Financial liberalization: the turkish experience essay

The slow but continuing reform has been successful in bringing about a relatively high rate of growth to the Turkish economy. The developments of the last two decades show that the Turkish economy achieved a notable improvement after the implementation of the structural liberalization and adjustment program starting in 1980s. The main purpose of this program was to increase the role of market mechanism in the allocation of resource by opening up the economy and reducing the state's role in the economic activities.

The reform of the Turkish financial system has relatively accomplished the goals since the time when the economic reform began. This paper examines both theoretical and empirical issues related to financial liberalization in Turkey. Theory of Financial Liberalization The most comprehensive implicit in the notion of financial liberalization is the concept of financial repression. In other words, financial liberalization is the process of breaking the economy away from a state of financial repression.

The concept of financial repression has been commonly associated with fixed interest rates and it's causing consequences on economy especially on the financial market. However, financial liberalization is not limited to just interest rate liberalization but it involves a much broader set of measures including the elimination of restrictions on the financial market, removing the government subsidies, the reform of the external sector, and changes in the institutional structure of monetary policy.

As Koska (2005) mentioned, until the 1970s, financial repression, which is a term used to describe policies that distort the domestic capital market through a variety of measures; such as ceilings on interest rates, high reserve requirements, overall and selective credit ceilings, and exchange rate overvaluation, had been a common feature of developing countries. The economies, especially several emerging economies, kept interest rates at synthetically low levels to facilitate capital formation.

Even though the concept of financial repression has been used long time ago, McKinnon (1973) and Shaw (1973) introduced a new paradigm in the design of financial policies early 1970 (Atiyas, Caprio, and Hansen, 1994, Chapter 5). According to McKinnon and Shaw, distortional government especially monetary regulations affected the development of financial markets including the banking sector adversely and resulted in depressing savings and promoting inefficient investment.

McKinnon and Shaw suggested those economies to liberalize interest rates and allow economic agents to allocate resources according to market principles rather than state policies. Their basic argument is that interest rate determination should be market-driven to realize an economically efficient allocation of funds for investment, which will cause both financial and economic growth. It is commonly believed that interest rate liberalization leads not only to a more efficient allocation of resources but also to a boost in loanable funds through household savings.

Increasing loanable fond practically means more investment and faster economic growth (Atiyas, Caprio, and Hansen, 1994, Chapter 5) McKinnon and Shaw argued that financial repression policy, like interest rate ceilings, compulsory credit allocations, and others, cause a severe distortion especially in domestic financial market. The real interest rate in such a financially repressed economy is, in general, negative and unstable, particularly in the case of high price inflation.

Moreover, it is believed that the outcome of financial repression is has highly adverse effects on the quality and quantity of real capital accumulation. The characteristic cure policies includes keeping the real interest rates positive, eliminating interest ceilings and mandated allocations of credit, stabilizing the price level, and so on. Among others, interest rate liberalization is the most important element in the financial liberalization policy package (Atiyas, Caprio, and Hansen, 1994, Chapter 5)

Today the idea of financial liberalization has been widely accepted as a standard policy advice by multinational and leading international organizations such as the World Bank and IMF. Yet, despite the wide recognization of the idea of financial liberalization, the mechanism working behind the borrowing and saving decisions and channels to investment, supply and demand of credit are more complex than it is thought. It is not hard to show many controversies regarding the efficiency of many liberalization policies like maintaining a positive real rate of interest in encouraging the quantity of investment and savings.

Moreover, some studies like Lee and Haggard (1995) point on the importance of institutional and political factors and assert that government intervention into the allocation of financial resources could be efficient under certain conditions. Those economists try to explain why efficient state intervention is possible using the concept of “ quasi-internal organization” especially after observing the successful economic development of the East Asian countries.

In addition, the financial liberalization experiences of some economies prove that some initial conditions including the existence of sound financial markets and macroeconomic (fiscal and monetary) policies (Levine, 1997). If a financially repressed system takes place, liberalization of financial system raises many concerns regarding its effects on the employment, price level, growth of the economy, production, incomes of stakeholders, government revenue and deficit, balance of payments, investment decisions, and so on.

To be able to give an economically sound decision whether or not to carry out financial liberalization, the government has to evaluate the costs and benefits of financial liberalization. The most important reason behind financial repression is fiscal rather than monetary. The governments of developing economies want to develop economy and increase the growth rate; however, they do not have enough resources to do so. To be able to solve this problem they impose a large liquidity and reserve requirements.

Imposition of large liquidity and reserve requirements create a captive demand for their own interest bearing or non-interest bearing instruments, respectively, and use them to finance their own priority spending (Agenor and Montiel, 1996, Chapter 5). This situation puts a cap on rates, creates excess credit demand, and mobilizes the credits to some sectors. Another way of financial repression involves the limitation of the instruments that the public can hold, for example, foreign exchange deposits, to ensure greater seigniorage revenue.

Due to the fact that repressing the monetary system fragments the domestic capital market with highly adverse consequences for the quality and quantity of real capital accumulation, McKinnon and Shaw claimed that financial repression is an economic illness. The adverse consequences of real capital accumulation would follow mainly through three channels (Atiyas, Caprio, and Hansen, 1994, Chapter 5):

1. Interest rates on the truncated bank loan flows differ from one favored or disfavored borrower to another, 2. The flow of loanable funds through the banking system is reduced, forcing potential investors to rely heavily on self-finance, 3. The process of self finance deteriorates itself; in the case of negative real yield on deposit, it would be extremely hard for firms to accumulate liquid assets in preparation for making discrete investments and socially costly inflation hedges look more attractive as a means of internal finance. With financial liberalization, as a most important component, free interest rates rapidly reduce reserve requirements, and eliminate directed credit schemes, while stabilizing the price level with a strong disinflation program.

This would help economies grow faster basically due to the fact that following financial liberalization, investment and growth would pick up either because of a " complementary effect", i. e. the need to accumulate funds to undertake lumpy investments would make money and capital complementary (rather than substitutes) or because of a " credit availability effect", i. e. increased savings into the banking system would increase investment through enhanced credit availability (Agenor and Montiel, 1996 Chapter 14).

In fact, to attain all those, real interest rate must be kept positive. Positive real interest rate resulting from financial liberalization leads to financial deepening or a higher level of intermediation and promotes economic growth. Thus, removal of controls over interest rates has become the centerpiece of the financial liberalization process. Although the early literature focuses mainly on interest rate liberalization, the scope of financial liberalization extends into a number of modern themes.

Thus, today's approach for financial liberalization is little bit different. Rather than interest rate liberalization and elimination of directed credits and high reserve requirements, the new understanding of financial liberalization engages some additional measures including the easing of portfolio restrictions on banks, changes in the ownership of banks, enhanced competition among banks, integration of domestic entities to international markets, as well as changes in the monetary policy environment.

Since removing restrictions on exchange and payments system and establishing a market functioning foreign exchange market are central to remove distortions that limit portfolio behavior, external sector reforms, of course, should be accompanied with financial sector reforms. Up to this point, we talked about the theoretical side of financial liberalization. In practice, it is not easy job to assess whether financial liberalization is successful or not mainly due to two reasons. 1. Financial liberalization has no long history.

In other words, the experiences of financial liberalization are relatively new. However, it takes several business cycles to assess whether financial liberalization efforts have been successful or not 2. Measurement of financial liberalization is itself problematic. While it is not easy task to determine exactly when financial liberalization started and ended, on the other hand, economists have not agreed on the empirical measures of financial liberalization and performance. (Atiyas, Caprio, and Hansen, Chapter 13).

What we have learned so far is that financial liberalization attempts, in general, have not resulted in happy end. Rather, it appears to have been heavily associated with financial especially banking crises. It is a well-known fact that the financial liberalization attempts, taken as an immediate freeing of interest rates, resulted in high interest rates, distressed borrowing, and banking crises. The most well known examples are the early Latin American experiences of the late 1970s and early 1980s (e. g. , Argentina, Chile, and Uruguay).

These economies had put serious efforts to slow down high inflation and to deregulate and privatize their banking systems. At the same time, interest rates on both bank deposits and loans were completely freed. These financial liberalization attempts generally ended in failure and this necessitated government intervention to uphold failing domestic banks and enterprises. Those results have been also supported by analytic studies. In their studies, Demirguc-Kunt and Detragiache (1998) and Fischer and Chenard (1997) try to analyze the relationship between financial liberalization and financial fragility.

Goldstein and Turner (1996), in a survey of banking crises in emerging economies, also includes inadequate preparation for financial liberalization, among the key factors that lead to banking crises. Demirguc-Kunt and Detragiache (1998) studied the empirical relationship between banking crises and financial liberalization with panel data of 53 countries for the period 1980-95 in a multivariate logit model. They concluded that banking crises are more likely to occur in liberalized financial systems, even if institutional factors reduce the likelihood of banking crises.

The link between financial development and growth is more direct way of exploring the relationship between financial liberalization and growth. Evidence in this spot looks like more conclusive and shows strong links between financial liberalization and growth. King and Levine (1993), using a cross-section data, investigates the link between various measures of the level of financial development and indicators of economic performance. They found a strong relationship between financial liberalization and growth. However, Fischer and Chenard (1997) are more skeptical of these results.

Fischer and Chenard (1997) suggests a research program that focuses more on time series techniques than cross-section analysis. Demirguc-Kunt and Detragiache (1998) also find strong relationship between financial development and financial liberalization, but weak relationship between financial development and growth in their panel data. Thus, they argue that financial liberalization at the cost of experiencing a banking crisis does not necessarily pay off in terms of higher growth, at least in a medium term time frame. However, other studies find results I favor of financial liberalization.

Easterly and Levine (1997), for example, find that financial underdevelopment of African economies is the most important factor among others that explain Africa’s low growth performance. De Gregorio and Guidotti (1995) bring a two-fold argument, which shows that the empirical relationship between financial development and growth is positive in general, but negative in Latin America. The Experience of Turkey The Turkish economy has undertaken important reforms in the 1980s, and successfully transformed into an open and export-oriented economy.

Financial liberalization has played an important role in this episode. However, macroeconomic stability in the sense of low inflation has never been achieved, because of growing fiscal imbalances. It may be useful to look at this experience in two distinct, easily observable phases: interest rate liberalization (early 1980s) and a full liberalization of the capital account (August 1989). Interest rates were liberalized in the early 1980s, in the context of a stabilization program. It was followed by a minor episode of “ Goodbye Financial Repression Hello Financial Crash” (Koska, 2005).

Somewhat ironically, the Turkish crisis was essentially a “ bankers'” crisis, whose ponzi-game went on unnoticed or uninterrupted by the supervisory authorities. Ironically, as noted in Atiyas and Ersel (1994), confidence in the banks increased after the crisis. Nevertheless, a couple of small banks went bust as well, and restrictions were re-imposed on deposit and lending rates and remained in place till 1988, but under a policy aimed at maintaining mildly positive real interest rates. Beginning in the mid-1980s, the Central Bank began to stimulate the growth of money markets and instruments.

Following the freeing of rates, the capital account was fully opened in late 1989. As to sequencing, interest rates as well as the current account were liberalized, and a free, reasonably well functioning foreign exchange market was established, prior to the opening of the capital account. Prior to the opening of the capital account, the central banks took important steps to stimulate the development of money markets and instruments, and largely shifted from an environment of direct monetary controls to indirect controls.

The key problem was that, despite the achievements in terms of reducing inflation, macroeconomic stability was tenuous owing to lagging fiscal and structural reforms. This has resulted, in an open economy context, in interesting macroeconomic relations (Koska, 2005). On the one hand, the government continued to dominate the domestic markets because of its heavy borrowing requirement. At the same time though, the banks as well as the public began to ask higher and higher real interest rates and the use of new instruments such as foreign exchange deposits or high yielding " repos" reduced the inflation tax substantially.

As a matter of fact, very illustrative of course, seignorage, as defined by the ratio of change in reserve money to GNP, started declining after 1988. It is also notable that in 1994, when inflation jumped significantly due to a financial market crisis, seignorage did not increase. The most popular game in town has become, and increasingly so, the financing by the private sector of growing fiscal balances exploiting the reasonably high interest differential.

Given the ongoing uncertainties in the economy, non-TL aggregates or risky means of financial innovation (e. g. foreign exchange deposits, overnight repos with customers) have become the means to maintain financial deepening (Koska, 2005). In some ways, the interest rate liberalization phase was more manageable. There was a “ banking crisis”, but whether this was a full-fledged “ systemic” crisis or not is debatable. They were quite serious, but did not seem to be the direct result of liberalization, i. e. a quick fix early on to stop the bankers’ ponzi game, would do, as the Turkish crisis did not seem to have many characteristics of the Latin American crises (i. e. excessive borrowing, coupled with enhanced external exposure).

The real problems in macroeconomic management or the implications of perhaps what one could call “ untimely” liberalization of the financial sector were begun to be felt more deeply, when the capital account was fully liberalized (Denizer, Gultekin, Gultekin, 2000). The capital account was opened in a bit of a “ big bang” manner. In principle, basic sequencing was in place: current account transactions were liberalized, Turkey was close to accepting the obligations arising from the IMF’s Article VIII clause, interest rates had been freed, and monetary policy implementation had largely shifted toward indirect monetary policy instruments.

However, at the time of the liberalization, macroeconomic stability and commitment to structural reforms, as noted above, continued to be slim. This did not stop capital account liberalization; on the contrary, it speeded up the process to signal commitment to reform or perhaps more to alleviate the costs of delays in fiscal adjustment. As a result, against the backdrop of declining TL-denominated aggregates, the system expanded and growth continued by way of money created through a balance of payments surplus. Since Turkey was a current account deficit country, this had to come through a capital account surplus (Koska, 2005).