Chapter 16
Economic Development and Its Impact on Turkish Banking Sector

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ABSTRACT
This chapter aims to understand the impact of major macroeconomic and regulatory changes on the Turkish banking sector. The authors specifically focus on the financial liberalization program of 1980s, inherent banking problems of 1990s, the 1994 currency crisis, the IMF stabilization program, the 2000-2001 financial crises, and the banking sector restructuring program of May 2001.

INTRODUCTION
Turkish economy has experienced substantial changes in the last three decades, starting with the implementation of liberalization policies on January 24th, 1980. Although positive measures were taken in the first years of the liberalization program, after 1987 the distortions in the Turkish economy started to emerge. Public sector borrowing requirements started to increase and budget deficit was financed by using either the Central Bank resources or domestic borrowing. The main role of banks was funding the state through government debt instruments. Large current account deficit and fiscal deficit, foreign capital-dependent growth and a lax banking regulatory regime resulted in the currency crisis of 1994. As a result of this crisis, inflation reached 125.5% on average, the Turkish lira (TL) devaluated against the US dollar by 165% on average, the interest rates of government securities rose to 190%, and the Turkish economy shrank by over 6%. (TURKSTAT). The crisis also affected the banking sector in such a way that total assets, shareholders’ equity, and deposit items in banks’ balance sheets decreased as well as number of branches and employees. Therefore, full state guarantees on all deposits were introduced in order to restore confidence and the stabilization program was conducted with the help of the IMF.

DOI: 10.4018/978-1-4666-7288-8.ch016
In fact, easy and politically-connected entry of banks, duty losses, open positions, low capital structure, maturity mismatches, high taxation, connected lending problems, and risky balance sheets were the main characteristics of the 1990s banking environment in Turkey. In addition to structural problems itself, existence of macroeconomic instability, high volatility in growth and real interest rates, chronic inflation, fiscal imbalances, and balance-of-payments problems also negatively affected the banking sector (Altunbas, Gambacorta & Marques-Ibanez, 2009). In order to eliminate imbalances in the economy, the Turkish government launched a three-year disinflation program supported by the IMF. The program aimed to improve growth, decrease inflation, and reduce the interest rate by focusing on areas of fiscal, monetary and exchange rate policies, agricultural policies, tax policy, transparency, the pension system, privatization of state economic enterprises, as well as banking system regulation (BAT, 2010). However, stabilization attempts were not able to create the expected recovery and high interest rates along with foreign exchange (FX) market distortions, budget deficits, large capital inflows/outflows, and current account deficits led to the financial crisis of 2000.

The 2000 and 2001 crises had devastating effects on the Turkish economy and banking system. In 2001, the GDP fell by 5.7% in real terms, inflation increased to 54.9%, the TL lost 51% of its value, and unemployment rate rose to 10%. Before the crisis, banks enjoyed high amounts of arbitrage income by borrowing from abroad and supplying money to the public sector. Government securities were an important part of banks’ balance sheets. However, during the crisis, banks experienced difficulties finding funds from abroad and tried to fund themselves by selling government securities in their portfolios. Asset size, loans and deposits of the banking sector decreased by 27%, 48% and 21% respectively, resulting in 20 banks being taken over by the Saving Deposit Insurance Fund (SDIF) during the period of 1999-2001.

Following the crisis, the Banking Sector Restructuring Program was launched. Restructuring of state banks, resolution of banks under the SDIF, strengthening of private banks’ capital structure as well as strengthening the regulatory framework were the main pillars of the banking sector program. In line with the program, public banks’ duty losses were liquidated, short-term liabilities were reduced, the capital structure was strengthened, and the number of branches and employees decreased. The capital structure of banks taken over by SDIF was strengthened by an injection of government bonds. Also, the number of branches and employees was reduced in order to achieve reductions in daily operational costs in fund banks. Private banks’ FX and interest rate risks were reduced, and non-performing loans (NPLs) of the banking sector were resolved by restructuring credit debts. Moreover, mergers and acquisitions were supported by granting some tax incentives during this period.

Over the period of 2002-2007, stable and high-rate economic growth was achieved, inflation dropped, public sector debt was decreased, financial discipline was ensured, and the resilience of the Turkish banking sector to external shocks was increased. Total assets, credits, deposits, capital, and profitability of banks all increased during this period. Another important aspect of this period is the acquisition activities performed by foreign banks. Foreign banks’ share increased from 7.3% in 2001 to 22% in 2007. The banking sector was affected from these adverse developments in the country. However, the effects of the global financial crises were rather limited compared to other countries and other crises experienced before due to the restructuring process started in 2001 (BAT, 2010).

The rest of this chapter is structured as follows. Section 2 reviews economic developments and