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Economy of Turkish Banking Reforms in the Age of  
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# **The Emergence of the Regulatory State: The Political Economy of Turkish Banking Reforms in the Age of Post-Washington Consensus**

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## **ABSTRACT**

The new era of Post-Washington Consensus (PWC) promoted under the auspices of multilateral organizations such as IMF and the World Bank centres on the need to develop strong regulatory institutions, especially the realm of banking and finance in developing countries. By focusing on the Turkish experience in the aftermath of the 2001 crisis, the article identifies the positive features of the new era the PWC in terms of the banking sector which as a result has become much more robust in terms of its ability to withstand external shocks and to avert future financial crises. At the same time, however, the article highlights some of the limitations of the new era. Important limitations are identified in terms of the distributional impact of the regulatory reforms with the banking sector and notably the foreign banks emerging as the major beneficiaries of this process. Additional limitations are observed in the areas of consumer protection and competition regulation. These weaknesses, in turn, highlight the limits of the emerging regulatory state in the era of the PWC. Similarly, significant weaknesses are evident in terms of the ability of the banking system to finance the real economy, and notably the small and medium sized businesses.

**JEL classification:** G21, G28

**Key words:** regulatory state, post-Washington consensus, banking, Turkey

## INTRODUCTION

Institutional realities of neoliberalism such as privatization and deregulation have increasingly been accompanied by re-regulation. The heightened regulation of the state in the deregulated markets points to redefinition of state as a *regulatory state* (Vogel, 1996; Majone, 1997). Independent regulatory bureaucracies constitute the main organizational manifestation of the regulatory state (Gilardi, 2008). Although the emergence of regulatory state in advanced developed economies and its consolidation towards regulatory capitalism (i.e., growth in the regulation by state and regulation of state) over the last two decades has been subject to extensive research (Levi-Faur, 2005; Braithwaite, 2008), there has been limited research on the regulatory state in developing countries.

Progress towards regulatory state has been particularly prominent in the domain of the financial sectors of developing countries since the late 1990s. The transition from the Washington Consensus (WC) towards Post-Washington Consensus (PWC) was based on the recognition of the perverse consequence of the financial liberalization process generated by deregulated markets in the absence of effective state regulation. With the inclusion of rule of law and the establishment of legally independent regulatory agencies and an emphasis on good governance practices such as transparency and accountability, the basic ideas underlying the WC have been adapted to the new era of the PWC. For example, the Asian financial crisis in 1997 opened a 'window of opportunity' for the multilateral organizations not only to transform protectionist and interventionist financial systems of Korea, Thailand and Indonesia towards free market (Bello, 1998; Jayasuriya and Rosser, 2001; for the Latin American experience, see Teichman, 2001) but also towards the regulatory state via the establishment of legally independent regulatory agencies such as independent central banks and financial regulation agencies (Jayasuria, 2001).

The previous studies on the regulatory state, however, narrowly focus on the establishment of independent self regulatory bureaucratic agencies. They fail to draw attention to how the institutional foundations of the regulatory state penetrate into domestic policy processes, through which mechanisms and with what distributional effects. This paper deals with these questions. In doing so, it aims to fill this void in the analysis of the PWC era with special reference to the radical change in Turkish banking sector regulation following the 2001 financial crisis. The paper also shed lights on achievements and limits

of the PWC in terms of macro-economic management and bank regulation. This discussion is also highly topical in the current era of global credit crunch.

Our analysis is based on the premise that the domestic political environment and key external actors both play an important role in shaping the outcomes of financial liberalization and the performance of the banking sector. We would like to highlight the importance of the following propositions. Firstly, the multilateral organizations such as the International Monetary Fund (IMF) and the World Bank had been the principal driving force behind the process leading to financial liberalization in the 1980s, the early years of the WC (Öniş and Şenses, 2005). Similarly, the key external actors including this time both the multilateral organizations and the European Union (EU) have been at the heart of the process leading up to significant regulatory reforms in the realm of the banking sector in line with the spirit of the new era of the PWC in the aftermath of the major financial crisis of 2001. Secondly, the domestic political economy had played an important negative role in terms of undermining the performance of the banking sector in the 1990s. In the absence of the regulatory state in the banking sector, we highlight the emergence of a powerful rent-seeking coalition involving state-bank-business relations which helped to contribute towards the deepening of a perverse financial environment. This perverse environment has, in turn, been instrumental in undermining the productive intermediation role of the banking sector and has emerged as a powerful contributor to the twin financial crises of 2000 and 2001. Thirdly, although the main impetus for regulatory reform originated from external actors, we also observe the emergence of a parallel domestic coalition in favour of bank regulation since 2001. The Turkish experience in this context is important in terms of highlighting how the combination of powerful external actors and a supporting pro-regulation coalition at home can contribute to the emergence of regulatory state and a significant improvement in the performance of the banking sector representing a case of real rupture from the pre-crisis era. The Turkish experience is also important in highlighting the crucial role of crisis in terms of changing the balance of power between the key external and domestic actors and empowering key external actors to facilitate the implementation of major regulatory reforms (Öniş and Şenses, 2007). We argue that the 2001 crisis also created a ‘window of opportunity’ for a ‘policy entrepreneurship’ which enabled the formation of a strong pro-regulation coalition between external and domestic

actors. Fourthly, the new regulatory environment, an important feature of which is the socialization of bank failures, has significant redistributive consequences privileging bank capital at the expense of broader public. Furthermore, in spite of the improvements in prudential regulation and banking performance, the performance of the banking sector continues to exhibit important weaknesses particularly in terms of its ability to finance the real economy. Foreign banks, as the powerful arm of the new pro-regulation coalition, emerge as the principal beneficiaries, whereas small and medium-sized firms constitute the societal groups which are largely excluded from the benefits generated from a more tightly regulated banking system.

These observations suggest that the transition from the WC to the PWC era with the emergence of regulatory state is characterized by both elements of rupture and continuity. There is a clear rupture in terms of the strengthening of prudential regulation. On the other hand, the privileged position of bank capital at the expense of broader public and persistence of rent-seeking elements within the pro-regulation coalition represent elements of continuity from the post-1980s era. As a result, the move to the ‘regulatory state’ in the banking sector remains incomplete. Elements of regulatory failure persist particularly in the regulations of the credit card market. Further, macroeconomic and foreign exchange mismanagement created perverse financial incentives such as high domestic interest rates and arbitrage opportunities promoting banks’ foreign debt.

#### **STATE-BANK-BUSINESS RELATIONS IN THE 1990s: THE ANATOMY OF A RENT SEEKING COALITION**

During the 1980s, country after country decided to adopt more liberal domestic and international financial policies (Helleiner, 1994). Turkey was no exception (Arıcanlı and Rodrik, 1990; Atiyas and Ersel, 1995). Following the major crisis of the import substituting industrialization in the late 1970s, the impetus for the liberalization drive came from the key external actors, the IMF and the World Bank.

In the political realm, Turkish democracy displayed a number of underlying deficits which were not unique to this period (Alper and Öniş, 2003; Kalaycıoğlu, 2001). These included a system of party politics based on clientelism and the distribution of patronage

resources. Key political institutions such as major political parties and the parliament were characterized by low degrees of accountability. The kinds of institutional checks and balances which are part and parcel of advanced democracies were conspicuous by their absence. These underlying democratic deficits were magnified during the 1990s by successive coalition governments contributing to further fragmentation and politicization of the system.

Turkey's deepening democratic deficits, in turn, were at the heart of the deteriorating macroeconomic performance. Turkey witnessed macroeconomic instability in the form of huge budget deficits and public debts, high and volatile inflation, and low economic growth. Implementation of the basic notions of the WC in this kind of institutional structure created an environment lucrative for rent-seeking activities rather than productive financial intermediation. Indeed, a rent-seeking coalition of corrupt politicians, bureaucrats, businessmen, and the mafia was formed over banking related issues (Bakır, 2006). This, in turn, contributed to financial crises that further weakened the banking sector. In this context, there were two interrelated factors that hampered the ability of the bank-based financial system to act as a catalyst for economic growth: a soft budget constraint and political repression.

### **Soft Budget Constraint and the Perverse Incentive Structure**

A soft budget constraint led to crowding out of private investment by the government debt. During the 1990s, successive Turkish governments adopted a 'hot money' policy of high real interest rates for treasury bills and domestic currency appreciation to attract short-term, unproductive, and speculative capital to be able to finance the uncontrolled growth in government expenditures. High real interest rates and financial arbitrage encouraged banks to focus on government deficit funding via large, open foreign exchange positions (i.e. foreign bank loans), which generated lucrative profits. For example, the annual *real* interest rate for government securities averaged 32 per cent between 1992 and 1999 (Treasury, 2001a: 1, 3). Not surprisingly, both public and private banks channelled most of their funds to the government debt market rather than to corporate lending; the share of government securities in total bank assets increased from 10 per cent to 23 per cent between 1990 and

1999, respectively (Treasury, 2001a:6). In this kind of banking environment, the crowding out of private investment by the government public debt became unavoidable.

The high real interest rates impaired fixed capital investment on the part of the industrial capital through two main channels. First, industrial firms directed a considerable portion of their gross profits towards the banking sector rather than towards working capital. For example, for top 500 manufacturing firms, the ratio of interest expenditures to total expenditures reached about 45 per cent between 1997 and 2000 (Boratav, 2007: 200). Second, the high real interest rates were paradoxically the major source of net corporate profits (Yeldan, 2001: 156).

The perverse incentive structure had also implications for the regulatory bureaucracies. The Treasury, for example, had no incentive to push for tight financial regulation and supervision of the banks, which were essentially seen as the instruments of funding government deficits, or to pressure the state banks to augment their capital base given the fear that this would help to worsen the fiscal deficit. Instead, the banks were allowed to have open positions up to 50 per cent of their capital, which were used for the funding of the government securities portfolio.

### **Politicization of Bank Lending and the Regulatory Process**

Banking became such an integral part of politics that it was at the centre of the establishment and collapse of governments in Turkey.<sup>1</sup> Not surprisingly, another striking characteristic that prevailed in the Turkish banking sector was a high degree of politicization of the bank lending and regulation. The dramatic consequences included inefficient credit allocation and the absence of the regulatory state. The lending aspect of the politicization process refers to heavy rent-seeking political intervention in the allocation of bank credit. The financial aspect of the politicization process prevented the allocation of bank loans to take place through market-based supply and demand mechanisms for credit and finance. Duty losses of state banks were notable examples. The state banks' *duty* of

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<sup>1</sup> For example, once a fragile coalition government in 1997 received the support of the opposition party in the vote of confidence in exchange for 28 per cent of the shares of İşbank which were left to the Republican People's Party. The same government collapsed in 1998 when scandal of rigging the privatization of a state-owned bank, Türkbank, in favor of the eventual winner who received support from a leading mafia leader became public.

lending at below market interest was abused during this period through channelling cheap loans to corporate and individual donors as well as farmers, and other electoral constituencies. Uncompensated lending subsidies and payments generated the ‘duty losses’ of the largest two state banks which increased from nearly 3 per cent of Gross National Product (GNP) in 1993 to about 12 per cent of GNP in 2000. The state banks’ Non-Performing Loan (NPL) portfolio reached about 37 per cent of their total loans in 2001 (BRSA, 2003). Under conditions of heavy politicization, the state banks had largely become the instruments of channelling deposits into political rent distribution. Not surprisingly, these banks became illiquid and covered their funding needs by borrowing from the market at very high rates with short maturities.

The important point to emphasize, however, is that in this overall politicized environment of banking, private banks too displayed a dual structure of rent seeking banking behaviour. At one end of the spectrum, one could identify banks which were not involved in corruption but nevertheless capitalized on the perverse incentives generated by the overall macro-political environment. These uncorrupted segments of commercial banks mainly focused on the lucrative gains derived from the high real interest bearing government securities funded via foreign borrowing. More significantly, at the other end of the spectrum, there existed corrupt private banks which directed public deposits and profits derived from arbitrage into group financing (i.e. connected lending) and ‘bad loans to good friends’. The private banks’ NPL ratio reached 28 per cent in 2001 (BRSA, 2003). Not surprisingly, the banking sector, both public and private, was at the heart of the twin financial crises Turkey experienced in November 2000 and February 2001.

The politicized bank regulation refers to heavy rent-seeking political intervention in licensing, regulation and supervision of bank which generated weak state capacity in the banking sector. This politicization process was responsible for the poor supervision and regulation of the banking sector, which mainly generated inadequate internal and external control, risk assessment and management mechanisms, and good corporate governance in the banking sector. Two principal mechanisms could be identified as obstacles before the emergence of the regulatory state. The first one was creating a legal environment conducive to the establishment of a rent-seeking coalition through statutory decrees in

banking. The Statutory Decree No.512 enacted in 1993 constituted a striking example. This decree legally protected corrupt bank managers by: (1) removing their individual responsibility in unlawful acts or misconduct leading to loss and/or bankruptcy of a bank; (2) removing the clause stipulating the expulsion of such bankers from any bank management activities; (3) removing of 5 per cent limit to loans provided by bank to its partners which had 5 per cent or above share in the bank capital; (4) reducing the number of required partners in a bank establishment to 5 from 100; (5) the participation of banks in non-financial entities was not subject to any limitation.

The second main mechanism preventing the emergence of the regulatory state was the concentration of ultimate decision-making power on bank licensing in the hands of ministers of the economy. Granting of bank licenses, privatization of state banks, and allocation of financial resources were based primarily on political criteria. In this environment, a few wealthy individuals dominant in financing political campaigns were actively acquiring or establishing banks with the help of the party they had supported during the elections (see Tartan, 2003). Rent-seeking behaviour was also rampant among some of the bureaucrats working for the key financial regulatory agencies such as the Treasury and the Board of Sworn Bank Auditors (see *Radikal*, 26 August 2003). Not surprisingly, six banks, which were granted entry following the 1991 general elections, failed in less than a decade. In 1999, they were all insolvent due to connected lending and were taken over by the Savings and Deposit Insurance Fund (SDIF), also known as SDIF banks (see BRSA, 2003: 17).

In retrospect, the implementation of the WC framework failed to produce an efficient allocation of resources and could not provide a strong foundation for economic growth and development. Underlying this failure was the weaknesses of the domestic institutional environment. More specifically, the persistence of soft budget constraint and the associated politicization of the regulatory process constituted the principal sources of disequilibrium in the banking sector that prevented the emergence of an efficient banking system capable of promoting sustainable economic growth via allocation of loanable funds to productive investments. The rent seeking coalition formed in state-bank-business interactions flourished in this environment. This coalition not only generated costs to

economic growth, systemic stability and the public purse but also created considerable obstacles to the emergence of the regulatory state.

### **THE POST-CRISIS TRANSFORMATION OF THE TURKISH BANKING SECTOR: ELEMENTS OF EFFECTIVE REGULATION**

In December 1999, in the midst of acute disequilibrium in the overall macroeconomic environment and the banking sector, the Turkish government agreed to implement an exchange rate-based Disinflation Program supervised by the multilateral organizations. In return for the financial support of the (i.e. US\$8 billion), the government committed itself to the economic and financial policies of the program. The multilateral organizations along with the EU were the key proponents of the regulatory state in the banking sector. Institutional foundations of the regulatory state included: (1) rehabilitation of insolvent state banks via public money and their subsequent transfer to private players; (2) enactment of a new banking law facilitating legal adaptation to Basel II, Banking Core Principles and banking norms of the EU; (3) establishment of a new formally independent financial regulatory agency; (4) granting legal independence to the Central Bank (see IMF, 1999; CEC, 1999).

Under the new banking law, banks were required to maintain proper internal and risk controls as well as management systems. This new act and its provisions were in compliance with the recommendations introduced by the Basel Committee of the Bank for International Settlements, and in accordance with the directives of the EU. Following the new law in 1999, regulatory limits on connected lending were also reduced to 25 per cent from 75 per cent, whilst those of open positions were tightened to 20 per cent of capital from 50 per cent. In line with these policy choices, five insolvent banks were taken over by the SDIF in December 1999. Finally, the Banking Regulation and Supervision Agency (BRSA) was established in June 1999 following the ratification of the IMF sponsored Banks Act No. 4389 by the Parliament (see IMF, 1999). At the same time the draft of new central banking law granting legal independence from the government was prepared. These efforts been the clearest examples of a movement toward depoliticization of bank lending

and the rise of the regulatory state in monetary and financial governance in Turkey under the auspices of the multilateral organizations guided by the PWC.

However, there was no strong domestic constituency allied with the multilateral organizations and the EU towards the emergence of the regulatory state except for the weak commitment of the incumbent government. In the period leading up to the twin crises in November 2000 and January 2001, for example, both connected lending and open positions were well above these regulatory limits with the full knowledge of the Treasury and the Central Bank. Moreover, the appointment of the members of the BRSA board took more than a year - the agency did not commence its operations until August 31, 2000. It became clear that the government's move was mainly motivated by the prospects of receiving the IMF financial support (*Financial Times*, 27 January 1999).

The 2001 financial crisis was triggered when on 20 February 2001 the President criticized the government of obstructing corruption investigations into the banking sector. The result was the largest economic recession in Turkey's history (see CBRT, 2002: 16; 2003: 12). Following the crisis, Turkey returned to the floating exchange rate regime with the Central Bank having control over short-term interest rates. Meanwhile, the crisis opened 'a window of opportunity' for the banking sector restructuring through the following several channels. First, it undermined the political power and legitimacy of the incumbent coalition government. There was strong public distrust of and anger at the government as evidenced by opinion polls.<sup>2</sup> Specifically, three parties in the weak coalition government were accused of corruption and of obstructing a three-year disinflation reform program backed by the multilateral organizations since 1999. Moreover, corrupt bankers and businessmen were among the first societal groups hit hard financially during the crisis period. Their power, in turn, was weakened as their stronghold on the market was put in jeopardy.

Second, the financial crisis exposed the structural weaknesses and the fragility of the banking sector as some of the private and state banks faced erosion of their capital base and deterioration of their asset quality. Massive state intervention via the SDIF led to a

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<sup>2</sup> For example, according to a poll, two-thirds of respondents indicated that they did not trust the government and 55 per cent thought it had to resign. It has been shown that voters preferred the opposition parties far more than the three parties in the ruling coalition (*Wall Street Journal*, 2001a: 18).

major consolidation process. Between 1997 and 2003, 20 banks were taken over by the SDIF, 19 of which were dissolved, sold and/or merged with other banks. The total asset size of mergers and acquisitions in the sector was around US\$26.5 billion (BRSA, 2003: 53). Majority shareholders of these 20 undercapitalized banks used US\$9.1 billion from their own banks (BRSA, 2003: 25, Table 11). There were 12 banks out of 20 which ‘were taken over on the grounds that their financial positions were seriously distorted and on that banks’ resources were used in favour of the majority shareholders thereby creating losses on the part of the banks’ (BRSA, 2003: 17). Furthermore, the corrupt private bankers involved had also utilized loans from state banks and other SDIF banks which later became part of non-performing loans (see BRSA, 2003: 72-101; Tartan, 2003: 72-74). The legacy of the politicization of the financial system has been devastating: The total share of non-performing loans in the banking sector gross loans reached 29.3 per cent in 2001 (SPO, 2004: 72). Third, the EU accession process, the supervision of the multilateral organizations, and Turkey’s need for adherence to internationally acceptable regulatory standards in the post crisis era were external pressures for the emergence of the regulatory state (see BRSA, 2004:v). Fourth, the 2001 crisis also created a ‘window of opportunity’ for a ‘policy entrepreneurship’ which paved the way for the formation of a strong pro-regulation coalition between external and domestic actors. This pro-regulation coalition played a fundamental the emergence of the regulatory state in the post-2001 era.

### **Emergence of Pro-Regulation Coalition under Policy Entrepreneurship**

The formation of the coalition in the sector gathered significant momentum with the appointment of well-respected and highly influential transnational bureaucrat Kemal Derviş as a new minister responsible for the management of economic reforms in March 2001. He was the World Bank’s Vice President for Poverty Reduction and Economic Management at the time and had served as an advisor to the Prime Minister in the late 1970s. Derviş, as a ‘policy entrepreneur’, effectively coupled the PWC solutions to the banking sector problems and to the political process (see Bakır, 2006, 2007).

Although Derviş was not an insider to the domestic political process, his background and presence helped to inject an element of optimism helping to build trust

among the key private and state actors in the viability of the reform project.<sup>3</sup> A pro-regulation coalition among the key public sector actors in the banking policy community was formed by Derviş around the Ministry of Economy and key economic bureaucratic agencies.<sup>4</sup> Derviş quickly achieved the much needed bureaucratic coordination and collaboration among the principal agencies of the economic bureaucracy. The highly influential Turkish Industrialists' and Businessmen' Association as well as the Banks Association of Turkey emerged as the key domestic private sector actors of the pro-regulation coalition (see *Cumhuriyet*, 18 May 2001).

Derviş was successful in translating the policy preferences of international financial capital into domestic policy processes. Thus, the Turkish experience with the PWC also exhibited multilevel governance including multilateral and supranational actors. These actors included the IMF with its Standby Agreements, according to which the IMF lending was conditional to the adoption of the IMF policy prescriptions; the World Bank, with its technical assistance for reforms via Programmatic Financial and Public Sector Adjustment Loans; and the EU, which required Turkey to adopt and implement the complete EU legislation and standards – the *acquis communautaire* – as part of the accession process. The compliance of the banking sector with international standards and best practices was assessed by the multilateral organizations via Financial Sector Assessment Program. Instead of supervising the economic reforms directly, the EU offered feedback through regular reports on Turkey's progress towards accession. The multilateral organizations adopted the rhetoric that the goal of the banking sector reforms is 'to align Turkey's supervisory framework more closely with EU standards' (IMF, 2004). Their goal was to have the PWC guided policy choices gain further legitimacy in the public, economic, and political spheres (see Derviş, 2001). Further, international banking community was supportive of the restructuring program personalized by Derviş (BBC News, 12 June 2001).

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<sup>3</sup> For example, within a month's time following his arrival to Turkish political scene, Derviş had '63 per cent approval rating which is three times more than the next most popular political leader' (*Euromoney*, April 2001: 38).

<sup>4</sup> The new Head of BRSA, Governor of the Central Bank, Undersecretary of Treasury, and Chairman of the Public Banking Executive Board were all appointed by Derviş between 14 March and 3 April 2001.

## **A Progress towards the Regulatory State**

In this environment, the government adopted a new stabilization program following the crisis. The IMF required the implementation of this program in return for US\$8 billion provided in May 2001. The major initiative of this pro-regulation coalition was the Banking Sector Restructuring and Rehabilitation Program (see HC Istanbul, 2002; BRSA, 2001, 2003). This program had two main pillars. The first pillar was the nationalization of insolvent banks, their recapitalization and restructuring of state banks between January-May 2001. Between 2000 and 2003, 8 banks were taken over by the SDIF (BRSA, October 2003). Total number of the SDIF banks reached 20. The rehabilitation included the elimination of about US\$27 billion stock of duty losses and related interest receivables through recapitalization. Between January 2001 and September 2002, non-cash bonds amounting to US\$23 billion was injected to these banks for their recapitalization. The second pillar included strengthening of private banking by the Treasury voluntary debt swap of US\$8 billion on 15 June 2001, which meant that the banks' foreign exchange-based government securities were swapped with lira-based securities. Accordingly, the banks' short foreign exchange position was reduced substantially. Following the debt swap, the short positions of the banks declined to US\$2.2 billion from US\$6 billion. The restructuring of the state banks included strengthening of management, reducing the number of branches and downsizing the bank personnel.

The second pillar of the restructuring was the implementation of institutional foundations of the regulatory state. The banking law amendments aimed to bring the regulation and supervision of the Turkish banking sector closer to the EU standards such as 'the definition of thresholds for a bank's own funds, the definition of credit, as well as rules on provisions against bank losses' (CEC, 2001: 52). Accordingly, the banking legislation aimed to incorporate market risk into capital adequacy requirement (CAR), clarify definitions for reporting and accounting purposes, include repurchase agreements on the balance sheet, improve monitoring the supervision of the banking system, and adopt international accounting standards between 2001 and 2002 (Bakır and Brown, 2004: 433). More specifically, in order to limit connected lending, the participation of banks in non-financial entities was limited by the BRSA in June 2001 to 15 per cent of such bank's

equity, provided that a bank's participation of this nature does not exceed 60 per cent of its equity. Further, banks were required to set up appropriate internal inspections and risk management tools by January 2002.

Progress towards the emergence regulatory state in the banking sector was facilitated by the transformation in the overall political environment. The financial crises and its economic consequences including a deep recession and heavy unemployment created a strong public awareness of the costs of having a rent seeking coalition and made its preservation more difficult by having the government replaced as a result of the elections. Following the November 2002 elections, the first single party government in 15 years was formed with 34 per cent of the vote and 66 per cent of majority in the Grand National Assembly under the aegis of the Justice and Development Party (hereafter AKP). Nine out of ten political parties of the previous parliament were pushed out of the legislature by the electorate, whilst for the first time in 40 years there was only one opposition party in the new parliament. In its first term in power, the AKP quickly gained domestic and international credibility and experience by managing to translate parliamentary stability into political and economic stability in its first term in government. The Transition Program designed jointly by pro-regulation coalition led by Derviş was fully adopted by the AKP. Indeed, the AKP government successfully implemented the program which was revised in early 2002 to cover the 2002-2004 periods. The AKP had promised a strong commitment to fight corruption, to implement structural economic reforms sponsored by the transnational financial capital, and to continue political and legal reforms to meet the Copenhagen criteria for the EU membership. For example, politicians facing corrupting charges were sent by the new Parliament to the High Tribunal to stand trial over the bank privatization scandals, whilst corrupt bank owners and bureaucrats faced imprisonment and fines.

The SDIF emerged as a key bureaucratic agency with administrative and financial autonomy. Indeed, the Turkish experience with the SDIF constitutes one of the highlights of the recent Turkish experience with bank regulation. With the enactment of Act No. 5020 on December 26, 2003, the management of the SDIF was separated from the management of the BRSA. The Ministry of Justice also drafted new bankruptcy and foreclosure laws in consultation with the World Bank. Following these laws drafted in late 2003, the SDIF

effectively nationalized companies and personal property of the insolvent bank owners who failed to propose a plan to pay the debts due to the collapse of their banks in 2004. The legal changes clarified the authority of the SDIF in its dealings with the SDIF banks and the administration of legal procedures for the Fund to collect receivables of those banks. The SDIF move towards enforcement of rules and laws to recoup the tax payer's money *marked* the end of a 'light touch' approach that prevailed during the previous decade. Further, blanket deposit insurance, which had caused a moral hazard problem and unfair competition among banks, was ended in July 2004 and aligned with the EU-15 average level.

In retrospect, a key element which characterized the post-2001 period was a relative deepening of the democratization process in Turkey under strong signals from the EU. The move towards democratic consolidation in Turkey, with much greater emphasis than before on accountability, the strengthening of institutions, and the rule of law helped to create an environment conducive to improved economic performance. This overall improvement was also reflected in the pro-regulation turn in the banking sector. At the same time, one should note that the process of democratic consolidation is still an on-going and incomplete process in Turkey. Although Turkish democracy is in better shape compared to the previous decade, democratic deficits persist and continue to influence bank lending in a negative manner and determine the limits of the regulatory state. These democratic deficits came increasingly into the surface during the second term of the AKP government following its comfortable victory in the general elections on 22 July 2007 where its power was consolidated further with 46.4 per cent of the popular vote. The AKP was not immune to the corruption and nepotism considering the fact that it also used public banks for political purposes in a manner rather reminiscent of the political parties that had ruled Turkey during the 1990s.<sup>5</sup>

### **Improvements in the Performance of the Banking Sector**

Between 2002 and 2007, the CPI, nominal interest rates for government securities, and economic growth averaged about 14 per cent, 28 per cent and 6.7 per cent, whilst net public debt to GDP decreased to 40 per cent from 78 per cent, respectively (see Muhasebat, 2007;

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<sup>5</sup> For example, on 22 April 2008, two Turkish state-owned banks had stepped in to provide US\$750 million in loans to a holding, which is owned by a close friend of Prime Minister, in order to enable it to purchase the second largest media group in Turkey (*Hürriyet*, 24 April 2008).

SPO, 2008). As a result of improved macroeconomic performance, the banking sector focused more on the provision of credit in the post-crisis era (see Table 1). The IMF-supervised tight fiscal policies and the appreciation of the Turkish Lira against US dollar generated improvements in public debt ratios. Thus, one should expect a sharp decline in crowding out of private loans by the government debt. However, although the perennial soft budget constraint of the public sector had been eliminated, securities portfolio constituted about a quarter of GDP in 2007. Further, securities portfolio constituted about one-third of total bank assets in 2007.

*Table 1. Improved Financial Depth, Intermediation and Capital Adequacy in the Banking Sector*

	2002	2003	2004	2005	2006	2007
Assets/GDP	76.6	69.4	71.2	81.5	86.7	87.3
Deposits/GDP	51.6	44.3	45.8	51,5	53	55
Deposits/Assets (Per cent)	64.6	62.3	62.8	61.7	61.6	61.9
Loans/GDP	22.6	21.8	25.8	33.6	39	44
Loans/Assets (Per cent)	23.3	27.3	33.3	38.3	43.8	49.1
Loans/ Deposits (Per cent)	36.0	43.9	53.1	62.0	71.1	80
Securities Portfolio/Assets (Per cent)	39.7	41.9	39.4	35.2	31.8	28.3
Non-Performing Loans/Gross Loans (Per cent)	17.6	11.5	6.0	4.8	3.8	3.5
Capital Adequacy Ratio	25.1	30.9	28.8	23.7	22.3	18.9

*Source:* various BRSA publications

The emergence of regulatory state has some positive consequences in the banking sector. The banking sector regulations set maximum exposures to interest rate, liquidity and foreign exchange risks and also limits related-party exposure. As such, NPL to gross loans ratio which was 29.3 per cent in 2001 decreased sharply to 17.6 per cent in 2002 and 3.9 per cent in 2007. Improved capital structure was among the key results of financial restructuring. Arguably, a significant improvement in the capital adequacy ratios constituted one of the most striking elements of success compared with the pre-crisis era. Consequently, the banking sector has become much more robust in terms of its ability to counteract possible shocks which became particularly evident in the context of the recent global financial crisis. In particular, the banks' capital strengthened as a direct result of the Bank Capital Strengthening Program which required private bank owners to reach 8 per cent CAR by December 2001. Against this background, one possible qualification is that the CAR will fall with the full application of the Basel II standard depending on the size of foreign currency Turkish government securities holdings which will be the 100 per cent

risk weight. The ability to attract large scale foreign capital to the sector also had a positive impact in terms of bank risk management.

### **POSSIBLE LIMITS OF THE NEW REGULATORY STATE**

The previous sections have shown that the implementation of the PWC prescriptions which included a combination of macroeconomic discipline and the establishment of the regulatory state have resulted in a significant improvement in the overall performance of the banking sector. To provide a balanced picture, however, the present section also tries to highlights some of the weaknesses of the neo-liberal restructuring during the PWC era.

#### **Privileging the Bank Capital**

*Table 2. Banking Sector Concentration, Profitability and Foreign Bank Penetration*

	2002	2003	2004	2005	2006	2007
Number of Banks	54	50	48	47	50	50
Share of top five banks in total assets	57.4	59.0	58.1	61.4	60.9	60.9
Return on Asset (ROA)	1.5	2.5	2.4	1.7	2.5	2.8
Return on Equity (ROE)	15.46	18.08	16.5	10.9	19.2	21.8
Share of state-owned banks according to equity ownership	38	38	38.2	31	28	26.1
Share of foreign-owned banks according to equity ownership	4.3	4.3	4.3	12.4	22.4	22.3

*Sources:* various BRSA issues.

Table 2 shows that new phase of restructuring in the banking sector led to interrelated phenomena: a striking increase in market concentration, foreign-owned bank penetration, declined share of state-owned banks, and high bank profitability. There were six foreign acquisitions that took place between January 2005 and March 2006. Not surprisingly, there has been a phenomenal increase in the share of foreign-owned banks according to equity ownership. Arguably, in addition to perverse financial incentives, such as high real interest rates and appreciation of the Turkish Lira, bank concentration has been one of the factors that contributed to the high bank profitability. Privatizations, mergers, and acquisitions had an important influence on this market concentration.

#### **The Limited Role of Banking Sector in Productive Intermediation**

*Table 3. Banking Sector Intermediation and Economic Growth*

	2002	2003	2004	2005	2006	2007
Real GDP growth	7.9	5.8	8.9	7.4	6.1	5.2
Savings/GDP	20.7	19.6	20.6	18.5	15.6	16.1
Investment/GDP	21.5	23.0	25.8	24.8	23.5	23.4
Current Account Balance /	-0.8	-3.3	-5.2	-6.2	-8.2	-7.4

GDP ( per cent)						
Business loans/GDP	2	2	4	4	5	8
Business loans/Total loans	16	13.1	18.9	15.0	15.1	19.9
Consumer loans/GDP	2	4	6	9	12	13
Consumer loans/Total Loans	6.6	9.0	13.1	19.1	21.6	22.8
Credit card loans/GDP	1	2	3	3	4	4
Credit card loans/total loans ( per cent)	9.1	10.9	14.3	11.4	10.0	10.3

*Sources:* Compiled and calculated from BRSA and SPO, various publications.

Table 3 shows that although there has been improvement in the private sector intermediation function of the banking sector, the sector is far from contributing to the rate of economic growth by financing productivity-enhancing innovative activities. Domestic savings and investment ratios have continued to remain relatively low by the standards of many emerging markets. Although deposit banks, with 94 per cent share in the banking sector assets, constitute the largest group in the sector (CBRT, 2007: 30), and most domestic savings are held in bank deposits, the banking community prefers mobilizing these weak savings to consumer consumption rather than productive investments. Consumer loans, such as housing and vehicle loans, and credit cards rather than business loans (i.e. working capital loans) have emerged as the key growth areas in the post-crisis era.<sup>6</sup> The combined share of consumer and credit card loans in GDP was more than double the ratio of business loans to GDP. It should be noted that credit cards have been the highest-yielding lending instrument in the banking sector (see HSBC, 2 March 2005).

The banking sector's massive concentration on consumer loans and credit cards as key profitable growth areas fuelled private consumption expenditures contributing to economic growth and the current account deficit via boosting consumption. Apart from deposits, the bank loans were funded via syndicated or securitized foreign borrowing by the banking sector. As such, there was a significant increase in total external debt of the banks from US\$11.7 billion in 2002 to US\$60 billion in March 2008 (CBT various issues). Furthermore, about one third of the bank total loans were in foreign currency or foreign currency related, whilst deposits which averaged three months constituted two third of the total bank liabilities (various BRSA issues). Thus, similar to the pre-crisis era, the banks'

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<sup>6</sup> It should be noted that banking sector loans to real sector do not always point to channelling loanable funds to productive investment. Banks may also play a significant role in sponsoring property bubble through construction credits.

assets and liabilities still exhibit maturity and currency mismatch: the duration of deposits is shorter than loan duration, whilst the banks' foreign debt is used to finance the government security and loan portfolios.

The persistence of perverse financial incentives such as high real interest rates and financial arbitrage encouraging banks to generate lucrative profits via open foreign exchange positions represents the element of continuity from the pre-crisis era. The open positions of the banking sector increased from about US\$600 million in 2002 to US\$7.7 billion in 2007. Large open positions rendered banking sector vulnerable to capital losses due to sharp increases in foreign exchange rates as it had been during the 2000 and 2001 crises.

### **Distributional Effects of the Interest Rate and Foreign Exchange Management**

*Table 4. The Distributional consequences of the new regulatory regime*

Years	Real Interest Rates (per cent)	Financial Arbitrage (per cent)	Net Bank Profits/GDP	FX Position in the Balance Sheet (In Billion Dollars)	Consumer Loan Interest Burden	Household debt stock/ Disposable income	Household interest expenditures/ Disposable income	Household financial liabilities /Assets
2002	25.22	52	0.8	-0.6	58.6	n/a	n/a	n/a
2003	27.35	26.6	1.6	0.0	60.2	8.3	2.4	7.6
2004	10.43	22.6	1.5	-1.4	41.2	14.4	3.5	13.5
2005	13.86	1.3	1.2	-1.9	26.0	21.9	3.8	22.5
2006	5.96	17.1	2	-5.5	18.1	25.5	3.8	27.9
2007	11.75	17.4	2	-7.7	17.0	28.1	4.0	35.0
Average	15.76	22.8	1.5	-2.85	36.85	19.64	3.48	21.3

*Sources:* Data for real interest rates and financial arbitrage are from Main Economic Indicators, SPO (2008). Other figures are from various BRSA and CBRT issues.

Table 4 provides useful information on why there was no notable decrease in the banking sector securities portfolio. Perverse financial incentives privileging bank capital have been preserved and remained intact in the post-crisis era. The IMF-supervised 'prudent' fiscal and monetary policies helped to sustain the privileged position of bank capital. Although inflation rates and nominal interest rates decreased, the high real interest rates coupled with appreciation of the Turkish Lira (i.e. financial arbitrage) provided lucrative environment for

the banking community by encouraging bank-based foreign borrowing. Not surprisingly, the high real interest rates were the key factor behind the increased net bank profits and consumer loan interest burden. The ratio of net bank profits to GDP increased to 2 per cent in 2007 from 0.8 per cent in 2002, whereas the ratio of consumer loan interest payments to average consumer loan debt balance averaged 37 per cent during the same period.

It should also be noted that the perverse incentives were the major factor behind a substantial increase in the foreign indebtedness of the non-financial corporations, which increased from about US\$30 billion in 2001 to over US\$100 billion, or 65 per cent of Turkey's total gross external debt stock in 2007, representing the main source for financing Turkey's current account deficit (CBRT, 2008). The banks are likely to experience asset quality problems should the availability of foreign loans to these corporations is limited in the global credit crunch.

Turkey has the worst income distribution with a Gini index of 45 per cent compared to the new EU member states average of 32 per cent (UniCredit, 2008:33). In this context, it is striking that average indebtedness of Turkish households reached 28 per cent of disposable income in 2007, suggesting a four-fold increase since the end of 2003. Not surprisingly, the household financial leverage (ratio of financial liabilities to assets) rose to 35 per cent from about 8 per cent during the same period. Between 2002 and 2007, the annual compounded rate of growth in household debt was about 50 per cent, whilst the real growth in household income was around 8.5 per cent (UniCredit, 2008: 33). Not surprisingly, during the same period, the share of the financial burden derived from consumer loans to GDP showed a phenomenal increase up to 11.5 per cent from 1.2 per cent. In other words, a considerable amount of household disposable income was transferred to the banking sector in the high real interest environment. As such, the post-crisis banking environment has negative repercussions in terms of sustainability of consumer spending driven economic growth contributing to the weak domestic savings mobilization and the rising current account deficit. Indeed, the growth rate has exhibited a falling trend since 2004.

### **Normative, Organizational and Institutional Weaknesses of the Regulatory State**

In addition to socialization of the private business failures, the implementation of this new regulatory framework in the absence of strong normative (i.e. risk management culture and rating based approach), organizational and institutional infrastructure implanted potential future regulatory and supervisory failures. Specifically, Basel II with risk-based model is about market-based approach to measure and manage financial risks. However, the newly established BRSA had a limited capacity to monitor risk management procedures and practices (i.e. risk models) utilized by banks in the new regulatory environment. When it started its operations, the BRSA did not have regulatory expertise on measuring, supervising, and regulating financial risks. Moreover, most of the banks did not have their own risk management systems either. As such, risk management culture was lacking among public and private sector actors. This normative dimension and institutional backwardness was the legacy of the 1990s shaped by perverse financial incentives (i.e. high real profits derived from the default free government securities portfolio) and the absence of effective regulation. Neither the BRSA nor the domestic banks in Turkey had sufficient experience with and knowledge about this new regulatory institutional structure as there was no credit-rating tradition in risk assessment. Hence, it was not surprising that in 2005, there were five banks only whose assets were adapted to Basel II at advanced-level, whilst 17 banks had medium-level and 27 banks had beginning-level adaptation (BRSA, 2005). There were five banks which did not have any progress in this respect. Consequently, the implementation of Basel II was postponed from 2008 to 2009. It should be noted that Turkish banks with foreign participation did not face significant costs of adaptation to Basel II as they benefited from support and oversight in internal control and risk management.

Establishment of legally independent regulatory agencies does not necessarily lead to a strong regulatory state in the banking sector. The emergence of the regulatory state requires *actual* independence of such agencies from powerful political and societal influences as well as effective coordination and collaboration, and the existence of institutionalized conflict resolution mechanisms among these agencies. The failure of Imarbank in August 2003 exposed such weaknesses of the regulatory state (see Bakir, 2006:190-192).

### **Distributional Effects of the Regulatory State**

The new regulatory environment favoured foreign owned-banks and their local partners more than households and certain sections of real industry, especially the Small and Medium-sized Enterprises (SMEs), which nevertheless continued to bear the distributional costs of the transformed regulatory environment. The SDIF-led nationalization process was a means of socialization of private business losses. The key point to emphasize, therefore, is that the move towards a regulatory state was process with major income distributional consequences. The financial cost of the crisis in 2001 was US\$47.2 billion in taxpayer's money, with capital support provided to banks to rehabilitate the banking sector (SPO, 2004: 72). The cost constituted 32 per cent of GDP in 2001. The SDIF held the biggest portfolio of NPLs in Turkey. The amount of funds injected into the SDIF banks reached US\$27.8 billion in 2004 (SPO, 2004: 73). By the end of 2007, the financial cost of SDIF bail-out reached over US\$60 billion where the SDIF collected only US\$16 billion (*Sabah*, 14 December 2007).

The IMF lending in the post-crisis era was based on the condition that foreign bank loans locked in the Turkish banks covered by the Treasury guarantee (IMF, 2000). As such, foreign banks recovered US\$5.4 billion and did not bear the cost of the crisis. Further, the emergence of the regulatory state facilitated foreign bank penetration into the Turkish market. For example, between 2002 and 2007, the bank consolidation exhibited nationalization of failed banks via tax payers' money and their subsequent sale to domestic banks, which were later taken over by foreign banks.

One of the major limitations of the regulatory state in the PWC era was that there were no major attempts to minimize the costs of adapting to a new model of risk management negotiated at the global level by the powerful foreign bank capital. The SMEs were the key actors whose interests were excluded; however it was them who had to bear the distributional costs of the regulatory change. The SMEs constitute 98.8 per cent of about 2 million enterprises in Turkey with 45.6 per cent and 37.7 per cent shares in employment and production, respectively (Yaşar and Topçu, 2008). However, the SMEs have been hit hard in the new bank regulatory environment. This is because they do not

have credit rating tradition and have a weak capital base. As such, their access to bank loans is limited due to higher costs.

Another major weakness of the emerging regulatory state in banking sector has been its focus on prudential regulation only, ignoring consumer protection and competition regulation. Fundamental to competition regulation in the banking sector are measures designed to prevent overpricing of products and under-provision of banking services fundamental to economic growth. The highest-yielding lending instrument of the banking sector has been credit cards.<sup>7</sup> Thus, the regulatory capture was most visible in the credit card market regulation by the BRSA and the Central Bank. The number of credit cardholders increased from about 22.5 million in 2004 to 28 million in 2007, whilst the number of people who defaulted on the credit card debt increased from about 412 thousand to over 1 million during the same period (*Milliyet*, 12 May 2008). There have been two major sources of regulatory failure in credit card lending as the NPL ratio in credit cards increased sharply from 4.9 per cent in 2002 to 8.3 per cent in June 2006 (BRSA, 2006: 51). First, the BRSA failed to exercise its bureaucratic autonomy from private banking interests in regulating the credit card market. Before the new credit card law, which became effective in 1 March 2006, common international practices in the credit card operations had been ignored. For example, cards were issued by banks without the permission of the holder, there was no payment control system to prevent late and non-payment, and more significantly, banks charged extremely high interest on the portion of the credit card debt that was not paid on a compound basis. Second, the Central Bank, which is the sole authority determining the monthly maximum interest rate and the monthly maximum default interest rate to be applied for credit card transactions, set rates well above its year-end inflation targets. In this environment, in 2004 for example, annual interest yields of the largest four private banks for credit cards were above 100 per cent, whereas deposit rates, bond yields, and consumer loans were about 17 per cent, 18 per cent and 23 per cent, respectively (see HSBC, 2005: 5). The sumptuous margin between deposit rate and credit card yield also points to the banks' exercise of power over customers in the oligopolistic market structure.

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<sup>7</sup> For a review of the credit card market and its regulation, see Aysan and Yıldız (2006).

## **CONCLUSION**

The Turkish banking sector is relatively stronger than it had been prior to the 2000-2001 to cope with global credit crunch: foreign exchange and interest rate risks have been minimised, asset quality (3.5 per cent NPL ratio) and capital structures (18.9 per cent CAR) have been improved considerably. This is partly due to a progress towards regulatory state in the realm of banking: the new banking law was introduced; BRSA as independent banking regulation agency was established; risk management mechanisms were strengthened; the SDIF was empowered and emerged as a key bureaucratic agency in the nationalization, rehabilitation and privatization of insolvent banks.

Turkey's encounter with the novel logic of the PWC dates back to the IMF program of 1999. The Turkish experience with the PWC has been the product of multilevel governance following 2001 financial crisis which enabled policy. What is interesting here is the manner in which the crisis helped to change the balance of power between the external and domestic actors, which was critical to the process of generating space for the relatively autonomous action of the new regulatory agency. The policy entrepreneurship helped to dismantle the previous rent-seeking coalition with a new pro-regulation coalition while socializing the costs of bank failures and privileging the interests of bank capital via interest rate and foreign exchange management, and the restructuring of the banking sector. We argue that in the absence of such a parallel development at the domestic level, the power of the key external actors to push for the regulatory state would have been considerably limited.

Another interesting observation from a comparative perspective is that the new wave of regulatory reforms improves the performance of the banking sector. Yet, there also exist clear limits to the degree of improvement that takes place. From a developmental perspective, one of the obvious limitations of the new environment is to make a sufficient contribution to the financing of the real economy, whilst a considerable amount of household disposable income was transferred to the banking sector. The SMEs, which do not have credit rating tradition and have a weak capital base, have limited access to credit. This clearly highlights the fact that the emergence of the regulatory state in line with the new logic of the PWC does not simply correspond to a technical issue of economic management but embodies serious distributional consequences.

Financial interests occupy a privileged position in the new transnational pro-regulation coalition, and foreign banks become progressively dominant actors. Parallel to the emergence of the pro-regulation coalition is a significant reconfiguration of power relations. The primary regulatory interest of the pro-regulation coalition in banking sector has been on the convergence of the prudential regulation toward international standards, which facilitates penetration of international bank capital into the developing country banking sector through mergers and acquisitions. However, consumer protection and competition regulation in the banking sector, which were of vital public interest, were not in the agenda of the pro-regulation coalition. Arguably, the PWC represents a new phase of privileging and advancing the interests of international bank capital via selective regulatory arrangements. Hence, the move toward a 'regulatory state' is an intensely political process. Finally, what is also significant is that rent-seeking elements may persist in the new pro-regulation coalition, which may limit the degree of progress achieved with respect to the degree of effective regulation exercised over the banking system. In the Turkish context, new kinds of regulatory failure are evident in the inability to control consumption-oriented lending by commercial banks with its costly consequences for sustainable economic growth.

These observations, in turn, bring us back to the question of the WC versus the PWC. Our analysis points towards an interesting paradox. The new era is characterized by a process of rupture from the previous era as well as by certain striking continuities. We should not exaggerate the degree of rupture experienced in the PWC era given that the privileged position of bank capital, for example, had also constituted an integral element of the WC era. Some of the key elements of the previous era carry over into the new phase and clearly put certain constraints on the effectiveness of the new regulatory environment from the perspective of financing the real economy, achieving a balanced allocation of credit, and creating a strong foundation for sustainable, crisis-free economic growth.

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