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ARTICLE INFO	Salih Katircioglu and Bilge Oney (2005). The Effects of Loose Monetary Union between a Small Country and a Large Developing Country in Crises: Experience from Turkey and North Cyprus. *Problems and Perspectives in Management*, *3*(4)
RELEASED ON	Tuesday, 08 November 2005
JOURNAL	"Problems and Perspectives in Management"
FOUNDER	LLC “Consulting Publishing Company “Business Perspectives”

The Effects of Loose Monetary Union between a Small Country and a Large Developing Country in Crises: Experience from Turkey and North Cyprus[1]

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Abstract

After the Turkish intervention in 1974, Cyprus was divided into two parts, North (Turkish) and South (Greek). In 1983, the Turkish Republic of Northern Cyprus (TRNC) was established and a sort of loose monetary union between the TRNC and Turkey started. The Turkish Lira (TL) replaced the Cyprus pound as the legal currency in the TRNC and a central bank – with no authority to issue money – was established. When Turkey tightened its monetary policy after signing an agreement with the IMF in December 1999, this immediately affected the weak banks in the TRNC – along with Turkey – and some of them collapsed. This study aims to look at how the banking crises that started in Turkey affected the banking sector in the TRNC. How it started, what were the reasons behind it, what caused it, could it have been prevented or what measures needed to be taken to reduce the effects of such crises in the TRNC. Results show that monetary union and economic integration between a small country and a large developing economy, even if it is a loose one, requires a careful preparation before unification and a good deal of cooperation and coordination between the two countries as regard to monetary policies. At the time of the crises, this cooperation and coordination between the central banks of two countries become even more important in guiding and supervising the sectors.

Key words: Monetary Union, Turkish Lira, Turkey, TRNC, Banks, Central Bank.
JEL Classification: E50, F33, F36.

1. Introduction

Globalization gained prominence especially after the World War II which is mainly caused by the liberalization of the world trade and monetary systems. There are two approaches to liberate the world trade (Chacholiades, 1990: 222): First is the global approach which is performed by the international conferences like Uruguay Round under the supervision of the General Agreement on Tariffs and Trade (GATT) and recently known as World Trade Organization. Second is the regional approach which includes the regional economic integration such as North American Free Trade Area (NAFTA) and European Union (EU) and is generally implemented by countries which are geographically close to each other and have a good political and economic relationships. This approach, in general, has more limitations and discrimination than the global approach. That is, members of the groups (e.g. EU) benefit from the free trade among themselves but non-members are subject to trade barriers.

Economic integration can be defined as the commercial policy of discriminatively removing or reducing trade barriers between participating countries, but continuing to impose trade barriers to non-participating countries (Salvatore, 1995: 229). It aims generally to expand the market, increase the productivity of factors of production, and thus, welfare, have a better resource allocation, speed the pace of industrialization and economic development. Preferential Trade Aggrement, where participating countries impose lower tariffs on each other's imports than on imports from other countries; Free Trade Area, where there exists free trade among the member countries, but each member is free to impose unique external tariff to non-member countries; Customs Union, where common external trade policy is adopted by all member countries to non-member countries; Common Market, where there is a free movement of factors of production; Economic Union, where the economic poli-

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cies are harmonized; and Complete Economic Integration or Union, where the economic policies (fiscal and monetary) are unified and central authority is assigned to control economic matters so that member countries become regions of one country; are all different forms of economic integration. Complete political integration is the final form of complete economic integration, where member countries become a single nation and central authority is needed to control economic and political matters which is responsible to a central parliament (El-Agraa, 1994: 2). The successful economic integration arrangement should possess the characteristics of Geographic Proximity (closeness), similar Levels of per capita GNP (Gross National Product), Compatible Trade Regimes and Political Will and Pledge for the Supra-National Organizations (Schoott, 1991).

Developed countries have completed their fundamental development requirements, therefore, their primary objective for the formation of economic integration is to facilitate their economic growth at stable and balanced levels. On the other hand, economic, political, social and cultural structures in the developing countries are more different than those in developed countries. In general, developing countries have the similar economic problems, potentiality and objectives. It is argued that the developing countries, in forming regional intergation, are aiming to pace the economic growth and to bring about fundamental changes in trade and production structure, by forming "regional trade structure" which will help them to adopt their economies towards regional specialization (basically, through import substitution) (Hitiris, 1994: 5-6). Most of the attempts toward economic integration failed and few of them gained little success (Salvatore, 1995: 314-315). These failures, in general, were due to three important factors: First is the political problem of sovereignty, where some member countries were not willing to give up their sovereignty for supranationalism. Second is the problem of transportation and communication, where most of the developing countries had inadequate transportation and modern communication means due to the financial difficulties. And third one is that small or less developed countries are afraid of being dominated by larger or more developed countries.

TRNC is a non-recognized state, possessing the characteristics of small island economies. Like many typical small economies it based its economic development on a few sectors: Tourism, education, banking and foreign Trade. GDP is 982.9 million US $ and per capita GNP (Gross National Product) is 4,610 US $ in 2002. Inflation rate is 53.2%, 76.8% and 24.5% per annum respectively in 2000, 2001 and 2002. Suffering from international non-recognition, an extensive embargo, limited natural resources and a population only around 211,191 people, North Cyprus has a small and a heavily service dependent economy, with 70% of GNP (Gross National Product) contributed by service sector, while industry and agriculture generate over 25% (SPO, 2002). This paper analyzes the effects of crises in two countries (Turkey and North Cyprus) which use the same currency. Section 2 represents important background information of North Cyprus banking sector; Section 3 includes developments in Turkey that have effects on North Cyprus economy. Section 4 and 5 defines methodology for survey done in the study and results and evaluations respectively. Section 6 concludes the study.

2. Background of North Cyprus Banking Sector

Although Republic of Cyprus was collapsed in 1963 due to the clashes between Turkish Cypriots and Greek Cypriots and since Cyprus was divided into two parts in 1974 somehow Greek Cypriots manage to possess the right of "Republic of Cyprus" identity and continue to carry out the embargoes and propaganda activities against Turkish Cypriots; even they use the aids provided by other countries or institutions under the name of "Republic of Cyprus", which all cause huge economic cliffs between two states. On the other hand, Turkish Cypriots proclaimed TRNC in 1983 which is still only recognized by the mainland Turkey. A central bank was established with no authority to issue money and the TL of Turkey is used as the legal tender. There were some differences such as interest rates and restrictions on the movement of TL between Turkey and TRNC at initial stages but they were removed in practice afterwards.

Because North Cyprus uses TL, it imports all the economic and political events to the island. There has been no preparation period or no convergence criteria to be met before this monetary union was realized. For example, the Maastricht Treaty set the conditions of passing to a single currency, EURO, for member states of EU (Eiteman et al., 2000: 35). The monetary union, which was established between Turkey and TRNC, was not the same as the monetary union in the EU. TRNC started with using the same currency, continued with free movement of capital and labor along with some inter-regional transfers, but matters such as, the free movement of goods and services, a common trade policy (in trade with non-member states) and common monetary and fiscal policies between the two countries were not realized in great extent. This is the reason why we call this union loose.

There were 7 local and 4 foreign on shore banks in North Cyprus before 1983. Today there are 27 on shore banks of which five are foreign banks. 10 banks were collapsed during the recent bank crisis. In Turkey, 20 banks out of 79 were collapsed in the recent crisis (Kibris, 2002: 15). The majority of the banks were established after 1990 in North Cyprus.

Despite its geographical size, there is excess number of banks operating in North Cyprus. Reasons are of 4 types: First, the government made the procedures and requirements relatively easy for banks to be established, as they believed that this would benefit the TRNC economy. Furthermore, they allowed free movement of currencies in and out of the country and they enforced a minimum exchange control system. They aimed to make North Cyprus one of the financial centers of the Eastern Mediterranean like Malta and Gibraltar. Second, the bank owners aimed to obtain considerably cheaper resources in order to run business since the financial markets in North Cyprus were not well developed and borrowing from others were more expensive. Third, if Cyprus ever enters the EU as a whole to have a bank already established would be beneficial. And the fourth one might be for money laundering purpose.

3. Developments in Turkey

Turkey signed an agreement with the International Monetary Fund (IMF) in December, 1999. The reason for this agreement was that, for more than two decades there had been high inflation, high interest rates and high level of domestic and foreign debt in Turkey. The average annual inflation between 1980 and 1990 is 33.6% and 75.2% between 1990 and 2000 (SSI, 2002). High levels of debts in Turkey were financed by the "hot money" policy. This means higher real interest rate than devaluation rate of foreign currencies. This was the way Turkey financed its budget deficit, domestic and foreign debt as well as trade and balance of payments deficits. Therefore, Turkey created a debt bomb. In 1999, Turkey realized that it could not continue with this policy as its interest payments reached 20% of GNP. Afterwards, everything went out of control with the February 2001 crisis and TL is left to flexible system resulting in almost losing half of its value. Debt of Turkey increased from 175 billion US $ to 205 billion US $ reaching 95% of GNP (Hurriyet, 2002: 17).

The aim of the program was to pull down the inflation and interest rates, and reduce the level of debts. This would be achieved by using foreign currency rates as an anchorage. As a result the foreign exchange rates would stay reasonably stable while the inflation and consequently interest rates gradually decreased. The duration of this program would be for 3 years and was hoped that by this time inflation and interest rates would gradually fall to a single digit. The plan was to reduce the inflation rates to 25% by the end of the first year, to 12% by the end of the second year and to a single digit by the end of the third year. The Central Bank would also work like a Currency Board and would not be creating money but only releasing TL against the amount of foreign currency entering Turkey (Central Bank of Turkey, 1999).

One effect of this program was that, the large and reputable banks in Turkey, taking into account the targeted inflation rates, started to reduce their interest rates. But smaller and weaker banks that were in need of liquidity had difficulty in reducing their interest rates. This deteriorated the financial position of these banks as well as posed a threat to the program and to the whole financial system. After the program, when controls were tightened and stricter measures were taken, the small and weak banks could not stand on their feet and they were taken over by the government (Saving Deposits Insurance Fund: SDIF) as there were full government guarantees for all personal deposits.

Unfortunately, one of the banks which were taken over by the government in Turkey had a subsidiary bank with the same name in North Cyprus. Everyone rushed to withdraw their money but because of the lack of sufficient liquidity, as a large part of the deposits was sent to the parent bank in Turkey and, as the TRNC Central Bank had no authority to create money to support it, the bank collapsed and the Central Bank took it over. The maximum state government guarantee for personal savings was 7000 pounds sterling per account in North Cyprus. Following this event, bank collapses continued and collapsed banks were taken over by the government. The important point was that there was a difference in the way the take over of collapsed banks were made in Turkey and North Cyprus. In Turkey, when a bank is taken over by the government, it is furnished with liquidity by the Central Bank and therefore it functions better than it did before. In North Cyprus, with a Central Bank, which has no power of supplying liquidity to the banks, those which were taken over by the government stopped functioning and clients could not even get their deposits despite the government guarantee. This situation did not only affect the bank clients adversely but at the same time it created an atmosphere of the lack of confidence for the whole financial system in the country.

A different practice was seen when four other local banks were taken over in December 2001. The TRNC Central Bank in cooperation with the Central Bank of Turkey – after securing the necessary fund – transferred all the accounts in those banks, together with necessary liquidity, to a state owned bank creating no victims. Only about 25% of the account holders withdrew their monies from the bank (information given by the bank).

4. Methodology

A survey is done for this study to observe the opinion of bank specialists in North Cyprus about the banking sector and recent crises in the country which were mainly affected by the crises in Turkey. Therefore, data are obtained from primary and secondary sources for this study. Primary data are created by employing a qualitative research with a semi-structured interview distributed to 14 of 27 on shore banks in North Cyprus. An average of one hour was spent with each respondent to get the answers to questions and discuss the problems in depth, which arose in the course of the interview. Local and foreign on shore banks are selected from the list of the Central Bank of the TRNC. The interviewers were top managers (chairman, general managers or assistant general managers) of those banks.

The results obtained from the questionnaire and interviews are extensively used in this paper. Additionally, some selected questions were cross-tabulated with each other to look at the situation from a small country's point of view.

The hypothesis of this study is: if a small country makes even a loose monetary union with a large developing economy, apart from the special measures needed to be taken to protect the small country, the coordination and cooperation between the central banks of these two countries as regards to monetary policies have utmost importance during a period of crises.

5. Results and Interpretations

As mentioned before primary data collection was implemented through a semi-structure questionnaire for this study. In answering the first questions, 65% of the respondents said that TRNC would have again experienced a banking crisis in the short run if the financial crisis in Turkey had not taken place. But a great majority (79%) mentioned that crises would have taken place in the long run due to the poor financial system and poor structure of some banks. There were many banks having inadequate capital which were also ineffectively controlled by the Central Bank. Even illegal transfers of bank resources by the bank owners to other business of them took place in North Cyprus prior to the banking crises. On the other hand, 86% of the respondents said that all the banks, small or big, were affected from banking crisis but 29% said that this effect went to the extent that pushed some banks out of business.

The majority (86%) of the respondents thought that banking crisis would have taken place even if TRNC had used a more stable currency, such as US dollar or Sterling Pounds. However, 57% believed that the effect would have been less if a stronger currency were used and 71% of the respondents said that if the TRNC Central Bank – in cooperation with the Turkish Central Bank – had supplied liquidity to the system, the effect of the crises would have been less. In answering question “what should the TRNC Central Bank have done in banking crisis?”, the respondents made the following suggestions in priority order; (a) it should have had effective supervision and control over the banks long before the crises started, (b) it should have supplied liquidity to the system, especially to the sound banks which had a temporary lack of liquidity. As known, the ultimate responsibility of a Central Bank is to provide banks under its charge with enough money to stop a run on the bank (lender of last resort) because all banks are illiquid – the average maturity of their loans exceeds the average maturity of their deposits. Some people argue that the only way to stop a run on a bank at no cost is to pump limitless amount of money into it and when the run stops and confidence returns to pull the money out (Hindle, 1989: 105).

The third suggestion was (c) to amalgamate the weak banks into the stronger banks. By doing so a confidence is created in the banking system and fewer clients withdraw their monies. Other three suggestions made in this respect were (d) to stop the money getting out of the country, (e) to establish an emergency center dealing with the crisis and (f) to reduce the reserve requirements.

An interesting example in this respect is the rescue plan (called LIFEBOAT), which was organized by the Bank of England in 1974 to rescue some of the small banks in trouble. Major Banks such as Barclays, Midland and Lloyds put up some 1.2 billion Sterling Pound to support the small banks that lent disproportionately to the property market before 1973 collapse. They threaten to bring down the perfectly sound banks with them (Hindle, 1989: 109-110).

In Turkey the banks, which had got into trouble and their losses exceeded their paid up capital, were taken over by the government. Afterwards, amalgamating and taking out the bad debts, and supplying the necessary funds to them, the government tried to sell them, even partly, to the other banks (their deposit savings, their branches with personnel, etc.).

Experiencing from previous mistakes the accounts of the last four banks that were taken over by the government in December 2001 were transferred to a state owned bank and made them available for the use of the account holders. Only 25% of the account holders withdrew their monies.

Almost 78% of the respondents stated that the Central Bank of Turkey had a duty to do in crises. Most of them believed that the Central Bank of Turkey should have guided the Central Bank of the TRNC and should have provided necessary funds to the system during the crises.

Additionally, 71% of the respondents preferred branch offices and 29% preferred subsidiaries of foreign banks to be opened in North Cyprus. Of those who preferred branch offices believed that the headquarters would supply the necessary funds to branches and would create the means of confidence in the system as they were part of major international banks. Of those who preferred subsidiaries mentioned that this form of business would be better controlled by the Central Bank bringing capital to the country, employing more local people and being on equal footing with the local banks. But in the last two banking crises those foreign banks which were subsidiaries all collapsed whereas foreign banks that had branch offices were not affected at all. In contrast, during the recent bank crises, Turkiye Is Bankasi, one of the major international banks in Turkey which had branches in North Cyprus increased its deposits and work volume tremendously.

All of the respondents mentioned that using the same currency and having monetary and economic integration with Turkey were the major reasons behind the crises in North Cyprus as caused from the crises in Turkey.

May be the most important result of the survey is that, if a small country makes a monetary union with a larger economy (even if this is a loose union), it is necessary to take certain measures to protect the small country, specially from the adverse effects arisen from the larger economy. For example, when Turkey experienced financial crises in 1994 and in 1999/2000 the TRNC had ones as well. Again in February 2001, when Turkey had to leave fixed exchange rate system all the negative effects of this decision were seen in the TRNC. But unfortunately, even the precautions which were taken to soften the negative effects of the crises in Turkey (supplying liquidity to the banks, paying the saving deposits to the account holders, etc. as they were guaranteed by the government) were not taken in North Cyprus. There was definitely a lack of cooperation and coordination between the two central banks.

The precautions needed to be taken in order to protect the small country are particularly important, if the living standards in the smaller country are higher than those in the larger one. In this case, the larger (and poorer at the same time) economy pulls down the smaller (and richer at the same time) country to its own level. In case of smaller country, such as Cyprus, that makes a monetary union with a much bigger and richer economy, such as the European Union, special measures are also needed to strengthen the financial system (e.g. increasing the capital base of the banks, effective credit and risk control of the banks by the Central Bank, encouraging banks to merge, encouraging international banks to come to the country, increasing the productivity of the banking sector, etc.) and to provide coordination of monetary and fiscal policies. For example, prior to European Monetary Union, each member is expected to meet certain convergence criteria as agreed in Maastricht, 1991 (See Eiteman et al., 2000: 35-36). It seems that, whether the small country is richer or poorer than the larger country does not make any difference. In both cases, the structure of financial system should be strengthened and certain monetary and fiscal conditions should be met prior to the unification. For one is to protect the small country from the adverse effects of the events in the larger economy and for the other is to make the small country ready for a more competitive larger economy. In either case a good deal of cooperation and coordination are needed between the two economies.

6. Conclusion

Results from this study show that monetary union and economic integration between a small country and a large developing economy, even if it is a loose one, requires a careful preparation before unification and a good deal of cooperation and coordination between the two countries as regard to monetary policies. At the time of the crises, this cooperation and coordination between the central banks of two countries become even more important in guiding and supervising the sector. This is also important for supplying liquidity to the system and working out a rescue plan to reduce the negative effects of the crises. Otherwise, the large economy transmits all the problems to the small country and pulls it down to its own level. This is especially important if living standards in the small country are higher than the larger one. Although the common currency in use, alone, could not be the main cause of the crises, if it is a weak one as in our case, it can increase negative effects of such crises. The main reasons were: too many banks for the size of the country, inadequate capital, ease in granting permission to establish new banks, illegal transfers of banks' resources by the owners to their other businesses, and ineffective control by the Central Bank and political inferences. The branches of important international banks are also important for supplying liquidity and providing confidence to the financial system, especially at the time of the crises.

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