforms, stabilization and development in 21st-century Turkey

Haluk Haksal

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Chapter 1

Introduction-hypotheses and research questions

“Ta Panta Rhei”: No man ever steps in the same river twice, for it’s not the same river and he’s not the same man.
Heraklitus of Ephesus (544 B.C. - 483 B.C.)

Introduction

Turkey is a developing country that in the 1930s chose state control in the hope to realize strong economic growth. While state-led economic development model initially allowed a positive trend, it did not work in the long-term. However, dismantling state presence in the economy during the 1980s even worsened the situation, leading to serious financial crashes in the following years. Then, Turkey moved to reforming financial markets and it seems that something changed by the mid-2000s putting an end to persistent economic instability though there are still serious concerns regarding economic development by the eve of 2020s.

This book tells this exciting story!

1.1. Background to the research

I have chosen this topic in order to shed light on the dynamics behind the transition process from a state-led to a market-based economy, inspired to a considerable extent by the objective of gaining full membership of the European Union (EU). The integration process has involved unprecedented challenges as well as providing important economic and political insights. My objective is to focus in particular on the degree of Turkey’s convergence to EU regulatory standards and to examine the impact of financial reforms from 1980 to 2010 on stability and development in Turkey.
This topic interests me because it offers an excellent opportunity to investigate several key factors behind a sound development policy. The book not only explores the complex relationship between economic instability and structural reforms in an emerging economy, but it also investigates why the international development policies proposed to developing countries have not always been successful.

1.2. Research problem - hypotheses - research questions

The role that governments play in devising economic reforms is the first factor, which needs to be examined. Turkey has traditionally pursued an inward-looking strategy through planned development programs where the state held a dominant position through public ownership. At the same time, its major goal has been to place itself within the Western world, which has always been identified with a functioning market economy\(^1\). For many years the pursuit of these inconsistent objectives was resolved in favor of State planning. However, aiming for full membership of the EU necessarily implied shifting the balance in favor of markets. Nowhere was this radical change more dramatic than in financial markets. How can a developing country with a state regulated and underdeveloped financial sector adopt a financial regulatory system designed for a highly sophisticated free-market financial system? What problems are likely to be encountered? This context leads me to investigate how culturally appropriate a de-politicized financial framework is for Turkey and how the deregulation of financial markets needs to be managed in an emerging market economy like Turkey’s.

Having identified the research problem, I can now formulate my principal research questions and hypotheses:

- Do deregulation of financial markets and elimination of exchange controls on capital movements create conditions for stable growth?

\(^1\) Throughout the book we identify the term “functioning” market economy as defined by the Copenhagen criteria introduced in section 1.6 below “The EU Requirements - Copenhagen Criteria”.
- What is the role of institutions, culture, and tradition? What is the appropriate regulatory framework for an emerging market economy like Turkey?

Finally, subsidiary questions, which rose during my investigations included:

- What is the role of monetary stability and the attitude of the central bank? How do central bank policies affect the vulnerability of an economy? Is its independence important?

- Was the “institutional migration” successful? If not, why was it not? Is it possible that “import” of Western pro-market formal institutions, i.e., an independent central bank or free financial markets, was not compatible with Turkish traditions and caused chaos rather than successful transition? Or perhaps it did go rather well?

To conclude, the Republic of Turkey has a long history of importing Western institutions since its foundation in 1923 by Kemal Ataturk. When import substitution industrialization (ISI) policy and State Owned Enterprises (SOEs) were the Western recommendation for economic development that is what Turkey did. When it was the period of the “Washington Consensus”, Turkey followed. When it was the EU guidelines, again Turkey considered them as a blueprint. Finally, what has Turkey obtained from all these policy imports? After several decades of unstable macroeconomic conditions and problems, Turkey in the early 2010s was, under certain aspects, one of the most successful emerging economies in the world. It even out-performed many advanced EU economies in its public debt/GDP ratio in the second half of the 2000s. This perspective leads me to explain in the next section the context of the study.

1.3. Context of the study

Towards the end of the 1970s, several countries began a radical change in how to run their economies. In China, Deng Xiao Ping began turning China away from central planning towards decentralized markets. In the U.K., Margaret Thatcher began doing the same, while Ronald Reagan and Mikhail Gorbachev followed shortly after. The winds of change had begun to blow. Turkey, along with many other countries in Latin America and South East Asia, was also caught up in this movement. Unlike other developing economies, however,

2 See Annex 1 for a chronological overview
Turkey had the added incentive that its aim was to join the EU (at that time). Not only were ideas changing, the incentive to apply them was pressing. This is a story of new ideas in economic development migrating around the world, applied with greater or lesser success depending on the country. It is a story of crises and the lessons to be learned from them. It is a story of how institutions developed in one part of the world become adopted and adapted in other parts of the world, each time with tensions, difficulties, crises. It is an on-going story of global intercultural institutional migration, of gradually sorting out best practices, adopting norms and standards, not in a forced top-down manner, but in a gradual, decentralized process of trial and error. This book tells the story and analyses the role that Turkey has played in this process from 1980 onwards (with some flashbacks to earlier times when appropriate) with special reference to the deregulation of its financial markets. One reason for concentrating on this area is because, in country after country, the transition process from state-planning to a market-based economy resulted in dramatic financial crises. Can we learn from these crises? Can the integration of an emerging economy into the global market become smoother? And in Turkey’s case, what role did the EU play?

I shall give particular consideration to two essential anchors which have served as benchmarks in the adaptation of Turkey’s financial market regulations to international standards: The “Washington Consensus” principles, an international development policy based on agreement among, principally, the IMF and the World Bank\(^3\) and the “Acquis Communautaire”, the legal and institutional framework by which the EU defines its requirements\(^4\). Turkey’s structural changes in its financial markets were launched in 1980 in line with the “Washington Consensus” principles, at a time when deregulation of financial markets was broadly associated with economic growth.

This process coincided with Turkey’s political will to advance the European Community integration program by introducing structural reforms. Turkey applied for a full membership in 1987 and the deregulation process reached its pinnacle two years later, in 1989, with the full liberalization of the capital account. However, shortcomings emerged due to the lack of an adequate institutional framework culminating in a financial crisis in 1994, a severe shock to the economy. Adoption of the Customs Union with the EU in the aftermath

\(^3\) A detailed examination of the “Washington Consensus” principles is provided in Section 2.1

\(^4\) Commission of the European Communities (2001), p. 46
of the 1994 crisis was not only one of the objectives envisioned by the 1963 Association Agreement but also represented a further step towards integration with the EU. The Luxembourg European Council meeting in December 1997 proposed a strategy to promote Turkey’s accession and identified adoption of the “Acquis Communautaire” as a key element for convergence. The European Commission adopted a communication in March 1998 on a “European Strategy” for Turkey, incorporating the initial operational proposals of the Luxembourg strategy. In December 1999, the Helsinki European Council granted Turkey the status of candidate country. Despite this promising progress, the economy experienced the most severe financial crisis of its history a little over a year later in February 2001. Nonetheless, accession negotiations started in October 2005.

The impression given by this sequence of events is that of a country with a great political will to adopt huge economic reforms at break-neck speed, somehow even using the inevitable accompanying crises to continue forcing the economy to bend to the political will of the nation.

1.4. Justification of research and Methodology

My study explores the case of a country in a unique position with several contradictory features. Turkey, a candidate country to the EU, is at the same time an emerging economy. Traditional state-led development plans were in conflict with the functioning market economy philosophy of the EU. Moreover, while several reforms undertaken during the 1920s and 1930s showed that Turkey aimed to become part of the secular Western world, it also presents an Oriental and Mediterranean style as a historical heritage. In fact, the Turkish Republic founded in 1923 as a national secular state is composed of many religious and ethnic groups, the Muslim-Turkish group representing a clear majority (more than 90 percent). These cultural and historical differences make the whole process more complex.

These contradictory features have created particular challenges for policy makers both in the EU and Turkey. Given that influential political figures in

5 Customs Union entered into force in January 1996.

6 Commission of the European Communities (1999), p. 30
positions of power, risk being removed in a competitive environment, the process of adopting modern rules and regulations also represents a major political challenge. Financial market regulatory reforms are no different and can, therefore, be considered as a Litmus test for the application of the rest of the “Acquis Communautaire”.

Most of the research on transition economies have a tendency to associate increased growth and prosperity with price stability. However, there is little research on how the unstable, volatile and inflationary environment can also result in rapid growth. Perhaps the occasional crisis is the price to be paid for unusually rapid growth? Does it matter the way growth is financed? I examine the Turkish case in order to find the causes and learn the lessons, which can become useful guidelines for other developing countries opening their economy to global markets.

A further justification for this study is its relatively uncommon qualitative methodology and emphasis on institutions in a field more accustomed to quantitative research. The book topic allows me to explore what a quantitative analysis cannot explain. I investigate, for instance, the following question: Why did some emerging economies, including Turkey that introduced stabilization programs successfully, achieve high GDP and low CPI levels but have nonetheless been unable to avoid financial crises? In this context, a quantitative methodology working on time series of GDP or CPI data does not suggest an answer. Moreover, I observe the particular context in a specific country, which allows me to explore the impact of diverging cultural, traditional and historical factors and introduce them into the analysis. Therefore, to test out the initial hypotheses I use a qualitative methodology. I show that a weak institutional and regulatory framework was a major reason behind unstable conditions and crises. Thus, my approach is based on the analysis of relations and not on analysis of correlations as in a quantitative methodology.

I used official statistical data and documents from both Turkish government authorities and the EU, International Financial Statistics from the IMF, Datastream and Reuters’ data from Universities of Geneva and Lausanne. The methods I used are observations and interviews held with experts in different areas including personal interviews and telephone and e-mail contact. These constituted the most appropriate methods for my research topic.

My findings demonstrate the impact of specific changes in the institutional and regulatory framework on the macro-financial risk profile of Turkey. This provides insight into why some measure of economic success was finally achieved. To prove my results, I use a variety of data. For instance, I make a comparison between macro data and assignments from a major credit ratings agency (Fitch Ratings). Then, I compare these results with Credit Default Swap
(CDS) spreads. Finally, I confirm my findings with Foreign Direct Investment (FDI) flows, which are also an independent measure of how external observers view the Turkish experiment. All these data on Turkey are compared with data from a sample of EU economies, which gives me the possibility to place Turkey in a comparative perspective.

Consequently, I enumerate the contributions of my study to the ongoing debate as follows: First, it approaches the development problem from the angle of the institutional and regulatory framework, thereby exploring factors that would be lost in a quantitative approach. Secondly, it identifies reasons for the chronic instability of the Turkish economy as well as factors behind some undeniable economic successes. Nevertheless, while an increased GDP and reduced CPI levels are important, my analysis shows that this needs to be achieved together with reforms introducing an adequate de-politicized regulatory framework. In the absence of the latter, the likelihood of a crisis will be higher, which in turn would cause a high level of inflation and low or negative growth, together with a severe shock that will hit the economy. Thus, the study illustrates basic elements behind a stable, and not volatile, growth. Finally, a book-length study examining the reforms Turkey undertook in the financial area in this period does not exist, which enhances its originality and contributes to the literature.

To note that the concept of economic development is different than economic growth though these have been used interchangeably in literature. Growth refers to the market value of final goods and services produced in an economy in a year, typically measured by gross domestic product (GDP). An increase in per-capita GDP is a characteristic of economic growth. Nevertheless, it does not necessarily lead to an improvement in living standards of people if growth is not evenly distributed. Development is a broader concept than growth as it consists of the removal of different types of obstacles that leave people with fewer opportunities of exercising their preferences and it thus aims to enable individuals to make effective choices by increasing their capabilities. While growth may be seen as a necessary condition for development, high GDP growth does not necessarily contribute to development. Poor countries are also less developed but for instance, some of the oil-rich countries with high per capita GDP present difficulties in different areas of development. In case the growth is low or unstable, governments will be obliged to cut public expenditures including education, healthcare, and

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social welfare. Thus, economic growth must occur first and only then policy
makers can direct these resources to promote development⁹.

There is no a universal framework to measure the degree of development, as
different individuals in different socioeconomic contexts may have different
development priorities. Therefore, a variety of variables and indexes are used as
a proxy for measuring development, i.e., a measure of health (life expectancy,
infant mortality, immunization rates), education (youth or adult literacy rate,
enrollment rates, average years of education) or other economic conditions
(unemployment rate, inequality of income distribution, child labor, poverty
rate, women’s literacy and employment rates etc.).

This study is on the impact of EU-inspired financial market regulations on
stabilization in Turkey and on emerging problems. In addition, I will also
question in chapter 5 whether stable circumstances achieved thanks to the
adoption of these international development policies contributed to
development. I will have a look at one of the economic conditions above, the
unemployment rate, to have an idea about the size of this social phenomenon
over time. I will then suggest in Chapter 6 for further research the use of other
development proxies from inequality of income distribution and women’s
literacy and employment rates to life expectancy and infant mortality and
others, to examine the degree of development in Turkey.

Finally, the book also shows that while “institutional migration” is common
and emerging markets around the world frequently adopt institutional features
from elsewhere, local differences and inconsistent policies can often lead to
unexpected results.

### 1.5. Outline of the book

Throughout this study, the European Commission’s regular reports, the
European Council’s decisions and the Treaty on the Functioning of the
European Union (TFEU) have been the main source of “EU requirements”,
while Annex 1 provides information also regarding the different stages of
relations between Turkey and the “Community”. The book is composed of six
chapters:

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Chapter 1 is the introduction, which lays the foundations for the book. Chapter 2 examines the Washington Consensus principles-led deregulation process in Turkey. Section 2.1 describes the “Washington Consensus” principles, which were closely followed during the deregulation process in several emerging economies, including Turkey. I examine the case of Thailand as a proxy and observe that the absence of an adequate institutional and regulatory framework was one of the root causes of the 1997 East Asian currency crisis, which resulted from an unsustainable asset bubble. Section 2.2 focuses on the deregulation process of Turkish financial markets and analyzes problems arising from the adaptation of the “Washington Consensus” principles and of the EU “acquis” into national legislation. It questions factors behind financial instability and investigates the role of the State through a survey of previous studies in literature. Section 2.2.1 covers the period from 1980 to 1988, during which policy makers introduced the “Washington Consensus” principles, and examines the Turkish Central Bank’s monetary policy through an analysis of its balance sheet.

Chapter 3 examines the impact of international development policies on the Turkish economy with an emphasis on the dynamics behind the problems that can potentially arise with their implementation. In section 3.1, I overview business cycle theory and introduce the Mundell-Fleming framework. While the former emphasizes the role of interest rates and provides insight on the dynamics of boom-bust cycles in the first half of the 20th century, the latter makes evident the impact of the exchange rate regime chosen on the effectiveness of central bank policies. In section 3.2, I examine “currency crisis models”. While “first generation models” are an extension of the Mundell-Fleming model, I use the latter to explain the 1994 financial crisis, whereas I use the “second generation models” and the “third generation models” to explain the 2001 Turkish currency crisis. Thus, sections 3.1 and 3.2 provide us with a theoretical perspective on problems that can arise in emerging markets integrating into global markets. In section 3.2.3.1, I explain the main features of hedge funds which can, in certain circumstances, lead to destabilizing short-term portfolio investment in emerging economies. Section 3.3 examines how the Turkish financial markets collapsed in 1994 and 2001. Section 3.3.1 covers the period from 1989 to the 1994 financial crisis and considers problems that appeared in adopting international standards. Section 3.3.2 analyzes the period from 1995 to 2002. It discusses the implications of realizing the Customs Union with the EU, a milestone in the process for full membership. Then, an analysis of the banking sector’s fragile structure in the same section leads to a detailed analysis of dynamics behind the 2001 currency crisis.

Chapter 4 examines institutional transformation from 1999 to 2002. Section 4.1 focuses on adoption of the EU-inspired regulations in reforming the Turkish
Central Bank and the creation of independent supervisory institutions. Section 4.1.1 starts with a review of EU requirements on monetary policy. Then, section 4.1.2 introduces a theoretical discussion aiming to define central bank independence. Section 4.1.3 examines how the Turkish Central Bank gained its independence and section 4.1.4 focuses on the creation of independent regulatory agencies. Section 4.2 examines political efforts to adopt the EU-inspired standards on privatizations, FDI and property rights over time. Sections 4.2.1 and 4.2.2 present improvements in the privatization process and FDI flows as evidence of the effect of adoption of EU-inspired institutional and regulatory changes. In addition, these sections aim to demonstrate the impact of improved institutional climate on country risk perceptions. Section 4.2.3 overviews the property rights situation in Turkey.

Chapter 5 examines the impact of EU-inspired regulatory reforms on Turkey’s macro-financial risk profile. It uses market-based metrics to measure the degree of success of these reforms. Sections 5.1 and 5.2 examine two major market indicators of risk exposure, namely credit ratings assignments and CDS spreads. Thus, this section not only shows the improvements in Turkey’s macro-financial risk profile after the completion of reforms but also compares Turkey with a sample of EU countries in terms of risk and expected return. Section 5.3 addresses certain outcomes that diverged from expectations in adopting the EU standards.

Finally, Chapter 6 draws our findings together, discusses the impact of adopting international standards, through a process of trial and error, on overall growth and unemployment in Turkey.

1.6. Scope of the book

While the book outline above highlights major topics covered in this study, I would like to make evident its scope as its basic structure includes also non-economic, i.e., political aspects, due to its interdisciplinary nature. This study aims to investigate the impact of financial market regulatory reforms introduced in Turkey during the 2000s, which boils down to the question of regulatory and institutional quality.

The state shapes the economic life of a country in a variety of ways\textsuperscript{10} and its performance interacts with the quality of institutions. Nevertheless, it is

\textsuperscript{10} La Porta, R. et al. (1998), p. 6
difficult to define the concept of regulatory quality as it will depend on preferences of different agents. While international institutions like the World Bank and OECD would associate the purpose of “good” regulation with the achievement of sustainable economic growth, poverty reduction, and better governance, a politician in the office can associate it with regulations that would increase, among others, his popularity\(^\text{11}\). On the other hand, a social scientist would define institutional quality according to how economic and socio-political considerations are balanced within his preference function\(^\text{12}\).

**Empirical overview to institutional quality**

Most empirical measures of institutional quality identify it with non-interventionist economic policies, protection of property rights, the rule of law, bureaucratic “red tapes”, the quality of the judiciary and the level of corruption\(^\text{13}\). Different authors use different proxies leading them to a variety of results. La Porta et al. (1998) measured institutional quality using proxies for interventionism, quality of bureaucracy, government size and political freedom. Ades and di Tella (1999) and Treisman (1998) focused on rent-seeking opportunities and corruption in the absence of competition. Bliss and Di Tella (1997) investigated whether competition reduces the level of corruption. Treisman (1998) also investigated causes of corruption discussing a variety of potential factors ranging from cultural and institutional traditions to historical legacy\(^\text{14}\). Rajan and Zingales (2000) focused on historical case studies and argued that competition reduces rents and consequently improves the quality of institutions. Cadot (1987) built a model of corruption in the context of game theory and investigated incentive structure behind bureaucratic procedures. Straub (2000) argued that the extent of corruption was a function of the size of SOEs, the degree of protectionism, the level of price controls and the number of regulations, among others. Islam and Montenegro (2002) found that trade openness is positively associated with institutional quality in addition to freedom of the press and checks and balances in the political system. They explained that more open economies tended to have “better institutions”\(^\text{15}\) because in a more competitive context, economic agents with poor institutions

\(^{11}\) World Bank (2010), p. 3  
\(^{12}\) Ibid  
\(^{14}\) Treisman (1998), p. 46  
\(^{15}\) Islam and Montenegro (2002), p. 3
would have incentives to change them for better ones. Moreover, rent-seeking and corruption would become harder when there is competition among agents. Finally, agents in open economies learn from practices in other economies leading to an improvement in institutional quality, for example, domestic and foreign businesses can lobby for better regulation in the banking sector. All these factors can contribute to a rapid evolution of institutional quality in open economies\textsuperscript{16}.

To note that measuring regulatory quality is not an easy task as it will depend on proxies selected. Let us overview the approach of an international institution in measuring regulatory quality.

**The OECD approach in measuring regulatory quality**

The OECD has developed indicators, through a series of surveys, to analyze the regulatory practices of OECD countries over time. These range from regulations promoting transparency and stimulating competition to those eliminating unnecessary regulatory barriers to trade and investment\textsuperscript{17}. These proxies for “good” regulations aim to measure whether the countries’ regulatory systems meet the quality standards that reflect the best practices. By the year 2005, 26 of the 30 OECD countries promoted regulatory reforms and 21 of them had introduced policies expressing explicit principles of “good” regulation\textsuperscript{18}. The successful design and implementation of a new regulatory framework depend also on the adequate set of institutions to introduce and maintain regulatory quality. Independent regulatory agencies are an example of specific institutions serving this purpose\textsuperscript{19}. On the other hand, quality assurance over time requires the use of a variety of tools ranging from consultation with businesses and the public to regulatory impact analysis\textsuperscript{20}, the latter aiming to identify and monitor whether the expected results of regulatory proposals are achieved. The most important contribution of the OECD regulatory impact analysis is not the precision of calculations but understanding the real-world impact of new regulations, i.e., whether regulations achieve the policy objectives at the lowest

\textsuperscript{16} Islam and Montenegro (2002), p. 4

\textsuperscript{17} For a detailed expositions of OECD Indicators of Regulatory Management Systems by the year 2005, see OECD (2008a), p. 2

\textsuperscript{18} OECD (2008a), p. 3

\textsuperscript{19} OECD (2008a), p. 3

\textsuperscript{20} Ibid., p. 4
total cost\textsuperscript{21}. By 2005, all OECD member countries had carried out some form of regulatory impact analysis, aiming to select “good” regulations in their specific contexts\textsuperscript{22}.

To note that, while the importance of institutions is widely accepted, there is no theoretical framework to identify which institutions, in what combinations are the most important ones for economic development\textsuperscript{23}. Major reasons behind this are, in addition to measurement difficulties, the historical, cultural and social divergences among countries.

Historical and cultural divergences in the Turkish context

Considering country-specific conditions, the historical background I introduce in chapters 2, 3 and 4 provides a larger perspective on what the Turkish Republic inherited from the Ottoman Empire and the development approach since its foundation in 1923. The Ottoman sultans had absolute power through near complete control over the military and the bureaucracy\textsuperscript{24}. While the Empire had traditionally maintained lands under state ownership and had intervened in economic management when necessary, the Republic of Turkey promoted and respected private property rights\textsuperscript{25}. However, state intervention in economy occurred in a variety of forms and lasted until the adoption of the Washington Consensus principles in 1980. This began the initial phase of non-interventionist economic policies and made evident the need for unfamiliar market compatible institutions. This book aims to show that while the Washington Consensus prescriptions were necessary, they were, at the same time, not sufficient as Turkey needed an “adequate” institutional and regulatory framework, especially in its financial markets. To explain what I mean by the term “adequate” in the Turkish context let us first introduce the EU membership requirements\textsuperscript{26}.

\textsuperscript{21} OECD (2008b), pp. 3, 4
\textsuperscript{22} OECD (2008a), p. 6
\textsuperscript{23} Payne, M. and Losada, C. (1999), p. 4
\textsuperscript{24} La Porta, R. et al. (1998), p. 11
\textsuperscript{25} Section 4.2.3.1
\textsuperscript{26} I use the terms « adequate » and « appropriate » interchangeably throughout the book.
The EU requirements - Copenhagen Criteria

The European Council identified in 1993 the economic and political requirements (Copenhagen criteria) that the candidate countries need to fulfill for full membership. These are:

1. the political criteria: stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;

2. the economic criteria: the existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union;

3. the institutional criteria: the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union. It includes the whole range of policies and measures that constitute the Acquis Communautaire that candidate countries must adopt, implement and enforce. This requires the administrative capacity to transpose European Community legislation into national law, to implement it and to effectively enforce it through appropriate administrative and judicial structures.

Regarding the economic criteria, the European Commission defined a series of sub-criteria:

1. Being a **functioning market** economy requires:
   - the existence of a broad consensus about essentials of economic policy;
   - macroeconomic stability (including price stability, sustainable public finances, and external accounts);
   - a free interplay of market forces (including liberalized process and trade);
   - free market entry and exit (including issues of establishment/bankruptcies of firms);
   - an adequate legal system (including a system of property rights, enforceability of laws/contracts) and a sufficiently developed financial sector.

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27 European Commission, official website
2. Being **competitive** in the EU requires:

- the existence of a functioning market economy;
- sufficient human and physical capital (including education, research, and infrastructure);
- adequate sectoral and enterprise structures (including issues of enterprise restructuring, sectoral shift, role of small and medium-sized enterprises);
- limited state influence on competitiveness (including issues of trade policy, competition policy, state aids, support for small and medium-sized enterprises);
- sufficient trade and investment integration with the EU.

In addition, it argued that:

“The progress of candidate countries in meeting economic accession criteria is assessed annually by the Commission in its progress reports on each candidate country.”

I examine in particular the first two conditions of the Copenhagen criteria, for a functioning market economy, namely:

- the existence of a broad consensus about essentials of economic policy;
- and macroeconomic stability (including price stability, sustainable public finances, and external accounts).

This is the reason why this study mainly examined the way the EU requirements on central banking were adapted to Turkey. I also focus on other Copenhagen economic criteria when these had a complementary function in telling the story, i.e., meeting the EU requirements in areas ranging from competition and state aids to industrial and intellectual property rights, and property rights themselves.

In the light of the literature on institutions, the approach of the OECD on measuring regulatory quality and the Copenhagen criteria introduced above, I can now make clear what I mean by an “adequate” institutional and regulatory framework in Turkish financial markets.

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28 European Commission, official website
What do I mean by an “adequate” institutional and regulatory framework in my study?

I start with the Copenhagen criteria for a functioning market economy. Turkish economic policies were traditionally politically managed until 1980, while it experienced macroeconomic instability from the early 1970s to 2000s. The definition of “functioning” market economy in Copenhagen criteria above leads me to state that Turkey lacked a crucially important institution for macroeconomic stabilization that is an independent lender of last resort: the Central Bank. Its independence is essential to combat crony capitalism and the constant politicization of economic affairs, without which it cannot achieve a stable macroeconomic monetary environment. These ends must correspond to a broad consensus about essentials of economic policy. This is the reason why the study focused on the Turkish Central Bank. In addition, the creation of an independent regulatory agency in the banking sector fulfilled another basic need in the Turkish economy, namely to de-politicize the interaction between the central bank and the banking sector. This was crucially important for stability in financial markets leading to a functioning market economy. Moreover, the other Copenhagen criteria allowed me to investigate the dynamics of the Turkish economy over several decades and to shed light on its historical and cultural features. Although these are not directly related to the Turkish financial markets, it is important to have a broad view of historical and cultural heritage in addition to political trends in order to increase our understanding of specific conditions and features of the Turkish economy. Thus:

- I examine the way “free interplay of market forces and free market entry and exit” were introduced in Turkey by investigating aspects ranging from the Customs Union with the EU to the FDI policy, privatizations and state aids, all requiring regulatory reforms;

- I discuss the evolution of the “legal system of property rights” over decades to investigate which reforms Turkey envisaged to introduce, in an attempt to get closer to EU standards;

- I emphasize the importance of the creation of an independent regulatory agency aiming to assure competition in Turkish markets: The Turkish Competition Agency.

To note that both the Washington Consensus principles and the Copenhagen criteria broadly promote private initiative. Nevertheless, while the Washington Consensus served only to dismantle state presence in the economy, the EU requirements contributed to macroeconomic and financial
stability through the creation of an “adequate” institutional and regulatory framework. Thus, I identify the term “adequate” in the Turkish context with institutions that allow both a functioning market economy and the appearance of competitive forces in markets. More specifically, the creation of an independent supervisory institution on competition in 1997, another in the banking sector in 2000 and introducing regulatory reforms in 2001 allowing the Central Bank to become an independent institution, correspond to an “adequate” institutional and regulatory framework in the context of this study. One of the proxies allowing me to measure whether Turkey adopted an “adequate” institutional and regulatory framework in the banking sector is the following: It gained, by the mid-2000s, its intermediation function between the financial sector and the real economy, as during previous decades, banks used to make profit mainly through speculative operations, i.e., the interest rate carry trades (see Chapter 3).

On the other hand, the book attempts also to make evident the problems related to the adoption of the inflation targeting framework. It allows me to question whether this policy could be the “adequate” one also in promoting development in Turkey over time, as high and persistent unemployment rates during the 2010s have signaled the need for policies capable also for the creation of employment. To note that Turkey adopted the inflation-targeting monetary policy and the central bank independence as the global best practice in April 2001 and the CBRT’s mandate is defined as follows: “The primary objective of the Bank is to achieve and maintain price stability.”

Throughout the book, the reader will question and make his own opinion whether the CBRT should have a unique mandate as defined above or broader mandates, including the development-oriented ones. We will observe that the inflation-targeting monetary policy has allowed a relative price stability in the general price level in the Turkish case, without nevertheless having a significant impact on the real aspects of the economy.
1.7. Definition: an additional 11\textsuperscript{th} principle to the “Washington Consensus”

During my examination of financial market regulatory framework changes, I present the two major anchors that Turkey followed in opening its economy to global markets: The “Washington Consensus” principles and the EU “Acquis Communautaire”. During the 1980s, Turkey implemented all “Washington Consensus” prescriptions except the last one, on the protection of property rights. A politicized state based economic management, together with a weak regulatory framework, impeded the achievement of the two major goals of financial market reform: The creation of competitive forces and the attainment of a functioning market economy. In chapters 2 and 3, I show that during the two decades of deregulation of financial markets from the early 1980s to the early 2000s, Turkey suffered from highly unstable macroeconomic circumstances. I identify the reason behind instability as being the absence of a de-politicized institutional framework. Thus, I propose an additional 11\textsuperscript{th} principle to the “Washington Consensus” which I define as follows:

“A de-politicized institutional and regulatory framework through which the state presence assures the respect of the rule of law and protects property rights. In this framework, while the presence of state is essential, it is needed to be present through supervisory regulatory agencies far from political influence, assuring formation of competitive forces in markets aiming thus to promote and reinforce private sector-led development.”

We will observe in Chapter 5 the impact of our 11\textsuperscript{th} element of “Washington Consensus” on the Turkish economy.
1.8. Delimitations of scope and assumptions

I identified my research problem as how culturally appropriate a de-politicized institutional framework for re-conceptualizing economic management in Turkey might be. Thus, my book is a case study on a specific country adopting a Western-style pro-market regulatory framework. I investigate whether this “institutional migration”, in terms of Douglass North, has been successful. Douglass North emphasized the role of informal constraints such as culture, habits, and codes of conduct specific to single cases which cannot be changed by the will of governments. While “import” of Western pro-market formal institutions (like an independent central bank or free financial markets) may be possible, I investigate whether these formal rules are compatible with Turkish “informal constraints”. While I will explore these issues further throughout the book, I cannot state that another emerging market economy adopting pro-Western market rules will face the same degree of difficulty as Turkey. For instance, I will demonstrate that in Turkey historically, public ownership created inefficiencies and persistent fiscal deficits, while the Central Bank functioned as a state agency to meet government deficits by creating high-powered money. Attempts to make the Central Bank independent provided incentives to the banking sector to purchase government securities. While I will examine these aspects in detail during the book, here I want to emphasize that these problems reflect specific circumstances related to the Turkish case. In Turkey, de-politicized regulatory reforms were introduced two decades after the initiation of the deregulation process. Would such a delay also be the case in other emerging economies? Differences between countries will depend in part on government relations with interest groups whose power will fluctuate according to changes in the fortunes of political parties. In the 1990s, Turkey experienced political scandals related to bank defaults and organized crime. Would this be the case in another country and cause a delay in achievement of reforms?

Therefore, while I will draw conclusions based on the importance of the institutional and regulatory framework as part of a sound development policy, I will assume that country-specific conditions will still, to a certain extent, influence the outcome.

EU “requirement” versus EU “inspired” rules

I associate the term EU “requirements” with the EU Commission’s Progress Reports on Turkey and the “Acquis Communautaire”, which involve an obligation for a candidate country. Nevertheless, this study focuses on the way the EU requirements are adapted to the Turkish environment, which can potentially give an outcome diverging from the expected one. The following example aims to make clear this aspect: State aids have always been an important obstacle in achieving a functioning market economy in Turkey. An independent regulatory agency on state aid is an EU requirement, as frequently emphasized in the EU Commission’s Progress Reports on Turkey during the 2000s. To note that the Turkish government finally created the State Aids Supervisory and Regulatory Agency in 2010\(^30\). Nevertheless, it was established under the auspices of a ministerial department, far from the spirit of the EU requirements on this subject. Therefore, in the context of this study I call an “EU-inspired” institution or rule, the adapted version of the original EU “requirements” to local conditions. This implies that the adapted version in Turkey can potentially either correspond to EU “requirements” or diverge from the latter to different degrees. To test this divergence can be subject to further research in the years ahead.

1.9. Conclusion

This chapter laid the foundations for the book. It introduced the research problem, research questions and hypotheses. It went on to explain the purpose, justify the research, describe the methodology and emphasize its contributions to the field. It then outlined the study, explained the scope and gave the limitations. On these foundations, I initiate the book with the “Washington Consensus” principles in Chapter 2.

\(^{30}\) Section 4.1.4, discussion points 2 and 3
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