cover story

ANATOMY OF A CRISIS

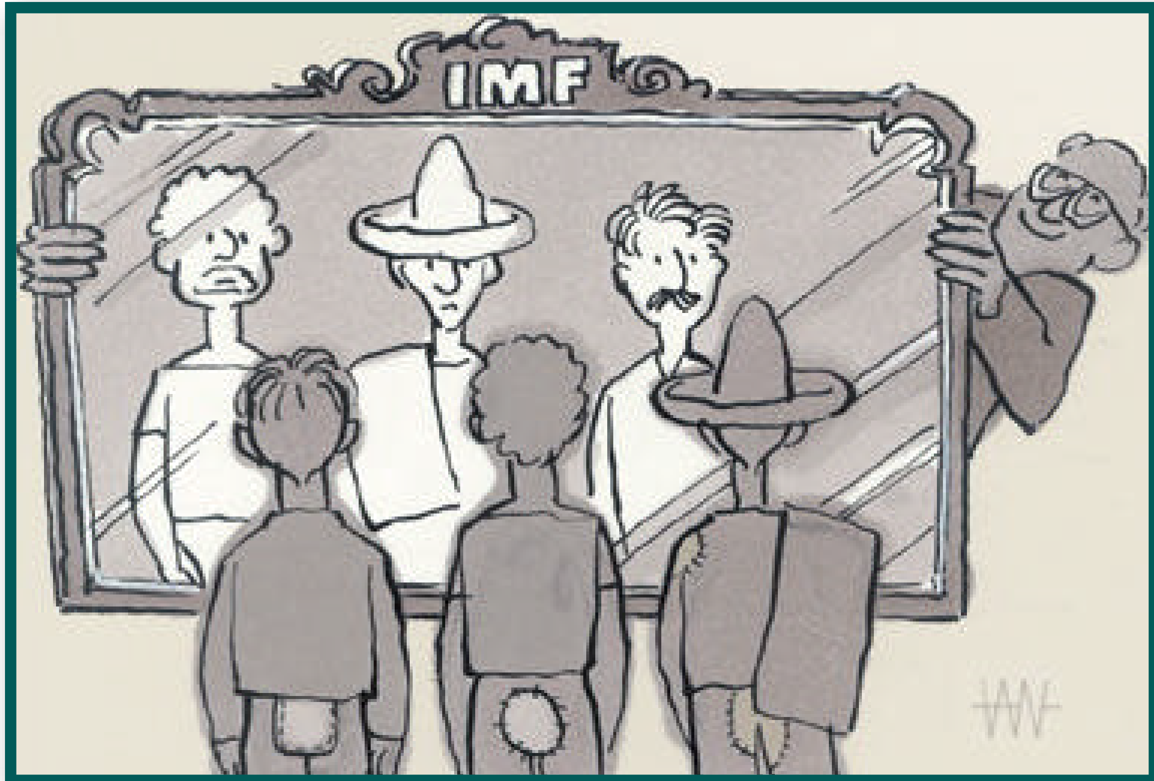
Servet Yıldırım

In October, several weeks before a severe crisis engulfed Turkey or alternatively just 10 months after the country launched its most comprehensive disinflation program of the past two decades, Turks looked to the future with optimism. They were hoping to see a long-awaited upgrading in the country's credit ratings, further declines in inflation and interest rates, an improvement in the current account balance, acceleration in foreign capital inflow; all this could hasten to fruition by better conditions in international capital markets.

But in November the mood rapidly changed with the emergence of a serious crisis. Turkey's rating came under downward pressure, interest rates soared, billions of dollars fled the country and Turkey was faced with exceptionally high costs to borrow abroad. And the IMF stepped in...

With the help of a $7.5 billion emergency loan from the IMF, Turkey calmed the markets in December and reaffirmed its commitment to the targets of the program that was intended to propel the country into a bright European future. As the country was trying to eliminate the impacts of the November crisis, the economy faced another harsh test in February after Prime Minister Bülent Ecevit unleashed a self-made crisis, storming out of a National Security Council meeting and publicly attacking the President. The timing of the new crisis could hardly have been worse for Turkey. The country was still trying to recover from the November crisis that already seriously jeopardized its reform plans. The crisis erupted on the eve of an auction to refinance nearly $5 billion of domestic debt. It sparked fears concerning the political stability that was essential to the success of the program and sent markets into violent spasms.

Nearly three months later, there was still no consensus on the true nature of the twin crises. According to the IMF: "The speculative attack on the Turkish Lira took place against the background of increased political uncertainty, policy slippage and a weakening of economic fundamentals." Was it a deep-seated economic crisis like the one the country suffered in 1994 or was it simply a banking crisis or only a liquidity crisis? The first comparison is not seen as an apt portrayal of the



November crisis. It is difficult to draw parallels between November 2000 and the economic collapse in 1994. But it is obvious that the second crisis in February had more devastatingly adverse effects on the economy than the one in 1994. Turkey braced itself for a sharp contraction and higher inflation this year .

Whether this was a banking crisis or a liquidity crisis, the fact remains that it was ignited by the decades-old problems of the banking sector. So any analysis of the crisis should begin by a candid look at banking in Turkey.

Risks in the Banking Industry

The most widely-voiced explanation of the November crisis suggests that it stemmed from the problems of several banks, including Demirbank, which accounted for around two percent of the country's entire banking system. The crisis was activated when a small number of banks that had overreached themselves by taking positions on treasury bills, turned to the interbank market for help. But when fellow banks shut their doors, the rates soared. As a result the market rushed for dollars and the Central Bank's funds were depleted as officials struggled to stem the tide.

This is a brief and simple explanation of what had happened in November. However, a more satisfactory explanation should focus on the weak spots in the banking sector. As has been witnessed in more than 125 countries in the past 20 years, including the United States, any crisis may occur at any time as long as a system harbors the vulnerable weak spots.

"No one country should consider itself immune to financial crises" said Michael Moskow, President of Federal Reserve Bank of Chicago, in a speech at an international meeting in January. Most financial crises have been caused by small mistakes that have been allowed to snowball. In the Turkish case, policy makers and the IMF massively underestimated the vulnerabilities of the banking industry.

When the three-year disinflation plan was designed at the end of 1999, it was clear that the Turkish banking system would face hard times. Narrowing margins, toughening competition, changes in the very nature of banking were the inevitable consequences of similar programs implemented in other countries.

The unfortunate combination of declining interest rates and high inflation expectations boosted domestic consumption in early 2000, increased the trade deficit and weakened the fight against inflation.

Turkey's real problems

In the first nine months of 2000, the banks' total net profits had fallen by 97 percent in dollar terms. The share of bad loans in the total loan portfolio had risen to 9.3 percent. These figures show that the outlook for the banks was bleak even before the crisis. The 81-strong Turkish banking system was facing four major risks -interest rates, foreign exchange, maturity mismatch and credit. Almost all had been generated by the macroeconomic imbalances of the past 30 years.

Interest risk

A major root cause of the imbalances was the ballooning fiscal deficits. The treasury offered high interest rates on its domestic borrowing to bridge these gaps, encouraging banks to heavily invest in government bonds and treasury bills. The bulk of the outstanding papers was in the hands of the banks since there was no developed system for private pension funds. Household demand for these papers also remained very low because of tax concerns. The upshot was that, the banks were unable to sell the bonds to individual investors. As of early November, Turkish banks were holding at least 75 percent of all outstanding state domestic borrowing instruments worth $46 billion in their portfolios. This situation had "a serious interest rate risk" written all over it.

Foreign exchange Risk

To benefit from high returns on government bonds, the banks also carried short fx positions -- many of them going above the legal limits. In fact monetary policies encouraged them to do so. Such behavior clearly meant that there was a fx rate risk. Any move to devalue the Turkish lira would bring prohibitively heavy costs to many banks.

Under the regulations introduced in early 2000, banks were asked to lower their open positions to 20 percent of their capital by the end of the year. This created an extra pressure on them. Almost all of them did in fact meet the requirement but largely with the help of currency hedging and swap transactions.

Maturity mismatch risk

On the liability side of the banks' balance sheets, deposits with an average maturity of around three months and short-term repo and money market borrowings had been the major source of funding. However, the government bonds they invested in had an average maturity of over a year. That means there was a clear maturity mismatch risk.

Credit risk

The fourth factor was the credit risk which was, of course, not at all exceptional for Turkish banks. But even so, frequent ups and downs in the economy, weaknesses in the banking sector, excessive lending to unproductive sister companies, and external shocks had exacerbated the credit risk predicament of Turkish banks. Non-performing loans had exceeded 10 percent of the total loan portfolio of $46 billion -excluding the state banks' "duty losses" of around $20 billion.

In addition to the four major risks listed above, the banking system suffered from chronic size and capital adequacy problems. The entire system had an asset size of only $140 billion -- much smaller than some middle range individual western banks. Their equities totalled around $10 billion.

Last but not least, the banking industry remained dominated by inefficient state banks. Four commercial state banks had a share of

around 40 percent in the industry's total assets. Another 10 percent was owned by banks put under the control of the Savings Deposits Insurance Fund.

Assured of state backing, these banks offered higher rates to collect deposits and created an environment of unfair competition. Despite their heavy stake, state banks, except for Vak›fbank, did not operate on a fully commercial basis. Some had to make heavy commitments because of the system of state subsidies. And the government failed to compensate them properly – creating yet another source of "bad debt" for the system. Decades of transferring state losses onto three state banks have left these banks scrambling for overnight liquidity on money markets, an option that froze up with the load during the November and February crises.

Given the above risks and weaknesses, any crisis or turmoil in the Turkish banking sector should have come as no surprise. In other words, Turkey could have been hit by a similar crisis anytime before November. Or it might have plunged into another crisis anytime in the future unless the risks and weaknesses were addressed seriously and permanent solutions were tried.

Other contributing factors

In November, there were some other external and internal factors that broke the ground for such a crisis.

Abroad, economic woes fed investor fears that Argentina, Latin America's biggest borrower, would default on its debts. Concerns on Argentina had adversely affected sentiment towards emerging markets including Turkey. So the uncertainty over the fate of Argentina alone, was enough for investors to remain at bay.

At home, financial institutions were just about to adjust their positions in a seasonal year-end move to square their books. Furthermore, Turkish banks were under pressure to narrow their short fx positions because of the aforementioned regulations.

The monetary side of the economic program worked more succesfully than expected in bringing nominal interest rates down. As nominal rates came down very quickly in early 2000, inflation expectations did not keep pace since the other elements of the program were not in harmony. The unfortunate combination of declining interest rates and high inflation expectations boosted domestic consumption in early 2000, increased the trade deficit and weakened the fight against inflation.

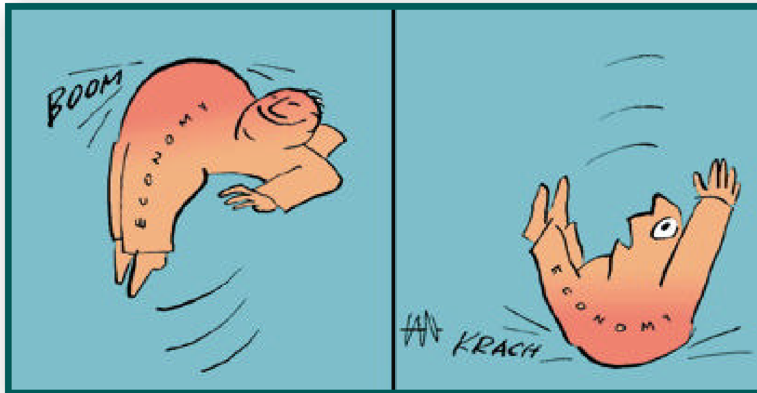
On the other side, the government, after an impressive start, had begun to show signs of reform fatigue - delays in some key structural steps such as the privatization of Türk Telekom, reforms relating to banking regulations and to the electricity and tobacco markets.

What really happened?

Towards the end of the year, Turkish banks moved to narrow their fx short positions. Their efforts to raise Turkish Lira to finance foreign currency purchases put an upward pressure on interest rates. Such a market trend was a serious threat for some banks, for example Demirbank. Banking on continued interest rate falls, Demirbank had set a strategy to beef up its already-large portfolio of government bonds after mid-2000. But by then it had begun to feel the pinch of the unexpected and unpredicted rise in cash rates. In other words, the interest rate risk mentioned above, had become an unpleasant reality for Demirbank, one of Turkey's 10 biggest banks in asset size. At the time, the bank was carrying more than $5.5 billion of government paper in its portfolio against its capital of around 300 million dollars. Like its peers, Demirbank was funding this portfolio through short-term borrowing. It was heavily dependent on short-term money markets.

Some Demirbank clients, scared by the developments, began to back away from the bank and this move closed the vicious cycle. Demirbank raised its repo and interest rates to attract desperately needed cash. This, in turn, was perceived as a rise in the bank's risk and triggered more withdrawals. The liquidity shortage forced the bank to sell government bonds which upped bond yields to around 40 percent from 35 percent in mid-November. With its hefty government bond portfolio, Demirbank was very active in the secondary bond market since it was one of 19 primary dealers. Amid mounting mistrust between Demirbank and other players, each move by Demirbank now raised concerns that the bank was emptying its bond portfolio. Bond yields went up to 42 percent. In a tense environment, even a small amount of bond selling -say $10 million- made an impact on a $45 billion market.

When the yields rose above 42 percent, primary dealers concluded that this was no longer a normal trading volatility. On November 20, they asked the Central Bank to assume the role of a market maker and lender of last resort by injecting liquidity into the market. More specifically the Central Bank was asked to buy papers on which foreigners had focused, such as the



It is widely accepted that efforts to stabilize the Turkish economy and correct economic imbalances will not produce the desired results unless Turkey's sick banks are nursed back to health.

bonds maturing on February 21, 2001. The Central Bank took no immediate action. Yields saw a high of 60 percent on accelerated bond sales. But high rates did not curb the demand for foreign currency from the Central Bank because foreign investors perceived the upward trend as a source of risk. Structured deals started to dissolve since rates around the 60 percent level triggered bond sales. After this widely unexpected bond dumping, yields went up to 100 percent.

This was a fast-unfolding crisis. In the next step, the fire -liquidity outflow- spread to the eurobond market. Turkish spreads over U.S. Treasuries, a gauge of how risky the market sees the debt of Turkey, widened sharply.

The market began to calm down after the Central Bank injected liquidity into the market and the IMF gave the signal for additional financial support. The Central Bank disclosed its intention of sticking to its monetary program and the government unveiled plans to implement reforms. Apart from the IMF's strong endorsement and the government's perseverance, another key move to halt foreign capital outflow was the introduction of a guarantee on bank liabilities. The government imposed a temporary state guarantee on all liabilities, including off-balance sheet items, in a move to encourage foreign creditors to keep their lending lines with Turkish banks open. The IMF support, state guarantee and new commitments by the government led to a foreign capital reversal and a fall in rates.

By early December, the fire had been extinguished but left the banks in a battered condition. On the asset side, they had commercial and consumer loans and government paper with a return of around 35 percent. On the liability side, they had funding items with costs up to 100 percent. Particularly, the banks that concentrated on the consumer loan business remained in a difficult position since, by law, they could not update the terms of such outstanding loans.

In January, the economy and the markets kept up their efforts for recovery. Inflation fell below 30 percent and the Central Bank was expecting the monthly rate of inflation to fall below one percent in the summer. Expecting that inflation will slow down, the Central Bank did not see that the real appreciation of the TL will have a huge impact on the country's balance of payments.

The economic management was confident that even a failure in the sale of landline monopoly Türk Telekom would not destroy the disinflation plan. However, there was a major test to pass –a key treasury domestic borrowing auction on February 21, which would enable the treasury to repay $5 billion of domestic debt. The treasury was widely expected to borrow in the auction as much as it needed –probably by assuming a little bit of extra cost.

In a move to boost the urgently-needed foreign confidence and the credibility of the program top economy officials had repeatedly assured investors who were wary after the November crisis that Turkey will not have a devaluation in excess of the crawling peg depreciation of the TL.

Amidst efforts for recovery, with optimism on the rebound about the future of the economy, no one was expecting Prime Minister Bulent Ecevit to commit political suicide. But he did.

The 75-year old Prime Minister stormed out of a National Security Council meeting after the President, Ahmet Necdet Sezer, attacked the government in an insulting manner according to Ecevit. With a brief but emotional public outburst, Ecevit declared "a state crisis". Within

several hours, stocks fell by 16 percent, bond rates soared and Turkish banks bought more than $4 billion from the Central Bank.

Within three-days Turkey was forced to float the TL. It abandoned the crawling currency peg that had been the centrepiece of the three-year program. Within a week, all IMF-backed reforms were in shatters. The TL has since lost around half of its value against the dollar. The treasury was forced to pay interest as high as 200 percent.

The crisis also revealed the fact that Turkey was not a major emerging market. When the country abandoned its controlled currency regime it prompted a knee jerk sell-off in other emerging markets. But these losses were swiftly reversed as contagion effects were seen as limited. When Thailand abandoned its currency peg to the dollar in 1997, it set off a domino reaction across Asia. A similar effect was felt across emerging markets when Russia abandoned its currency peg to the dollar in August 1998. Brazil followed Moscow some six months later.

Impact of the Crises

As Moskow of the FED said: "The cost of resolving a crisis once it has occurred is almost certain to be very high." It will be very high for Turkey and the IMF too.

The crises came just at a time when Turkey was looking for ways of strengthening and cleaning up its undercapitalized banking system. But during the crisis, Turkish banks suffered substantial losses on their bond portfolios due to sharp falls in prices. Their capital was partly eroded by these losses which aggravated the existing problem of capital inadequacy in the system. Unless interest rates decline to pre-crisis levels, deterioration in their balance sheets will continue.

The banks' credibility and ratings were severely damaged. Despite an improvement in their foreign borrowing conditions in the first half of 2000, they may face difficulty rolling over their maturing foreign debt this year.

The treasury had enjoyed a sharp fall in interest rates and big savings in its interest spending on domestic debt in 2000. But its borrowing cost will be higher in 2001, exerting pressure on fiscal balances due to the rise in interest rate expenditure for this year and next year. Turkey now needs a stronger primary surplus to attain the desired fiscal balance.

A primary dealership system, introduced in early 2000 as a big hope for boosting liquidity on the secondary market, almost collapsed during the crisis. It might be very difficult to revive that system again.

The crisis has sharply lowered the value of the Turkish banks at a time when they were in negotiations with foreigners for possible mergers and acquisitions.

Lessons of the Crisis

The crisis cast its shadow over almost all sectors, but there are some salutary lessons to be learned from it.

It highlighted the need to act quickly and decisively before a calamity takes hold. In the midst of the crisis, a banker told Reuters: "If this crisis teaches the government anything, it is that it must act decisively and quickly on banking...Half measures taken too late is the real problem."

Some bankers accused the Central Bank and the Treasury of delayed action. They believe that both institutions should have intervened in the market and played the role of the market maker and lender of last resort either before or around November 20. As it is, they announced a buy-back move five-days later and by then it was too late.

There is still some controversy over whether the Central Bank was late in intervening. But one thing that is clear is that Turkey was late in addressing the problems of its banking industry. Measures to solve these problems made their first appearance on the agenda in 1997. But no serious action was taken for the next three years. Such efforts lacked sufficient political support. Several years ago, before these problems had surfaced, the Turks were proud of their banking sector, which was known as the most profitable among the OECD countries. But the sector is now regarded as the Achilles' heel of the economy. It is widely accepted that efforts to stabilize the Turkish economy and to correct economic imbalances will not produce the desired results unless Turkey's sick banks are nursed back to health. The twin crises have in fact deepened the problems. It is a well known banking rule that some of the loans extended in high growth times may not return in slow growth times. There is a potential threat for the system that a rise in bad loans and contraction in the loan market may create more problems for the sector over and above the existing ones.

The most critical of the banks' problems is the capital inadequacy in the industry. Turkey's powerful Banking Board is expected to give priority to solving this problem. Those who want to keep their banks alive should beef up their capital. They must either sell equity participation, land or

property, or look for a partner to bring in much-needed capital. Or they will have to sell their banks to more powerful groups. Therefore, in the coming months, we may well see more mergers and/or acquisitions in the banking sector.

The international context

It is not only the changes in the Turkish economy that are taking place under the three-year program that pose a challenge to Turkish banks. There is also the challenge of the increasingly complex global financial system that forgives no errors. Banks should accelerate their move to switch from making profits on arbitrage and short-term lending activities to traditional banking services.

For the international community, the crisis has served to highlight the importance of pre-emptive rescue packages to avoid world-wide financial crises and their contagion effects. During the Asian crisis, the IMF was harshly criticised although it led bail-out packages for Thailand, South Korea, Indonesia, Brazil, Argentina, Russia and others. Markets blamed the Fund for not intervening earlier to prevent these crises.

In the Turkish case, the IMF was not too late. Some believe that in December it moved as early as it could. It did not sit by and watch the Turkish economy be ruined by speculators. Supportive remarks from senior IMF officials in the early days of the crisis were followed by a quickly organized emergency funding in the form of a Supplemental Reserve Facility. After the second crisis, the IMF gave Turkey a sum that exceeds its quota at the Fund.

Still, despite its successful post-crisis performance, the IMF was still accused of being partly responsible for the crises. It had not drawn up a contingency plan when the 2000-2002 programme was designed in late 1999 jointly by the IMF and Turkish officials. If there had been a contingency plan, critics say, the liquidity squeeze would not have evolved into a crisis. The need for a contingency plan was particularly vital because the Central Bank, under the IMF-designed model, was deprived of its major weapon -the ability to adjust the liquidity in the markets. The IMF, with its "blueprint" approach, made another mistake in setting constraints for the Net Domestic Assets (NDA) which kept the Central Bank from injecting liquidity in November. The Central Bank needed to meet NDA targets as part of its pledges to the IMF under the stand-by accord. Yet it also should have been able to provide liquidity to the troubled banking industry to solve the deadlock in the financial system. Finally it was forced to keep the TL within a pre-announced trading band during a strong attack on the lira. It was a very difficult task to fulfil particularly in a country with a fragile government. Under its standard approach the IMF hoped that any foreign capital outflow would send interest rates up and that such a movement would draw back foreign capital. But in reality, things did not work as they do in textbook cases.

Another criticism laid at the Fund concerned the pegged currency regime that the IMF recommended to Turkey. Currency devaluation in countries like Turkey and Morocco underline the problems inherent in fixed-exchange rate systems. Countries like Poland and the Czech republic that have shifted to free-floating currencies are in a far better position than the countries with dollar-pegged currencies. Many Turks believe that the IMF which advised the Asian countries during the 1997 crisis to leave pegged regimes in favor of a float gave Turkey a poor recipe. The currency regime, the nominal anchor of the disinflation programme, helped Turkey cut inflation but the success was achieved at the cost of a record high deficit in the current account last year. For some, the size of the initial stand-by loan -$4 billion- was not enough to back such a risky fx rate policy.

From the perspective of the IMF such criticisms are based on incorrect premises and inaccurate information. The IMF's former Turkey desk chief Carlo Cottarelli thinks the Turkish authorities were initially very effective in implementing the program "but were less successful in coping with unexpected events "such as the rise in oil prices and the strong dollar". He says that the IMF alerted Turkey to the risks that were emerging in mid-2000. "The February 2001 crisis was also preceded by policy slippage, " argues Cottarelli. His remarks point at the role of politics - coalition governments ruling with a shaky hand rather than an iron fist. This is particularly true for Turkey where the same faces have dominated the political scene for four decades.

No country is immune to financial crises. But there is another reality which might be the most important lesson to be drawn from the Turkish experience. As Michael Moskow, the senior FED official, says: "Countries with strong financial infrastructures including good operational and not just theoretical systems of supervision and regulation, legal frameworks, and private property rights have tended to be more immune to financial shocks and have tended to enjoy more stable rates of growth."

Servet Yıldırım is an analyst at Reuters in ‹stanbul