Topics in Middle Eastern and African Economies
Vol. 1, September 1999

Financial Markets and Globalization in Turkey

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Abstract

Turkey's liberal financial markets have been facing serious destabilising effects of financial globalization. Turkey's experience with liberalization and deregulation and open financial markets have been dissapointing. The most painful and explosive experience has taken place in the public sector deficits and indebtedness. This paper tries to discuss more serious sources of financial instability in the framework of the theory of the fiscal crises of the state, specifically, the theory of "bifurcation of monetary and real accumulation" and the consequent "socialization of debts". It reaches to the conclusion that financial flows were delinked and severed from real accumulation and real economic activities; private saving surpluses were shouldered by the public deficit.

1.Introduction

Turkey has "emerging" financial markets. The process of liberalization and deregulation began in 1980. Since mid-1989 Turkey is a financially open economy with a fully convertible currency. In terms of capital flows, it is far more open many European countries. Financial liberalization and financial deepening have not resulted in a significant internalization of the markets or in providing useful net transfer of funds. Yet, Turkey's liberal financial markets have been facing serious destabilising effects of financial globalization. The general characteristics of Turkey's financial markets are extreme volatility and fragility.

2.Theoretical Framework

This paper tries to define more serious instability sources and tries to explain why Turkey's experience with liberalization and deregulation and open financial markets have been dissapointing after almost two long and paiunful decades of efforts. The most painful and explosive experience has taken place in the public sector. In Turkey, the most common explanation of the financial problems focuses on very high budget deficits and public sector borrowing requirements. An alternative explanation finds the source of the problem in the timing and/or squencing and/or the degree of the liberalization and deregulation. However, explanations must take into account the fact that budget deficits in Turkey exploded after financial liberalization, they are financed by borrowing in domestic and international markets This paper, rather than concentrating solely on domestic policy failures, intends to elaborate on the explanations related to the effects of globilized financial markets on causing and/or intensifying the problems of macroeconomic instability, especially in budget deficits. These explanations will be discussed in the framework of the theory of the fiscal crises of the state, specifically, the theory of "bifurcation of monetary and real accumulation" and the consequent "socialization of debts". This theory formulates an explanation why state debts are a functional necessity in deregulated global financial markets in order to secure monetary assets by transferring liabilities from the market forces to the state domain.

The theory concentrates on the process in which money is severed from the rules as a public property and money becomes increasingly privatized, thus money bifurcates from real economic relations. Monetary accumulation and real accumulation become delinked from each other. The theory of delinking monetary and real accumulation and the fiscal crises of the state was developed by German economist Elmar Altvater (Altvater 1997). This theory is a new interpretation of the theory of fiscal crises of the state that was developed in the 1960's and 1970's to analyze the simultaneity of a growth in private wealth and a corresponding increase in public poverty and public sector burdens. In the more recent interpretation, the focus is on the growth in private financial wealth, increasing poverty in real accumulation and a corresponding increase in public deficits and public debt. Theories that concentrate on imperfections, instabilities, fragility, failures and crises of financial markets certainly illuminate how monetary accuumulation works. However, we think that, the heart of the problem lies with the nature of financial accumulation.

According to the theory, the substance of money is formed by production. However, after the dissolution of the gold standard and as foreign exchange and finance markets have been deregulated and computer money and financial innovations developed enormously, money has become "privatized". Financial transactions have very little to do with world trade and real investments any more. The monetary and real economy part company. Delinking of monetary and real accumulation happens when steering of profit use for real and monetary investment is separated. When profits are used for investment in real capital during the process of real accumulation, production increase, income and employment are stimulated. On the other hand, when profits are used for investment in financial assets, it results in competition on global financial markets. Thus, the development of financial innovations means competition over the division of the globally produced surplus. This puts pressure on the profit rate of real assets, and difficulties with debt payments. When debtors are not in the position to service their debts ordinarily, credit risks increase. As creditors are willing to lend when risks can be wiped out, the global interest rate increases by the higher risk component. Thus, financial investments become potentially even more attractive than real investments. The competition for a share of global value added becomes even more severe. Investing in financial assets instead of real capital is detrimental for debtors, also for medium and long term economic development and growth rates, making risks even higher, and making financial investment even more attractive. The bifurcation of money from real relations continues until it becomes clear that there is too little globally produced surplus to meat all the claims. A debt crisis sets in.

In the following sections of the paper, we will try to examine several aspects of the process of delinking of monetary accumulation and real accumulation has evolved in Turkey via financial deepening, as new financial instruments were introduced and financial openness showed its effects.

3.Liberalization and Deregulation in Turkey

The timing and the process of liberalization and opening up of foreign trade and capital markets started after Turkey fell into foreign debt payment problems in the late 1970's. The stabilization program began to be implemented under the International Monetary Fund conditionality. Foreign trade was liberalized basically in the early 1980's, and further in the process of joining the customs union with the European Union in 1996. Financial deregulation began in 1981 when controls on interest rates were removed. In 1984 foreign exchange trade was liberalized. In 1986 Istanbul Stock Exchange was reopened. In 1987 the central bank began open market operations. The benchmark date for financial liberalisation is 1989 when controls on capital movements were removed and Turkish currency became convertible. After this date Turkey became a financially open economy.

Below, we analyze the extend of foreign capital flows to Turkey and the share of capital flows in total domestic financial markets. We will concentrate on the period of 1987-1997, since it is a period during which trade liberalization and financial openness proceeded well.

A. Trade Openness and Current Account Balance

Trade liberalization resulted almost no increase in the importance of exports of goods Its share to the GDP was stuck around 12-13 percent. Rather, exports of services have risen and import of good and services has surged tremendously. The share of imports to the GDP rose from around 15 percent to 30 percent. Trade openness increased continuously. as the share of foreign trade to the GDP rose from 25-30 percent to around 55 percent. Trade openness resulted in higher dependency on imports. Trade account deficit deteriorated continuously which jumped by almost three times, from around 4 percent to 11 percent of the GDP. However, .as trade account deficit was deteriorating, service incomes were growing. Thus, during this period Turkey did not face seriously high current account deficit

B. Current Account Balance and Foreign Capital Flows

Table (1) shows current account balance and foreign capital flows to Turkey as ratios to the GDP. Table (1) shows net inflows and outflows of foreign capital. The volume showed an increasing trend. Thus net flows as a percent of the GDP has an increasing tendency. This is expected, since the correlation between liberalization and capital mobility generally is high.

TABLE (1)-CURRENT ACCOUNT, FOREİGN CAPİTAL FLOWS AND RESERVE MOVEMENTS

-THE SHARE OF THE GDP-%

Year	Foreign Direct Invest-ment	Portfolio İnvestment (net)	Medium/ Long Term Credit (net)	Short Term Credit (net)	Total Capital Flows (net)	Current Account Balance Inc.Net Error&Om.	Reserve Move-ments
1987	0.12	0.33	1.71	0.06	2.21	-1.53	-1.33
1988	0.41	1.3	-0.23	2.52	-1.06	2.33	-0.98
1989	0.62	1.29	-0.65	-0.55	0.73	1.82	-2.61
1990	0.47	0.37	-0.37	2.01	2.71	-2.07	-0.88
1991	0.52	0.42	-0.53	2.02	-1.61	0.81	0.70
1992	0.51	1.54	0.61	0.91	2.33	-1.38	-0.95
1993	0.35	2.21	0.77	1.72	5.05	-4.88	-0.17
1994	0.42	0.88	-0.66	-3.89	-3.19	3.34	-0.16
1995	0.46	1.03	0.05	1.37	2.81	-0.04	-2.78
1996	0.34	0.31	0.9	3.81	5.36	-2.87	-2.51
1997	0.29	0.85	2.43	1.27	4.83	-3.11	-2.66

Central Bank of Turkey, **Quarterly Bulletin**, 1998-I, January-March.

In the early1990's there were important amounts of capital inflows, mostly in short-term capital. However, Turkey experienced net outflows of capital in 1988, 1991 and 1994. In 1995-1997, capital inflows were higher than those in the previous inflow periods, reaching 5 percent of the GDP. Again, short-term movements were more important. The composition of capital flows changed over the period. Foreign direct investment was very disappointing in volume and in its ratio to the GDP. It was never higher than around half a percentage point. In addition, its paak was juust before capital account liberalization in 1989. Net portfolio investments were positive along these years. Their ratio to the GDP was relatively higher only in 1992 and 1993. There is no systematic information about the type of portfolio flows going into debt securities or shares. Foreign capital flows to and from Istanbul Securities Exchange were ridden with fluctuations. There were surges in 1988-9, 1992-93. Declines or reversals were severe in 1990, 1991, 1994 and 1996.

In recent years, the most important flows were in short term capital. Short term credit use and changes in the reserves and asset holdings of commercial banks were determinants of these flows. The movement of funds between commercial banks and the central bank related to reserve positions influenced net short-term capital movements. This results in the inclusion of transactions between domestic entities. Thus, balance of payment statistics does no longer represent transactions between foreigners and nationals. Turkey was a net payer of short-term credit in 1988, 1991 and 1994 in which years Turkey experienced financial crisis.

In 1987-1995, Turkey was a net payer of medium and long term credit, except in 1987 and 1993. Only in 1996 and 1997 net flows took place, mainly as a result of some tax exemptions of firms and commercial banks for borrowing for longer maturity than one year. In 1997, borrowing was switched from short term to medium term.

In total, foreign capital flows did not provide significant and dependable amount of funds; they proceeded literally by bursts and busts; also, a systematic degree of diversification in capital flows could not be observed. Turkey experienced foreign capital inflow surge in 1990 when capital account liberalization was in effect. The Gulf Crisis put a very serious break on this. In 1992-1993 there was another surge which was interrupted and reversed by 1994 financial and following real crises. In 1996-1997 there was an even higher inflow mainly in the form of short-term capital movements. These were again interrupted and reversed by 1998 word-wide crises. As the importance of portfolio investment and short-term loans increased, Turkey faced with the types of capital inflows that could be reversed abruptly. As a matter of fact, both types of capital showed similar patterns in inflows and outflows.

We should evaluate foreign capital flows in relation with the current account balance. The current account balance shows an erratic pattern. During the period it was in deficit in seven years, in surplus in four years. When in deficit, it was quite small, around 1.5-2 percent of the GDP. Nevertheless, last two years it was showing increases, climbing to around 3 percent. These levels were not indicating a serious balance of payments problem. However, beneith this appearance, certain signs indicate that the relationship between current account balance, foreign capital movements and the real side of the economy were becoming apart and delinked. We will concentrate on three areas of connection: Errors and omissions; actual and optimal current account positions; and reserve movements.

One of the characteristics of current account statistics is that the "net errors and omissions" item which shows unrecorded transactions has become so important as to change the current account balance very considerably. This is obviously the result of the deregulation of capital movements that makes difficult to capture all transactions. As a matter of fact, net errors and ommissions are accepted as short-term capital movements as called "hot money" that moves for speculative purposes.

A comparison of actual and optimal current account balance positions could be served to establish the relationship between current account balance and the real side of the economy represented by optimal current account. Actual and optimal current account balance positions for the Turkish economy was tested by a study (Akcay and Ozler 1998:44-45). This study used a model that does quite well in capturing the current account shifts of a large number of developed as well as less developed countries. The application of this model showed large divergences between actual and optimal current account balance positions. The actual current account balance was found to be larger than the optimal current account balance. Since there was almost no capital account restrictions, the deviations could not be interpreted as an indication of imperfect capital mobility. The writers came to the conclusion that the higher variance of the current account movements after 1989 could be interpreted as an indication of the presence of speculative capital movements, and not restrictions of capital flows. Thus, the relationship between current account balance and the real side of the economy became apart and delinked.

In addition, the relationship between current account balance and total foreign capital flows diverged considerably, as can be seen from Table (1). The difference was taken up by foreign exchange reserves. The volatility of foreign capital movements and the monetary policy that had to be adapted to financial openness were directly reflected in and taken up by foreign exchange reserves. The relationship between the current account deficit and capital flows was weakened especially after 1995. This means that the relationship between the real economy's external gap represented by the current account deficit (which also reflects the saving-investment gap) and foreign capital flows wakened. Because. the reserve movements to the GDP ratio were very close to the current account deficit to the GDP ratio since 1995. This means that this relationship was even severed.

C. External Capital Flows and Internal Capital

During the period, the ratio of investment to the GNP did not change much whereas the ratio of total bank credits increased by 20 percent, that of portfolio assts by three times. Even if foreign capital flows may seem small relative to the GDP, their volume may be important relative to internal real and financial investments. However, in the case of Turkey this was not true for foreign direct investments and portfolio investments. Table (2) shows the share of foreign capital flows in total investment and financial assets. Foreign direct investment was never higher than 2.79 percent of total investments, and relatively higher shares were observed in the first years of financial liberalization. Later, it had a declining trend, falling to around percent in 1997. Capital account liberalization failed to attract real investment funds. Foreign portfolio investments in relative terms fluctuated considerably. They were important relative to the total in 1988, 1989, 1992 and 1993. Then they fell especially as short-term credits increased. In 1997, their relative share was no larger than that was in 1987. However, what is important, as their share fluctuated, they caused serious instabilities in financial markets. Considering that an important part of foreign portfolio investment appear to go in treasury bills and bonds, the fluctuations affect directly budget financing. As we will analyse below, the pattern of financing budget deficits.and their relation with the monetary side of the economy has bifurcated severely from the real side of the economy. Thus, at least some part of foreign portfolio investments contributed to the delinking.

TABLE (2)-SHARE OF FOREIGN CAPITAL FLOWS IN TOTAL INVESTMENT AND FINANCIAL ASSETS-%

Year	Foreign Direct Investment	Foreign Portfolio Investment	Total Foreign Credit/	Growth Rate Of the GNP
1987	0.49	3.23	6.88	9.8
1988	1.63	13.66	-13.23	1.5
1989	2.79	12.52	-10.38	1.6
1990	1.84	3.44	10.38	9.4
1991	2.24	3.28	-14.96	0.3
1992	2.09	8.47	1.70	6.4
1993	1.34	11.22	14.82	8.1
1994	1.97	4.42	-29.10	-6.1
1995	1.83	5.26	7.66	8.0
1996	1.36	1.74	23.70	7.1
1997	1.11	3.52	16.51	6.0

State Planing Organization (SPO), Turkish Central Bank (TCB), Istanbul Stock Exchange (ISE), Privatization Associaton (PA), Banks Association of Turkey (BAT).

As mentioned earlier, systematic information is not avaiable on the foreign share in the stockmarket. A recent comprehensive study by Gunes and Saltoglu on the Istanbul Stock Exchange states that, due to data insufficiency, the issue of foreign investment on stocks could not be analysed (Gunes and Saltoglu 1998:121). The total volume increased from 1.5 percent to the to around 30 percent during the period. The study analysed econometrically the movements of stock earnings and sources of extreme volatility. It found that the movements of earning rates could not be explained by any macroeconomic and financial factors, meaning that earning movements were determined outside the basic macroeconomic and financial relations; there were no macroeconomic and financial basis for earnings volatility. The stock exchange market was not related to other markets and the overall macroeconomic system. It operated in a speculative and manipulative manner. The volatility was related to daily transactions that were not in line with macroeconomic influences. Even if economic fundamentals and parameters did not change, the stock market experienced very high volatility. This volatility was determined essentially within the market itself and by speculation. (Gunes and Saltoglu 1998:64-67, 109, 121, 136). Thus, whatever the role foreign portfolio investments played in the stock market, the market itself is not related to the real economy, circulating significant amount of money for speculative and manipulative manners, absorbing resources from real accumulation, contributing only to financial instability.

Financial volatility and instabilities are even much greater in credit markets. The ratios of foreign credit relative to the internal credit volumes were much bigger and erratic compared to other types of foreign capital flows. As explained above, short-term foreign credit flows are much more important. Also, Turkish credit supply is largely short-term. During the period, the volumes of these foreign flows were increasing and the ratios of inflows and outflows were getting bigger. Such leaps and bounces and busts reaching minus 29 percent and plus 24 percent within a period of only three years in 1994-1996, drove the economy extremely unstable. Any real economic foundations cannot possibly explain these movements. Thus, foreign credit flows relative to the determinants total credit extension in Turkey were severed. However, the effects of these erratic flows on growth rates of the economy were serious. As Table (2) shows, in every year that foreign credit outflows took place, growth rates were very low or negative.

4. Financial Accumulation after Financial Liberalization

A. Pattern of Financial Deepening

Between 1987 and 1997, financial deepening proceeded as the ratio of total financial assets to the GNP rose from 37.3 to 67.1 percent (Capital Market Board; The Banks Association of Turkey). The most important form of financial assets was still bank deposit, though its weight fell from almost three fourths to two thirds. Thus, the share of total securities increased from 27 to 36 percent. The most prominent change was in the increase in foreign exchange denominated deposits that became as large as the Turkish Lira denominated deposits. Private securities were issued mostly in the form of shares. Corporate bond issues were minimal. Private securities had a 15 percent share in 1991 at its highest. This share fell to less than 5 percent in 1997. Financial deepening took place essentially in public securities. Around one third of the total financial assets were comprised of public securities. The weight of public securities in the total had reached to 87 percent in 1997. In short, financial liberalization, deregulation and deepening resulted essentially in currency substitution and public sector borrowing. In addition, both deposits and securities were concentrated in short-term and very short-term assets.

B. Financial Accumulation and the Banking Sector

The biggest financial sector is still the banking sector and it has grown relative to the GNP. The ratio of the total balance sheet of the banking sector to the GNP reached to 60 percent in 1997 (The Banks Association of Turkey 1998). The pattern of financial accumulation that took place within and through the banking sector created serious systemic risks and resulted in a bifurcation of financial accumulation and real accumulation. We will summarize some of them below.

The source of the growth of the banking sector assets was deposits, especially forex deposits. Deposits were concentrated in short-term deposits, as economic and financial instabilities increased after financial liberalization. In order to protect deposits from price increases and currency devaluation or to benefit from a major devaluation, deposits were increasingly held in foreign currency. The whole process was also influenced by a complete deposit guarantee since the 1994 financial breakdown. In addition, around 40-45 percent of credits extended was denominated in foreign exchange. Thus, credits were also subject to currency substitution.

The banking sector, especially the commercial banking sector, has moved away from its basic function of providing credit to the real sector and especially to the industry. The ratio of their credits to their deposits was a little more than 50 percent. Bank credits were around 40 percent of their total assets. Instead of credit extension, banks were buying government bonds and treasury bills. In 1997, banks were holding almost 85 percent of government securities. However, as we will see below, government borrowing has not been used for real capital accumulation. Therefore, financial development was proceeding with a weaker relation to the real sector of the economy.

Another consequence of financial liberalization was an increasing use of derivative instruments and repos. This was shown by the so-called "off-balance sheet account" of the banking system. This includes transactions that do not take place in the regular balance sheet. Off-balance transactions comprise guarantees, warrantees, and more importantly, foreign exchange and interest rate transactions and commitments, futures, swaps and options and repos. In recent years, these transactions were growing much faster than regular balance-sheet items. They amounted to a volume that corresponded to 92 percent of the total regular balance-sheet assets, or, 45 percent of the GNP. The main source of this growth was increases in forward foreign exchange purchases and sales, and especially repos. The growth was fast since 1995 as short-term foreign capital flows were increasing. Private commercial banks carried around three-fourths of these transactions (Banks Association of Turkey 1997:I-48-49; 1998:II-11). Open market operations and repo operations are directly related to the borrowing operations and liquidity requirements of the treasury. Therefore, a part of the off-balance operations of banks is also a part of the relation between banks and public borrowing. The growth in these extremely liquid funds is a very important indicator that the monetary world has been growing and bifurcating from the real economy.

C. Financial Accumulation and Fiscal Crisis of the State

The most prominent and the most urgent economic and political problem facing Turkey today is public deficit and its financing. Therefore, the management of fiscal deficit is the center of general economic management. It is a widely held view that financial instability in Turkey is not arising from international financial integration and foreign capital flows per se; on the contrary, Turkey's public deficit is making the country risk so high as to shape the pattern of foreign capital flows. This may be true for today. However, this argument ignores the fact that the process of deterioration in public deficit was basically determined by the general structure of the liberalization in the public sector, finance, and foreign exchange and capital movements, the process that started in the early years of the 1980's. The major effects of liberalization on public finance were through significantly devalued foreign exchange rates, hiked interest rates and great losses in tax revenues. All these effects resulted in increases in public borrowing and put a great pressure on the debt payment capacity of the public sector.

During this process, the public sector overtook the saving deficit of the private sector and the credit demand deficit of the banking sector. Banks were facing difficulties in placing credit funds due to very high interest rates an economic slowdown. Meanwhile, as public revenues were lost and borrowing needs increased, foreign borrowing conditions worsened due to international debt crises. Thus, the public sector resorted to domestic financing for deficit financing. This is how the banking sector became the major credit giver to the public sector and how it became the holder of 85 percent of public securities. Short-term foreign capital flows also circulate through the banking system mostly to buy short-term government securities. The main reason for an increasing need to borrow was a dramatic decrease in tax revenues. One of the major aims of the policy of liberalization was to reduce the size of the public sector. Taxes were reduced and generous tax incentives were provided to promote the private sector and exports. From 1981 to 1984 the tax ratio fell by 25 percent. This was a direct takeover the saving deficit of the private sector by the public sector. Due to declines in taxes, the savings of the private sector increased dramatically; and the private saving-investment gap turned to a surplus in 1986, continued to be in surplus until 1995.

Since the beginning of financial liberalization, not only banks, but also private sector enterprises, especially big ones have used important parts of their busines funds to earn interest income. According to the periodical study done by The Istanbul Chamber of Industry on the biggest 500 industrial establishments of Turkey, an average of fifty five percent of earnings of these establishments were from other activities than their main activities and from public debt instruments and repos (Istanbul Sanayi Odasi 1998:86, 200). These big establisment were not using these earnings for investment and banks were not using their funds to enlarge credits for real accumulation.Private surpluses that were borrowed by the public sector were not used to to close the public saving-investment gap and public investments. In fact, they were not used even for current public services. After 1994, interest payments from the budget reached 8 to 10 percent of the GNP; the PSPR ratio to the GNP was moving between 8 and 12 percent, whereas the budget was producing primary surpluses. Borrowing was mostly for rolling over of debt and interest payments. Interest payments have finally come to swallow forty percent of the consolidated budget.

5. Conclusion

In Turkey, financial liberalization since 1989 resulted mainly in currency substitution and public debt, private surpluses and public deficits. The relationship between savings and productive investments is delinked. The relationship between foreign and domestic borrowing for deficit financing and public service and public investment financing has been severed.

* This paper was supported by the University of Istanbul Research Fund. Project No. B-58/280998. I am grateful for this support. I also thank Professor Simin Mozayeni of New York State University, New Paltz for valuable comments on the paper.

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