TUSIAD VIEWS ON
THE OBSTACLES TO ACCESSING CREDIT
FOR INDUSTRIAL SECTOR
THE CASE OF TURKEY

THE MEETING OF POLICY DIALOGUE AND COORDINATION COMMITTEE
EUROPEAN INVESTMENT BANK

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Dear Ministers, President and Guests,

I would like to thank you for giving me this opportunity to address such a distinguished audience. It is a great pleasure and honor that the Policy Dialogue and Coordination Committee of FEMIP decides to organize its annual meeting in Istanbul.

We all know that one of the major elements of creating a Euro-Mediterranean Free Trade Area is the development of the private sector in the Mediterranean. TUSIAD is and will be an active participant to the discussions and actions on strengthening the private sector in that area through Union of Mediterranean Confederations of Enterprises (UMCE) established in March 2002 in Istanbul. It is obvious that all UMCE members have the same concern, which is developing innovative and flexible financial instruments to facilitate creation and growth of local cluster of firms.

Today, I would like to share with you the financial market situation in Turkey and the problems and the solutions for access to capital of Turkish private sector.

Turkey's financial markets have gone through a series of reforms as a part of the stabilization and liberalization program that started in 1980. The steps undertaken include efforts to transform a closed economy to a market economy. However, in the aftermath of financial liberalization taken place at 1990's, lack of fiscal austerity resulted in consumption driven economic growth, which financed via short-term capital inflows. This elusive growth practice, bringing considerable volatility in macroeconomic aggregates, triggered high and persistent inflation. Despite high and persistent inflation experienced throughout 1990s, strong growth rate achieved in some years, thanks to excessive short-term capital inflows, curtails financial sector inefficiency. Furthermore, huge public debt, accelerating via populist policies, prevents the financial sector to flourish parallel to economic activities requirements. Even more, the real sector suffer the consequences of higher deficit policies financed by the issuing of bonds in the form of crowded out investment in plant and equipment, culminating in reduced output growth. This fatale cycle caused by tremendous domestic debt reached his peak at 2000 and ended up with severe twin crisis at 2001.

The three major problems before private sector for its access to capital are the twin crises, which resulted in credit crunch and severe shrinkage in banking sector; policies on reducing public sector borrowing requirement and its crowding out effect and lastly the unfair competition resulting from the assignment of zero risk weighing and tax incentive to Turkish Treasury bills and bonds.

The twin crises, which resulted in credit crunch and severe shrinkage in banking sector, demonstrated clearly that Turkey lacks sufficient funding for investments to switch sustainable growth pattern. The financial sector, which acts as an intermediary channeling depositors' savings to the real sector for new investment purposes, undertakes a vital role in accessing to capital. In addition to source scarcity, rapid change and intensive competition in the global world and unrecovered crisis in Turkey requires that the existing resources in Turkey be channeled to the investments in the most efficient way. Accordingly, promoting financial sector via new financial instruments and removing obstacles to facilitate access to capital should be taken as a primary action.

Over the last decades, many factors contributed to the deterioration of the Turkish banking system such as:

- Large public sector borrowing requirements,
- Chronic high inflation,
- Use of tax advantages to favor government debt,
- Deposit insurance that undermined market discipline,
- Lax prudential regulation and supervision,
- Undercapitalized state banks

Furthermore, generous deposit insurance and a lax regulatory and supervisory environment triggered moral hazard and encouraged risk seeking. Connected lending, high exposure concentrations, large foreign exchange positions allowed banks to increase risk and lenient prudential regulations allowed these risks to remain hidden.

These factors also contributed to dissuade foreigners from investing in Turkey because the current situation makes it difficult to anticipate even the medium term. Structural difficulties for investors and macroeconomic fluctuations even deter domestic investors from investing in Turkey. The share of domestic investment in GNP is decreasing steadily and it is now below 1989 figures.

When we come to the crowding out effect of public sector borrowing we see that it reached to an unbearable point and pushed private sector through external funds in 2001 with the twin crisis. The share of banking sector in total financial assets was 60.2 percent as of the end of 1997 while share of private sector in capital market was 13.3 percent. In 2001 the former ratio fell to 44.2 percent and the latter ratio fell to 7.8 percent due to boom in government securities as a result of public debt operation. These figures also indicate that the Turkish financial sector is still dominated by banks. Consequently, new stabilization program mainly based on reducing public sector borrowing requirement via high primary surplus and tight fiscal policies occupy a significant place to promote accessibility of private sector to capital.

Brief assessment of banking sector points out immediately that the sector holds very poor credit penetration in an international context due to large crowding out by public sector borrowing. Extremely high intermediation spreads also obstruct intermediary role of the sector. Even more, an indicator of the level of efficiency with which the sector fulfills its intermediating role is the difference between credit and deposit interest rates (intermediations spreads). Reasons of unbearable intermediation spreads may broadly be classified into two categories, micro and macroeconomics factors. While, macroeconomic instability spawned by critically high fiscal debt burden and reflected via chronic and volatile inflation is one of the fundamental cause of high spread level, fiscal and para-fiscal costs bearing by banking sector also take a crucial place in this inefficiency.

As the banking sector acts an intermediary channeling depositors' savings to the real sector for new investment purposes, removing obstacles to reduce high spreads should be taken as a primary action. In other words, fiscal and para-fiscal burdens bearing from banking sector limit the funds provided by the banks and trigger legislation arbitrage and offshore banking.

Governmental tax policies rely heavily on indirect taxes due to collection facilities so that indirect tax burdens on banking operations reach intolerable level. In deed, local investors switch to foreign market to find cheap fund. Thus these fiscal and para-fiscal burdens should be reduce to international level.

The last issue is the assignment of zero risk weighing and tax incentive to Turkish Treasury bills and bonds. This unfair competition between government securities and banking sector's instrument, boost crowding out effect of public sector and scarcity of capital in private sector. Given that the spread on Turkish Eurobonds have been increasing, it may be prudent to attach some risk-weight to these instruments and tax advantage of these also should be annulled.

In response to credit crunch and severe banking crises, the government has taken a number of serious reform actions. These include:

- Significant reform of prudential regulations (such as new risk management legislation, inflation account legislation…);
- Strengthening of regulatory and supervisory authority (assurance of independency of BRSA);
- Restructuring of private and public banks (takeover of unhealthy banks by SDIF and capital injection to SDIF and public banks);
- Re-capitalization of the banking system; and
- Debt re-structuring for the corporate sector (Istanbul approach).

The government's financial sector reform program has been supported by the FSAL, and PFPSAL-I and II provided from World Bank.

However, execution and bankruptcy law stands as a significant obstacle to implement Istanbul approach properly and it should be amended via market requirements. Moreover, government should encourage to found asset management company and to establish a suitable endowment in which it could function properly.

In summary, in the long run the institutional framework to make banking sector reforms sustainable is key. Since twin crisis, strengthening prudential regulation and supervision, recapitalization of the private banking sector, the move towards restructuring and privatizing the state banks, efforts to resolve the NPL problem and to ease the restructuring of the corporate sector have been taken as important steps. However, in the long term, a healthy and effective banking system requires a stable macroeconomic environment, reduced public sector borrowing needs, lower state ownership, a lower regulatory and taxation burden and a better designed deposit insurance scheme that does not undermine the private parties incentives to monitor the banks. Public supervision tends to be much more effective when it is free from political intervention and reinforced by private discipline, and bank recapitalizations without paying adequate attention to factors that undermine the effectiveness of regulatory/supervisory environments and impediments to bank profitability are doomed to be repeated.

Thank you very much for your attention.