Lessons for the eurozone

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Over the last year, many eurozone nations will have asked themselves why their economies can't be more like Turkey's, which grew by 8.9 percent in 2010, and is set to expand by perhaps as much 11 per cent this year. In short, they might wonder, where did Turkey's financial sector go right?

Based on the many similarities between Europe's current problems and its own financial crisis a decade ago, Turkey illustrates the benefits of implementing long-term, although often initially painful and politically unpopular reforms to the financial sector.

In 2001, after a decade of funding Government high spending, domestic debt was unsustainable: its GDP ratio increased from 6 per cent in 1990 to 42 per cent in 1999; and its banks could no longer borrow on the international markets.

Successive Governments had borrowed from Turkey's private banks, which in turn borrowed from European banks and local lenders on a high-interest rate, short-term, basis, or they had turned to state banks who were obliged to lend to the Government.

After political infighting stymied reform in the early part of 2000, in October, Demirbank, which had 80 per cent of its portfolio in Government papers, was denied borrowing by the overnight markets. A sharp overnight hike in interest rates followed, prompting international investors to exit sharply. Then came the credit crunch. Meanwhile, oil prices rose, the euro fell against the dollar, and a slowdown in inward investment all swelled the current account deficit.

The collapse came in November 2000 when Prime Minister Ecevit and President Ahmet Necdet Sezer very bitterly, and publically, failed to agree on a rescue package. Any market confidence that had remained up until then was lost. The lira came under attack, and lending rates soared.

As the Central Bank's reserves dwindled, by 2001 overnight REPO rates went higher, and on February 2001, the Istanbul Stock Exchange fell by 18 per cent. The Government had no choice but to float the lira the next day: it devalued by 44 per cent.

The collapse of the financial sector hit the economy hard and GDP shrank by 5.7 per cent in 2001.

The good news was that the Government now had no alternative but to overhaul the financial system.

It was the newly appointed Finance Minister, Kemal Devis, a former World Bank economist of 30 years standing, who took advantage of the crisis to finally implement root and branch reforms to address the financial sector's long-standing structural problems. He introduced a new economic program on May 15, 2001, with banking reform at the top of the list.

The setting up of a politically independent governing board, the Banking Regulation and Supervision Agency (BRSA), which applied commercial criteria to operations, freed state banks from the obligation to lend to the Government. They would now borrow from the Central Bank instead of from private investors with high rates, thus allowing them to meet regulatory capital adequacy rations.

The next objective was to give private banks a healthier structure. The Saving and Deposit and Insurance Fund (SDIF) devised a strategy to encourage private banks to increase their capital adequacy ratios. Banks that were willing and able to meet its terms were eligible for financial support from the BRSA, thereby attaining a minimum capital adequacy ratio and an adequate operational structure. Banks were also asked to reduce their non-financial participation to further strengthen their structures.

By the end of 2004 the result of the banking reforms was greater transparency, supervision, and regulation. This enabled the flow of funds to small and medium-sized entrepreneurs, the engines of economic growth. During this time, Ankara had borrowed an amount equal to 14 per cent of its GDP from the IMF, reduced spending to generate primary budget surpluses, and convinced trades unions to take a 20 per cent cut in real wages.

Four years later, the 2008 financial crisis hit even harder than in 2001: this time shrinking GDP by 14.7 per cent. But having radically reduced its debt and strengthened its banking sector over the previous seven years, by the first quarter of 2009 Turkey had bounced back, joining the list of the world's fastest-growing economies. In 2010, Turkey's economy grew by 8.9 percent. In the first quarter of this year, Turkey's 11 percent growth rate outpaced China's.

Turkey has lessons for Europe. The first is that countries must cut their cloth to suit their means. In other words, like Turkey in 2001, for some peripheral eurozone countries the only way to restore lenders' confidence is by slashing spending. Try to skip that stage without the pain, say Turkish economists, and the interest rate that creditors demand to take the risk of lending will just keep rising. F