



## **Impact of Shocks on the Development of Turkish Banking Industry**

Özlem Olgu, PhD

*College of Administrative Sciences and Economics, Koç University, Istanbul, Turkey*

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### **Abstract**

*Shock concepts have been studied in the literature to identify their impact on the development of various industries. Banking industry particularly in a developing country context seeks more attention as there has certainly been a close association throughout most of their shared history. This paper, therefore, aims to illuminate the impact of industry specific, country specific and international shocks on the development of Turkish banking industry since its existence from the period of Ottoman Empire until today's modern Turkey (1299-2013).*

**Keywords:** *political instability; banking industry; shock concepts; Turkey; Ottoman Empire*

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### **1. Introduction**

The rise of the service sector as an economic driver of growth has attracted an increasing level of interested body of research, whether as an aggregate study of different service sectors or studies of an individual sector. Factors driving the growth or decline of the service industry, banking and finance, tourism and retailing sectors have also been widely studied to examine this relationship. Within this context, shocks as a concept has been explored to illuminate the exogenous factors that is unexpected and unpredictable events, surrounding an organisation, industry or the economy that are instrumental to their growth or demise.

Previous research (Quek, 2011; Burt, 2010; Collier and Hoeffler, 2004 and Elbadawi and Hegre, 2008) studied the influence of various shocks on different industries in developed countries and regions including the UK, the United States (US) and the European Union (EU) countries. However, there is a dearth of research looking at the influence of shocks on banking industry in a developing country context. This paper therefore seeks to examine a number of shocks and their impact on the Turkish banking industry since its existence from the period of Ottoman Empire until today's modern Turkey. This study focused on shocks upon three categories as industry-specific, country-specific and

international. By doing so, it is hoped that this paper will propose several contributions to the business history literature by taking a historical and evolutionary perspective to our understanding of influence of shocks on the development of a banking industry.

This paper studied the Turkish banking industry because of several reasons. Firstly, there is a dearth of research about Turkey as an emerging economic power. This is interesting given that Turkey is at the crossroads of Europe, Asia and Africa; one of the biggest emerging financial markets of the developing world and also a country of transforming economies in Central and Eastern Europe promising to offer unique contribution to the existing business history literature (De Bonis et al., 1999). Secondly, the findings of this paper demonstrate that Turkey has a very dynamic history. This history is so vibrant with economic, political, socio-cultural and technological changes that it is inevitable to separate Turkish economic and banking industry development from history of the country. It could be even argued that historical heritage of Turkey is one of the key determinants of its banking industry development. It is important to emphasize that Turkey and Turkish Banking industry have evolved from economic and political chaos to an emerging power with many lessons to be drawn for today's world, in particular for the political and economic systems of Middle Eastern countries including Egypt and Syria.

Thirdly, financial progress since the 2000-01 twin crises, enforcement of internationally accepted banking regulatory and supervisory standards, for instance Basel I and II, as well as macroeconomic reforms increased stability and trust in the country. The last months of 2008 witnessed the worst global financial crisis since the Great Depression of 1929–1930 and major world markets as well as a number of the US and the EU banks declared massive losses which had considerable reflections in Turkey, although to a rather limited extent. It is interesting to identify the reasons behind the relatively limited negative effects of this international shock on the Turkish banking sector.

## **2. Chronology of Banking Development in Turkey**

### *2.1. Period from the Ottoman Empire to the Turkish Republic (1299-1922)*

As predecessor of modern Turkey, Ottoman Empire was at the centre of the main trade routes between the Eastern and Western worlds during the 1299-1922 period. By developing commercial centres and routes, the state performed basic economic functions in the empire. But in all this, the financial and political interests of the state were prevalent and the Ottoman administrators could not have realized the dynamics and principles of the capitalist economy of the Modern Age.

In spite of being a world economic power for such a long time, the introduction of banking business to Ottoman's occur much later than Europe. Establishment of the first bank in the Ottoman Empire dates back to 1847, which coincides with the introduction of first banknote named *Kaime* in 1840. Prior to this period, all banking activities were predominantly carried out by moneychangers and the so called "Galatia bankers" who were mostly from the minorities

of Jewish and Armenian of Istanbul. Moreover, the Ottoman Empire was experiencing continuous budget deficits during this period. In an attempt to solve this problem the Ottoman Treasury increased the amount of national currency, and as a result, the value of *Kaime* faced a sudden devaluation<sup>a</sup>. With an aim to preserve the value of national currency and help financing the trade deficit in international financial markets, the first recorded official bank of the Ottoman Empire, Istanbul Bankası, was formed by the Galatia bankers, which was closed later on in 1852.

In fact, the first significant bank of the Empire, the Ottoman Bank, was established in 1886 as a joint venture between British interests, the Banque de Paris et des Pays-Bas of France, and the Ottoman government. The bank, which had its head office in London, began to serve as the central bank of the empire's financial system and was also granted the authority to print money in 1963. In addition, the Ottoman bank was given authority to supervise the government budget, and the Ottoman treasury not only held all its accounts in the bank, but also issued all bonds concerning its domestic and foreign borrowing through the bank.<sup>b</sup> However, according to Akguc public had no confidence on the money printed by the Ottoman Bank and the bank could not pursue an effective role defining the liquidity and credit volume of the economy due to previous sudden devaluation of the national currency.

In general the financial needs of Ottoman Empire have changed considerably due to deterioration of financial system after the Crimean War, which led to a dependency of external support. As a consequence, a large number of foreign banks started to operate in Istanbul with the purpose of extending credits to the Empire at high interest rates. Majority of banks within the Turkish financial system during this first phase of banking were established by foreign capital. The main function of these banks was to earn speculative profits from foreign exchange transactions and domestic and foreign borrowings of the Ottoman governments in addition to give investment credits to foreign investors.<sup>c</sup> On the other hand, the existing banks were funding mainly the treasury.

Even though progress had been achieved in the financial system during this period, there was a lack of financial institutions to support local farmers, which constituted the majority of population and also economic activity. In order to fill this gap and extend agricultural loans to farmers through state supervision, a state fund was established in 1863 which was converted into the first state bank, Ziraat Bankası, in 1888.

As a reaction to foreign banking, a national banking movement started in the Ottoman Empire during early 1910s and twenty-four national banks were established with national capital in Istanbul and Anatolia over the years 1908 and 1923. These national banks, privately owned by tradesman and farmers, were extending loans for commerce, agriculture, trade and housing. Once again, Akguc suggested the main reason for the establishment of national banks as to take control of national capital from the banks owned by foreigners and minorities and utilize these funds in promoting and developing national trade. Despite the supportive national economic policy followed by government most of these banks could not last long due to powerful competition of foreign banks. Moreover, as a result of the

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<sup>a</sup> Banks Association of Turkey. 'In its 40th year the Banks Association of Turkey and Turkish Banking System'.

<sup>b</sup> Banks Association of Turkey. 'In its 40th year the Banks Association of Turkey and Turkish Banking System'.

<sup>c</sup> Banks Association of Turkey. 'In its 40th year the Banks Association of Turkey and Turkish Banking System'.

consecutive wars (1911–1922), capitulations granted to foreigners and scarcity of national capital, foreign banks continued to dominate banking activities.

The following years were a milestone for the history of Turkish banking when the Turkish Republic was established in 1923 from the ruins of the Ottoman Empire. Following the founding of Turkish Republic, policymakers mainly focused on promoting and establishing industrial manufacturing and support private entrepreneurship by the development of national banking sector to provide the necessary financial instruments for investors. As indicated by Akguc, in 1923 the formal financial system comprised of 35 banks, of which 22 were Turkish owned and 13 were foreign owned, with a total number of 439 branches. Most of these foreign banks only dealt with foreign trade and foreign companies operating in Turkey and their involvement with Turkish firms was limited. On the other hand, Turkish-owned banks were mostly small local banks and were too weak to support the newly emerging industry and commerce.

## *2.2. 1923-1980 Period*

Turkey was formally announced as a republic in 1923, with Atatürk being its first president and served until his death in 1938. During the 14 years of Atatürk's presidency, the country underwent a great transformation, which attempted to change the religious, social, and cultural bases of Turkish society as well as its political and economic structure. The economy in early years of the Turkish Republic was once again mostly dominated by foreign capital. Economic policies, introduced and implemented in the first years of the Turkish Republic were to create agricultural and industrial consensus in cooperation with the state and individual enterprises. During this period, policymakers mainly focused on promoting and establishing industrial manufacturing and supporting private entrepreneurship by the development of national banking sector to provide the necessary financial instruments for investors. However the lack of national capital enabled the private sector to a set up banking sector and state participation for the establishment of national banks became a necessity.

The first main bank of this era was Türkiye İş Bankası, established as a joint venture between the state and private initiative in 1924, with the main aim of supporting commerce. Later in 1925, Türkiye Sanayii ve Maadin Bankası<sup>d</sup> was founded as a development bank to provide loans to private industrial companies and also to provide know-how in economic, financial and technical matters. Government also strengthen Ziraat Bankası by injecting capital and widen its operation outside the agricultural sector. Another major bank, Emlak ve Eytam Bankası<sup>e</sup> was established in 1927 to provide housing credits.

Denizer (1997) states that parallel to its broad strategy of industrialization via private sector encouragement, the Government's regulatory approach to banking and finance was quite liberal and aimed at developing a national banking system during 1923-1932. While the government provided the initial capital for four public banks and lead development efforts, it allowed and actively encouraged the formation of private banks. As a result, 29 new private

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<sup>d</sup> Subsequently changed its name to Türkiye Sanayii ve Kredi Bankası.

<sup>e</sup> Later on changed its name to Emlak ve Kredi Bankası.

banks and the central bank of Turkey were established during this period and there were practically no restrictions for entry to the banking sector.

By 1932, the number of banks reached to 60, of which 45 were national and 15 were foreign. According to Denizer (1997), the important aspect of this period for banking was the creation of new public banks to provide support for the new state enterprises. Accordingly, during this period, Sümerbank in 1933, Belediyeler Bankası in 1933, Etibank in 1935, Denizbank in 1937 and Halk Bankası in 1938, were established by state as special purpose banks in order to support and fund the state led enterprises. Sümerbank was providing the main funding to enterprises in manufacturing sector while Etibank was set up with the aim of managing and financing the enterprises in the field of mining and energy. Belediyeler Bankası was extending credit to municipalities for development of infrastructural services such as water, electricity, and drainage system. Denizbank was established to construct maritime enterprise and finance their investments while Halk Bankası were predominantly supporting small tradesman. During 1944-1960, 27 private and three public banks were established. Some of the largest private banks of today's banking system were founded during this period such as Yapı ve Kredi Bankası in 1944, Garanti Bankası in 1946, and Akbank in 1948. The development of the banking system in Turkey can be divided into two base periods as before and after 1980.

Beginning of 1980s was a period of liberalisation and establishment of free market economy model in Turkey. Together with the removal of capital account controls, Turkey adopted flexible exchange rate and positive real interest rate policies. These measures reflected to the banking sector as removal of interest rate controls. Turkish banks started to establish banks or open branches outside the country and increased their business on foreign trade, leasing, factoring, forfeiting, being intermediary in export of securities, and short-term credit operations and increased financing from international markets. Besides diversifying their services, banks improved their technological infrastructure by extensive use of computer systems; began employing more qualified human resources; and at the same time put an emphasis on training programs.<sup>f</sup>

In order to increase the speed, quality and efficiency of the banking services, the banking system has undergone a rapid technological transformation in the 1980s. Over this period, the Turkish economy, like many of its peers in developing world, was characterized by heavy regulation, protection from foreign competition, and extensive state involvement in commercial activity. Turkey's relatively poor growth performance and high inflation during this period convinced many that a new paradigm was needed, and a comprehensive reform program was launched under the government of Turgut Özal in the early 1980s. But the impact of reforms was ultimately undermined by poor financial discipline and fractious political environment in the country. During the 1980s and 90s, Turkey had 15 governments, 10 of which were coalitions or minority governments. Agreeing on and sticking with the difficult policy choices that were needed, especially on the budget, proved to be impossible in this setting. The result was chronic budget deficits, financed in part by printing money, leading in turn to inflation in the 30–50 percent range throughout the 1980s.

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<sup>f</sup> *Previously called the State Investment Bank.*

### *2.3. 1980 – 2000 Period*

In 1983 democracy was restored again with democratic elections and the 1983-1989 period was relatively stable where Turkey experienced export led growth and financial liberalisation. Due to loosening of entry restrictions with the reforms, there were 31 new entries into the banking system between 1980 and 1990, of which 19 were foreign and 11 were national. Denizer (1997) emphasized that almost all of the new banks were specializing in trade finance and wholesale corporate banking. None of the new banks, foreign or Turkish, established offices beyond the three largest cities, and by and large they eschewed the retail banking market despite the fact that there are no restrictions on the scope of their operations.

One of the most significant occurrences of early 1990s was the financial crisis of 1994 which had significant adverse effects on banking system in Turkey. Due to chronic high inflation, the level of dollarization increased in the Turkish financial system prior to 1994 crises. After 1994 crises, the closed foreign exchange positions reopened and borrowing from abroad started. In addition to the fragility of private banks, public banks started to create major distortions to the financial system. In their paper, Alper and Onis (2001) argued that aftermath of the 1994 crisis public banks have created an uneven playing field in the banking sector due to the fact that both their borrowing and lending operations have been politicized. According to them, these institutions have emerged as major instruments of rent distribution in the political process and directed lending at subsidized rates to favored sectors has in part heavily undermined their capitalization, liquidity and profitability.

Following, the introduction of the three year stabilization program with International Monetary Fund (IMF) support has significant implications for the Turkish banking sector in 1999. Firstly, a new Banking Law went into force introducing the establishment of BRSA. This decision-taking authority independent from the political influence had administrative and financial autonomy aimed at the more efficient use of supervisory power. BRSA became the sole authority for licensing, regulating and auditing of banks. Previously the duty of regulating financial markets shared between the Treasury and Central Bank. The staffs working at banking evaluation and supervision departments in the Treasury and the Central Bank was transferred to the BRSA and the saving deposits insurance fund (SDIF) became a legal entity administered by the BRSA.

According to Alper and Onis (2001), establishment of BRSA constituted a major source of progress in terms of establishing a well-regulated banking sector, which is a fundamental requirement for full capital account openness. However, the operation of the BRSA has been subjected to significant delays and the institution was not in a position to prevent the twin crises, which were very much associated with a malfunctioning banking system. Another main aim of the new Banking law was to parallelize the Turkish banking regulations with Basel II and EU directives. In general the new law introduced tighter risk management and control, introduction of supervision, and new principles in the calculation of capital adequacy ratio and foreign exchange exposure limit.

Soon after the agreement and establishment of BRSA, open positions of the banks were limited. However, the limitation of forward foreign currency transactions were not welcomed by foreign investors since it was claimed to

decrease liquidity and the domestic banks started to struggle for closing their open positions in tune with new regulations. Decrease in the short-term interest rates, change in taxation of capital gains and withholding tax brought to banking transactions, and Russian financial crisis's impact on investor behaviour towards emerging markets have all tightened the business of the banks prior to 1999.<sup>5</sup>

#### *2.4. Post 2000 Period*

In December 1999 the Turkish government launched a comprehensive belt-tightening program with the help of an IMF supported three-year agreement in order to bring down inflation and reduce the already unsustainable level of public debt. The program appeared to be on course until fall 2000 and enjoyed wide public support. However, in November 2000 the overall mood rapidly deteriorated with the emergence of a serious crisis. In a matter of days interest rates soared, billions of dollars fled the country and Turkey was faced with exceptionally high costs to borrow from abroad. Following a few months of relative calm, another crisis erupted in February 2001 in the immediate aftermath of a harsh political quarrel between Prime Minister Ecevit and President Sezer.

As in most other episodes of financial crisis, the fluctuating Turkish lira witnessed a free-fall, interest rates rose sharply and the economy contracted at an unprecedented rate. Kemal Dervis, a vice president of the World Bank, was given the helm of the economy as a non-political/technocratic minister in charge of the economy. However, Dervis failed to lead a political movement despite the strong winds behind him. In the summer of 2002, at a time when the program had yielded some positive results, the coalition government risked calling for early elections. At this time, Dervis decided to join the opposition Republican People's Party (CHP). Subsequently, AKP, a party established just a year earlier and led by Recep Tayyip Erdogan, a former mayor of Istanbul, won the elections in November 2002, yielding AKP an overwhelming majority in the parliament.

The early general elections on 3 November 2002 dramatically changed the political climate in Turkey. The established single-party government contacted the IMF to make minor changes in the programme. Large IMF loans tied to the implementation of ambitious economic reforms enabled Turkey to stabilize interest rates and the currency as well as meet its debt obligations. In 2002 and 2003, the reforms began to show results. With the exception of a period in the run-up to the Iraq War, inflation and interest rates have fallen significantly, the currency has been stabilized and confidence has begun to return.

In 2002, the EU's refusal to set a date for the start of negotiations for Turkey's membership caused major disruptions between the EU and Turkey's relationship. Cyprus, who became an EU member in 2004, was still a main issue between Turkey and EU. Turkey's ties with US also weaken for the first time since 50 years when the Turkish parliament refused to grant the US permission to invade Iraq from bases located in Turkey.

After serving for five years, AKP won the elections in 2007 with a greater majority of votes (47 per cent). One of the factors for such a strong representation was the aforementioned economic growth experienced as a consequence of

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<sup>5</sup> *Banks Association of Turkey. 'Banks in Turkey Report 1999'.*

implementation of delayed structural macroeconomic reforms. However, although a good economic performance was achieved, the political background of AKP and its PM have led to concerns about a background Islamist agenda which the party is accused to follow in secret. AKP's policies such as easing the ban on the wearing of a Muslim headscarf in public institutions and efforts to criminalize adultery are shown as a proof of such agenda. These conflicts on secularism between the two sides of the Turkish society are yet to create other conflicts that have a potential to lead more political instability within the country.

Overall, since 2002 the outstanding performance of the Turkish economy and political stability had positive impacts on the banking sector. As credibility increased in international markets, banks' borrowing capacity abroad led to growth in banking sector. All these positive economic and regulatory developments increased foreigners' interest on banking sector and during 2005 and 2006 a significant number of foreign banks increased their shareholdings in the Turkish banking sector. Most of the deals were between large and medium size Turkish banks and leading banks in the global arena mainly with European origin. Turkey attracted a historical amount of investments from foreigners since 2001 and a significant amount of this flow is directed to the banking sector (around USD 14 billion), where several foreign banks increased their shareholdings through acquiring majority shares in locally established banks.

The earliest entrant to the Turkish banking sector was HSBC, which started its financial activities in 1990 and later on named as Midland Bank Inc. HSBC expanded its operations in Turkey through the acquisition of Demirbank in 2001, which was the 5th largest private bank in Turkey during that period. In 2002, the 50/50 shareholder partnership agreement between Koçbank, the 6th largest private bank at the time of the deal, and UniCredit of Italy, one of the Europe's largest banks, was the first foreign partnership established in the Turkish financial sector. In 2005, Koçbank/UniCredit joint venture bought majority share of Yapı ve Kredi Bankası, one of the largest and well established private bank, as the biggest merger project in the history of Turkish banking. Following, UniCredit, BNP Paribas bought 50 per cent stake in Türkiye Ekonomi Bankası (TEB) while Fortis of Benelux acquired 89 per cent of Dışbank, a privately owned medium sized bank. The largest deals in terms of value were those of Citigroup, National Bank of Greece (NBG), Dexia Bank of Belgium and General Electric Capital Corporation. Both US based financial institutions, Citigroup and GE Capital Corporation, preferred to be minor shareholders and strategic partners of Akbank and Garanti Bankası.

It is observed that most of the foreign entrants have been banks of European origin, which might be due to the expectations of positive negotiation talks between the EU and Turkey. In fact, Turkey has been an EU associate member since 1963 when the parties signed the 'Agreement Creating an Association between the Republic of Turkey and the European Economic Community'. Later in 1987, Turkey made a formal application to join then called European Community. In 1995 the integration of Turkey into Europe went one step further with the Customs Union agreement signed between the two parties. Eventually in 1999 Turkey was officially recognised as a candidate for full membership with other potential candidates and later in 2005 Turkey was declared an EU Accession Country and negotiation process officially started.



Moving onto recent periods, the global crisis of 2008 surfaced at a time when the Turkish economy was already showing signs of changing direction from its earlier path, as demonstrated by a slowing economic activity since the second half of 2006 and rising unemployment. The fact that the Turkish financial system and banks were immune from the risky derivatives business as well as being highly capitalized and closely supervised saved Turkey from the initial waves of the subprime toxic assets tsunami. Moreover, not only the high capital adequacy ratio, high asset quality, low currency and liquidity risks, successful risk management and effective public supervision of Turkish banks but also measures taken by the Central Bank of Turkey (CBT) and BRSA against the increase in global financial risks helped the banking sector to maintain healthy functioning.<sup>h</sup>

### **3. Shocks Affecting Turkish Banking Sector**

#### *3.1 Industry Shocks*

##### *3.1.1. Deregulation and Liberalisation (1980)*

The financial system in Turkey has gone through an extensive structural change resulting from regulatory reform and technological innovations over the last 30 years. Ozer states that prior to the 1980s, the financial system was characterised with important restrictions such as controls on price and volume of business conducted by financial institutions as well as allocation of funds among borrowers. Edey and Hviding emphasize these regulatory restrictions that repressed Turkey's financial system to serve a number of social and economic policy objectives of Turkish governments.

Turkey liberalised its financial sector through deregulation of interest rates and removal of entry restrictions in 1980 (Denizer, 2001). As a consequence of development of offshore financial centres, rapid technological and macroeconomic developments, Turkey took the first step towards liberalisation of the financial system by increasing the interest rates on personal time deposits in June 1980 (Akyuzi 1980). The overall programme of structural adjustments is known as the '24 January decisions'.

Besides the liberalisation of interest rates and foreign exchange regime in 1984, there were other developments regarding the banking system in Turkey during 1984. Firstly, a uniform accounting and reporting system was developed and an independent external auditing mechanism was established to increase the soundness of the banking system. Secondly, foreign banks were allowed to open branches with the same rights as Turkish banks which resulted in a significant increase in their number and brought a fierce competition in the banking system (Akkurt et al., 1992).

Miskin (2006) pointed out that the worst effect of financial liberalisation in Turkey was the financial crises. Dominance of public banks, insufficiency of deposits and loans, high level of duty losses of public banks, increase in open positions, lack of control and political problems related to the government have all played important roles in macroeconomic fluctuations in 1980s. This situation combined with financial distress in real sectors led to the collapse of six banks during 1983 and 1984. Moreover, Turkey could not cope with this financial turbulence and at the same

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<sup>h</sup> *Justice and Development party is mainly formed by the members of previously banned Islamic parties.*

time satisfy the economic criteria of the EU which resulted in signing the economic recovery program with the IMF in 1999. Following, the economy and financial system experienced two consecutive crises in 2000 and 2001, known as the twin crises.

### *3.1.2. Foreign competition*

Foreign bank existence in the Turkish banking sector can be categorised in three stages. Stage 1 is the Ottoman to Turkish Republic period (1299-1922) when many foreign banks were active in the sector. Stage 2 is the period of national bank development (1930-1980) where number of foreign banks decreased considerably and finally Stage 3 is the post 1980 period, period of market economy when foreign banks started to re-enter the sector once again. Getting into details, prior to foundation of the Republic, Turkish banking system was dominated by foreign banks. When the Republic was established in 1923, there were 35 banks operating in Turkey, 13 of which were foreign owned accounting for 50 per cent of total deposits. While foreign banks dealt mainly with foreign trade and foreign firms, Turkish banks were thought inadequate to provide for the credit needs of the domestic economy.

During this period the credit market was not developed enough and being dominated by foreign banks was considered a major economic problem, and development of national banking was regarded as a necessary condition for promoting industry and trade. Although number of foreign banks increased during early years of the Republic, their number decreased continuously starting in the 1930s. Negative effects of the 1929 world recession on Turkey's foreign trade and changes in Turkey's economic policy and foreign exchange controls after the 1930s resulted in limitations on the operations of foreign banks in Turkey.

Between 1963 and 1980, only two new commercial banks, Amerikan-Türk Dış Ticaret Bankası in 1964, and Arap-Türk Bankası in 1977, were established which demonstrated the existence of strong regulatory entry barriers. On the other hand, 23 banks were either liquidated or merged, which reduced the number of banks to 43 by 1980 from 59 at the end of 1959. Another characteristic of this period, particularly in early 1970s, has been the emergence of private banks owned by industrial groups, which Akguc refers as the beginning of holding banking in Turkey.

In 1980, Turkey started to take steps towards transforming itself into a market economy with financial liberalization being a central ingredient of the process. The establishment of new commercial banks was permitted and number of foreign banks underwent renewed growth. The sector experienced growth due to new entries and expansionary policies of the existing institutions. While concentration ratios declined considerably, the sector continued to exhibit properties of monopolistic competition, and large state-owned banks continued to be dominant in the system.

Opening the banking system to foreign competition was considered as an important component of increasing competition in the sector. Foreign banks that entered in the 1980s, however, were not 'classical deposit banks'. They targeted foreign-trade-related activities and did not compete with domestic banks in traditional banking activities (Akguc, 1987). However, Pehlivan (1996) illustrates that despite their small scale of operations, entry of foreign banks was instrumental in motivating domestic banks towards modernizing themselves as they brought in new services, advanced technology and market oriented management techniques into the sector.

In order to strengthen the banking system, some modifications were introduced to the Banking Law in 2005. These included changes to permissions and authorization for bank licences and activities, increase in minimum capital requirements and transparency of financial institutions, introduction of new corporate governance principles for financial sector, limitations on loans to risk groups, strengthening internal and external audit mechanisms, and introduction of minimum liquidity adequacy requirements. Even though, the share of foreign banks in terms of total assets in the banking sector has been stable around 3 per cent during the 1990s and early 2000s, FDI wave observed in the financial sector have increased the level of foreign ownership with a controlling share to 33 per cent of total assets in 2006. Furthermore, banks' assets that have a significant amount of foreign shareholding, between 10 and 49 per cent, have risen to 23 per cent of total banking sector assets in 2006, where in 2003 such foreign influence did not exist.

Overall, since 2002 the outstanding performance of Turkish economy had positive impacts on the banking sector. Furthermore, as credibility increased in international markets, banks borrowing capacity abroad led to growth in banking sector. Total asset size of the sector was USD 347 billion in 2006, displaying a 167 per cent increase from 2002. Total number of banks (including investment banks) in the system, however, dropped to 46 in 2006 from a record number of 79 in 2005. Loan portfolios of banks increased significantly after the 2002 crises, from 26 per cent of total assets to 46 per cent in 2006. All these positive economic and regulatory developments increased interest of foreign investors on banking sector and during 2005 and 2006 a significant number of foreign banks increased their shareholdings in Turkey.

### *3.1.3 Oil price shock (1973)*

The oil price shock of 1973, which had shaken the world economy, also affected the developing Turkish economy mainly as a result of high costs of oil imports, which led to high inflation, energy bottlenecks, foreign exchange (FX) shortages, unemployment, and budget deficit. In order to increase economic growth rate, governments considered substantial state investments. However, Altunbas et al. suggest that this policy caused instability in the Turkish economy despite high growth rates observed between 1973 and 1977 since the consumption had not been limited. During this period, the gap between national savings and investments widened together with an increased trade deficit, both of which led to a sharp increase in budget and current account deficits. Thus, external debt crisis became inevitable in 1978, which has resulted in financial distress and bankruptcies.

## *3.2 Country Specific Shocks*

### *3.2.1 Establishment of Turkish Republic (1923)*

After founding of the Turkish Republic in 1923, policymakers mainly focused on promoting and establishing industrial manufacturing and support private entrepreneurship by developing the national banking sector to provide necessary financial instruments for investors. Lack of national capital enabled private sector to set up banks to support industrialisation and state participation for the establishment of national banks became a necessity.

Denizer (1997) argued that, during 1923-1932, parallel to its broad strategy of industrialization via private sector encouragement, the Government's regulatory approach to banking and finance was quite liberal and aimed at developing a national banking system. While the government provided initial capital for four public banks and lead development efforts, it allowed and actively encouraged the formation of private banks. As a result, 29 new private banks, mostly single branch and local and the current central bank were established and there were practically no restrictions for entry.

By 1932, number of banks reached to 60, of which 45 were national, up from only 13 in 1923, and 15 were foreign. According to Denizer (1997), the important aspect of this period for banking was creation of new public banks to provide support for new state enterprises. Although there was no significant change in the Government's regulatory policy in this period, there was no entry into the system. In fact, this period was characterized by the exit of small private local banks due to the economic slowdown in Turkey resulting from the global economic crisis and advent of the Second World War. In turn, these developments reduced number of private banks and increased dominance of public banks in the sector.

### *3.2.2 Military interventions (1960, 1971, 1980, 1997)*

A significant feature of Turkey since 1960s has been the instability in politics, which directly led to failures in macroeconomic policy, leading to financial and economic crises. Over these 50 years, Turkey has seen four military coups and 41 different governments which served on average a 1.4 years each. Moreover most of these governments were formed by several parties from different political ideology as a coalition which made it complicated to pursue consistent policies. Political stability, where single party governments ruled, was only stored for limited time periods. Turkish politics can be attached to populist policies, large budget deficits, moral hazard problems and high foreign and domestic debt. These features coupled with high real interest rates, persistent high inflation and devaluation of currency, large current account deficits and volatile short-term international capital flows formed a very weak economic structure.

Between 1960 and 1970 Turkey experienced eight different governments and though civil unrest caused by political conflicts between left and right coupled with severe earthquakes in 1970 led to political instability. With the military's pressure the government changed once again in 1971. Turkey followed a state-led inward-oriented growth strategy by following import substitution policies and economy-wide planning between 1960 and 1979. Akguc (1987) pointed out that these development plans aimed to merge small banks in the sector to reduce the overhead costs with a goal of creating stronger financial sector. Therefore, instead of new commercial banks, government only permitted the establishment of new development and specialised banks between 1962 and 1975 period, which were not authorised to collect deposits. These were Tourism Bank in 1960, Industrial Investment and Credit Bank in 1963, Eximbank in 1964, Turkish Development Bank in 1975, State Metal Bank in 1968 and State Industrial and Labour Bank in 1976.

Industrial Investment and Credit Bank was a private sector bank and was aimed to sustain the long and medium term loans needed to finance investments in the private sector listed in the development plans. Eximbank was established as

a state bank to finance the credits of state economic enterprises needed for their investments projects in manufacturing industry, energy, mining, and transport sectors.

The 1960-1980 interval is defined by three military interventions in Turkey. While import substitution was launched as a serious endeavour with the earlier coup of 1960 and 1971, the 1980 military intervention spelled its end. It was less than one year before the September 12, 1980, military coup, an intervention that deeply affected Turkey's social and economic route, when Süleyman Demirel, the centre-right political leader, founded the 43rd Turkish government, although his Justice Party finished second in the October 14, 1979 elections. Turgut Özal, a former advisor to Demirel, became the Prime Ministry undersecretary after the foundation of the new government. These two political figures, who marked Turkish politics for several decades, were the architects of what are known as the January 24 decisions, before they became two strong rivals. Özal was the author of the decisions, which were launched upon Demirel's order. Turkey took a huge step into neo-liberal economic policies with the January 24 decision.

The program, announced on January 24, 1980, consisted of devaluing the Turkish Lira by 32.7 percent, shrinking the state's role in the economy, lifting or reducing support for agriculture, promoting foreign investment and providing major tax relief for importers. Meanwhile, in the political field, several developing countries, including Argentina, Chile and Portugal, were experiencing military coups during the 1970s. Back in Turkey, it was initially the coup that shook international players' trust in political stability. In 1980, annual FDI hit bottom with USD 18 million, the lowest in five years at the time. Still, it was the same military coup that paved the way for the implementation of the changes brought by the January 24 decisions.

According to the Turkish Statistical Institute, Turkey's foreign trade volume was USD 7.33 billion in 1979, while the proportion of imports covered by exports was 44.6 percent. According to World Bank figures, foreign investment into the country stood at USD 75 million in the same year. Moreover, it took the country six years to raise the foreign direct investments to over USD100 million, a moderate rise when compared with the 2008 volume exceeding USD 28 billion.

International lenders in the Turkish banking sector achieved noteworthy growth starting from the 1980s. 'With the process of financial liberalization, the obstacles to foreign capital inflows were lifted and some regulations to encourage foreign capital were implemented,' Mete Bumin said, in a book titled 'Foreign Banks in the Turkish Banking Sector'. Ertuğ Yaşar, an economist and business professional, agreed with Bumin, telling the Daily News that the January 24 decisions can be considered a turning point. 'They accelerated the competitiveness of the country and formed a proper finance and banking sector', he said. Later on, the Istanbul Stock Exchange was founded in 1986 and would become a lucrative destination for foreign capital, although until late 2010 no foreign companies traded on the ISE.

In the general elections of 1995, no political party managed to establish a government on its own. Necmettin Erbakan's Islamist Welfare Party (RP) was the leading party, with 21 percent of the votes. A coalition government of two 'centre-right' parties, Mesut Yılmaz (ANAP) and Tansu Ciller (DYP), was formed on March 5, 1996, with Mesut Yılmaz as

prime minister. However, both the ANAP and DYP were steadily losing credibility and electoral support, and the coalition government of these two bitter rivals lasted only four months. Although Tansu Ciller had stressed the importance of stopping the Islamists and declared during her election campaign that she would categorically reject any coalition with the RP, she decided to end the coalition government and ally her party with the RP.

The Turkish military presented an ultimatum to the government following a meeting of the National Security Council (MGK) on February 28, 1997. This was the fourth military intervention in Turkey since the end of the Second World War. However, there has been a discussion in Turkey of the dangers of a military coup under conditions in which the country is being rocked by the current financial and economic crisis.

### *3.2.3 Economic/financial crisis*

1994 Crisis: According to the 1994 report published by Bank Association of Turkey financial sector was amongst the most affected from 1994 financial crises. It is argued that public banks' share increased in the financial system which shrank considerably due to the decrease in the domestic savings. Moreover, the banking system was prone to balance sheet risk with most banks carrying very large open foreign currency positions with foreign exchange liabilities and large Turkish lira government securities. Privately-owned banks carrying the highest risk, the total open foreign currency positions of the system reached to over USD 5 billion in 1993.

In addition to the fragility of private banks, public banks started to create major distortions to the financial system. Alper and Onis (2001) argued that aftermath of the 1994 crisis public banks have created an uneven playing field in the banking sector due to the fact that both their borrowing and lending operations have been politicized. These institutions have emerged as major instruments of rent distribution in the political process and directed lending at subsidized rates to favored sectors has in part heavily undermined their capitalization, liquidity and profitability. The losses created for these operations were called duty losses. The unwillingness of Treasury in meeting these losses resulted in costly and heavy borrowing of public banks. This in turn helped to generate a major distortion in the system with artificially high interest rates on deposits as well as inter-bank borrowing. Initially, IMF pressurized government to cease sources of rent distribution in Turkey involving the state economic enterprises and extra-budgetary funds have largely been placed under control.

Alper and Onis (2001) stated that the crisis of 1994 was triggered by two proximate causes, namely, the government's attempt to control the interest rates as well as the level of the exchange rate in a high inflation environment and the lowering of Turkey's credit rating. Accordingly, the end result was a steady decline of foreign exchange reserves of the Central Bank, ultimately leading to a successful speculative attack on Turkish Lira (TL), generating a large devaluation. The perverse outcome of capital account liberalization manifested itself in a striking fashion with the outbreak of the 1994 crisis reflecting the inability of policy makers to adjust themselves to the new environment; because the policy makers still continued to operate within the parameters of a closed economy model and tended to neglect the current account as an important source of disequilibrium on the assumption that capital flows would be irreversible and sustained on a steady course.

Twin Crises (2000-01): Turkey faced two severe financial crises in 2000 and 2001. In November 2000 a major liquidity crises together with prevailing weaknesses of the banking sector led to further bank fails and 3 banks were taken over by Savings and Deposit Insurance Fund (SDIF), increasing number of banks under funds control to 11. A year after start of the program and although an IMF-led emergency package succeeded in normalizing the situation for a while, the Turkish lira came under heavy attack in February 2001, which turned into the most serious financial and economic crisis Turkey has experienced in its post war history. Ozkan (2003) proposed that not only the short-term portfolio investments, which were easily reversible and made up of most of the inflows, but also the slow pace of reforms under the stabilization program and political uncertainty are other contributors that further exposed fragility of the banking system. Crisis in 2001 hit the financial system leading to a major downsizing in banking sector.

As a consequence of a series of mergers and liquidations, there were large layoffs generally in the banking sector and number of employees dropped from 168,000 in 2000 to 132,000 in 2001. According to Altunbas et al. (2009) worsening economic conditions have also doubled non-performing loans in banks' books. Non-performing loans soared to a record of 17.8 per cent in privately owned commercial banks. On the other hand, and as expected, banks under the SDIF were ones with the highest non-performing loans and total banking sectors non-performing loans more than doubled after the 2000 crisis.

#### *3.2.4 Application of Basel II*

Capital adequacy requirements in Turkey were already established in-line with Basel I, which adopted in 1989 and market risk was incorporated in the calculation of capital adequacy ratio in 2002. The Banking Law required banks to maintain a minimum capital adequacy ratio of 8 per cent. The capital charges were not required for operation risks but only credit and market risk. The capital requirements due to credit risks were calculated based on Basel I methodology, where market risk consists of interest rate, equity position and foreign exchange risks. Market risk was allowed to be calculated using a standardised method or an internal risk-measurement model. Interest rate and equity position risks covered risks arising from the trading book only, while the foreign exchange risk applies to all the bank's activities. Banks were not required to hold capital for risks to underwriting, credit derivatives, collective investment undertakings, settlement/delivery, counter party credit, and commodities.

Turkey is amongst more than a hundred countries that practices the Basel II to regulate and supervise the banking sector at the highest international standards. With Basel II applied in 2008; a rating system is brought among the banks and the banking system being open to external control have more transparent structure. BRSA is the sole authority to plan the implementation of the Basel II, later to oversee the system, and strongly supports the approach of Basel Committee on Banking Supervision that envisages creating a more robust and risk sensitive capital adequacy framework. In early 2003, BRSA established an efficient cooperation and discussion forum called 'Steering Committee on Basel II', and meet with banks' representatives regularly to hold discussions on better implementation of Basel II and CAD 3 and enhance knowledge its requirements.

In May 2005, BRSA announced a plan 'The Road Map for the Transition to New Basel Capital Accord (Basel II)', which outlined the path for the transition process from current system to Basel II for Turkish banks in detail. With the plan, BRSA asked each bank to appoint a Basel II coordinator at a senior manager level and a committee, to initiate internal road plans, to decide on approaches that will be used in risk measurements and to invest in necessary information technology (IT) and other system infrastructures for application of advanced methods. The banks were required to report on their progress every three months. The plan also set out the dates and periods for Quantitative impact studies and questionnaires that will be carried out by BRSA. BRSA planned to implement Basel II as of January 2008, with the model-based approaches to be implemented beginning of 2009.

### *3.3 International Shocks*

#### *3.3.1 Wars*

After the World War II, Turkey allied with the West and became a recipient of US assistance under the Truman doctrine. Being very close to the Union of Soviet Socialist Republics (USSR) geographically and an ally of the US had affected the dynamics of the local politics for more than forty years until the collapse of Soviet empire. As a consequence of the cold war, Turkey became a member of the North Atlantic Treaty Organization and the US air and missile bases were subsequently established at Izmir and Adana, where US had also nuclear weapons against the Soviet threat. The US had been influential in domestic politics especially when it put pressure to switch to a multiparty democracy in Turkey. As a result, for the first time Turkey practiced democracy with two parties, Democratic Party and the ruling Republican Peoples Party, competing in the elections of 1950. The Marshall Plan was successful for economic expansion in this period whilst has been terminated with a serious economic crisis towards the end of 1950s. The outcome of this event was demonstrations against the government and ended with a military coup in 1960. The military regime executed the Prime Minister Adnan Menderes together with several other party members for violating the constitution. Turkish ties with the US were later strengthened in infamous Cuban Missile Crises when Turkey stood next to the US against USSR.

During the Prime Minister Ecevit period, Turkish troops attacked Cyprus following a Greek-oriented military coup in the island, and gained control of roughly around 30 per cent of the island in 1974. The situation of the island had always been a political obstacle between Turkey and the EU on Turkey's probable membership. Turkey faced many minority governments between 1975 and 1980. The impact of global economic crises of 1970s on local economy once again led to civil violence mainly between leftists and rightists in the country, which ended yet with another military takeover of the control in 1980.

During the Gulf War, Turkey let the US use its military bases located in Turkey to pursue operations in Iraq. Chronic high inflation, a large foreign debt, and large budget deficits led to a financial crisis in 1994. In 1995 Turkey joined in to the customs union with the EU, with hopes to get closer to a full membership. In 1995 elections, an Islamist party, for the first time in republic's history, won the majority votes and led to a coalition headed by Necmettin Erbakan. The conflict between the secularism and religious oriented views became highly apparent during this period. Erbakan's



close ties with Islamic countries and attempts to dilute the secular state structure led to a pressure by military and other secular institutions of the country for him to resign. Later Erbakan was banned from politics for five years and his party was closed.

### *3.3.2 Global economic crisis (2008)*

The World Bank's former Turkey director, Andrew Vorkink, said that Turkey could emerge unscathed from the global financial crisis assuming that political stability continues. He said reforms after the 2001 financial crisis strengthened the economy. In fact, Turkey has had an average growth rate of 6 percent for the past six years. The country was able to attract a record USD 21 billion in FDI in 2007, and its export volume has substantially increased.

Turkish banks seem to be in a strong position despite the global economic downturn triggered by the credit crunch. Bank balance sheets look promising as their lending policies are closely monitored by state agencies. Turkish banks have limited foreign exposure, unlike the banks of Europe. Deposits and savings are strong and are in line with bank assets. While many global banks have lost billions in write-offs, Turkish banks have increased their profits. Even foreign banks operating in Turkey posted record profits while their parent companies were busy with write-offs on unpaid loans and credit. For instance, Fortis Bank and Dexia Bank, two European banks with operations in Turkey that suffered losses outside Turkey and were bailed out by European governments, are strong in Turkey.

In fact, what happened in 2001 is like a vaccine that prepared Turkey for the global financial turmoil. After 21 banks were seized by the government during early 2000s, reforms were implemented, resulting in a strong and independent regulatory framework supervised by the BRSA. These reforms included the full implementation of risk management with respect to liquidity, assets and liability management, credit risk, market risk and operational risk.

The Central Bank of Turkey (CBT), the Capital Markets Board (CMB) and the Treasury were empowered with the tools needed to intervene in the financial sector. According to the BRSA, the total assets of the Turkish finance sector had reached YTL 844.6 billion by the end of the second quarter of 2008. Banks can easily cope with the unlikely possibility that frightened depositors will withdraw their assets.

## **4. Conclusion**

This paper aimed to analyze the evolution of Turkish banking industry over an extended period of time. It promised to offer thorough historical analysis of banking development in Turkey starting from the Ottoman Empire period until today's modern Turkey. By doing so, the study made several contributions to the business history literature.

Firstly, the study is informed by shock concepts to analyze the development of banking industry in Turkey. Previous research used shock concepts to understand certain developments at different levels including organisations, industries and economies. However, the previous research did not take a historical and evolutionary perspective to understand development of an industry from 'shock perspective'. This paper exploited shock concept as a set of lens to understand the stages of growth of banking industry in Turkey. The shock concept acted as a framework and enabled us to

identify three levels of shocks that affected the development of Turkish Banking industry. The identified three different types of shocks are industry, country and international shocks (Please see Figure 1).

----- Insert Figure 1 here -----

It became apparent that these different levels of shocks made different levels of impacts on the Turkish banking industry at different historical stages. In the early stages of Turkish republic, the influence of military interventions is apparent. In the recent years, military interventions have been replaced with economic and legal liberalisation emerging as clear signs of enablers of banking industry development in Turkey. What is interesting here is that the impacts of these three levels of shocks identified in the paper are interrelated and dependent upon each other. The international shocks can trigger off country and industry level shocks and the impacts on banking development cannot easily be associated with one level of shock only.

Secondly, the paper also offers interesting insights about the development of an industry in an emerging economy, Turkey. Previous research studied the development of different industries in developed countries including the UK, the US and the EU countries. However, there is a dearth research about Turkey as an emerging economic power. This is interesting given that Turkey is at the crossroads of Europe, Asia and Africa promising to offer unique contribution to the existing business history literature. The findings of this paper demonstrated that Turkey has a very dynamic history. This history is so vibrant with economic, political, socio-cultural and technological changes that it is inevitable to separate Turkish economic and banking industry development from the history of the country.

One could even argue that historical heritage of Turkey is one of the key determinants of banking industry development. Turkey and Turkish banking industry have evolved from economic and political chaos to an emerging power with many lessons to be drawn for today's world, in particular for the political and economic systems of Middle Eastern countries including Egypt and Syria. For example, the history showed that the military interventions in Turkey might have brought political stability for a period of time but did not contribute to the development of the banking industry. On the other hand, deregulating the market and following the international standards led to a more transparent structure, regulation and supervision at international standards, increased capital adequacy requirements so making banks more risk averse and strong against possible bank rushes.

Finally, the paper makes an important contribution to the banking industry context. It demonstrates the vulnerability of banking industry to the developments in broader environment, including country and international domains. Being able to manage the dynamics and shocks of a country and international domains requires strategic planning and more importantly learning from the past experience. Turkish banking case in this paper showed that banking industry requires stability, confidence and trust in order to function properly. This can only be achieved by carefully analysing the signals of 'different levels of shocks' before shocks occur. For the banking industry, it appears to be crucial to develop a proactive risk management strategy evaluating and identifying the signals of a possible shock including oil price changes, military intervention and economic and political crisis both globally and nationally. Identification of the signals of these shocks could enable a banking industry to develop scenarios about possible impacts of these on

development of the industry and likely plans to respond to the emergence of any instability, lack of confidence and jeopardize of trust among consumers and investors.

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Figure 1: Impact of Shocks on Turkish Banking

