# “An analysis of the efficiency of associations in providing financial stability: the case of Turkish banking system”


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# An analysis of the efficiency of associations in providing financial stability: the case of Turkish banking system


## Abstract

This article explores how associations can help to provide financial stability. According to the paper, even if public authorities implement regulatory and supervisory measures too strict, and undertake packages of monetary and fiscal stimulus too huge, they cannot solely be sufficient to preserve a long-term financial stability. Moreover, these measures and stimulus packages also induce a number of side effects. Therefore, this paper proposes two different instruments, democratic participation and self-control, that require active participation of associations in processes of decision-making and implementation. These instruments are vital for more stable economic and financial environment.


**Keywords:** financial stability, regulatory and supervisory measures, associations, democratic participation and self-control mechanisms.
**JEL Classification:** G01, G30, G32.

## Introduction

The global crisis has significantly damaged the global economic and financial system. The global economy has dealt with serious problems, including recession, unemployment. This is the most destructive crisis the world economy has faced since 1929. Unlike previous crises, it has threatened unprecedentedly the current economic and financial system. The global economy has been able to stand with government supports with difficulty in the face of aftermaths of the global crisis. According to Shiller (2008), the global crisis has brought about fundamental social changes, which affects our consumer habits, our values, and our relatedness to each other. Hence, the global crisis has raised serious concerns about the stability of economic and financial system.

On the other hand, the recent global crisis has sapped confidence in the regulatory and supervisory authorities in providing economic and financial stability. According to many academic and politic environments, it needs to take measures more radical in preventing a destructive crisis such as the global crisis. These authorities have put forward a number of solutions for a more stable and more resilient global economic and financial system. For example, so far, G20 countries have held four summits for a stable global economy. They have agreed on the next steps reforming and strengthening financial systems and creating global growth strong, sustainable and balanced (The G20 Toronto Summit Declaration, 2010). These steps include much more strict regulatory and supervisory measures, the plans of too much larger monetary and fiscal stimulus and far more comprehensive support programs.

Especially, new Keynesian policies seem to be effectual on the decisions taken in G20 summits. The global crisis has rekindled interest in new Keynesian policies. To build a stable and resilient financial and economic structure, they believe to be required much more and stricter public measures. New Keynesian economists accept that the policies supported by new Classical economists have been responsible for the global crisis.

However, it is too difficult to sustain the economic and financial stability through public authority alone. A reduction in interest rates, including reliance on standard monetary policies, and fiscal expansion, including additional public spending and tax cuts, and tighter regulatory and supervisory measures can enable an only temporary improvement (Akerloff and Shiller, 2009). According to this paper, the public interventions are necessary but not adequate for the stability alone. Even if the public agencies highly regulate and supervise the markets, they alone can not tackle the economic and financial instabilities. Moreover, the tighter regulatory and supervisory policies alone can also induce a number of side effects adverse. Thus, leaving ideological arguments aside, to eliminate these problems, this paper proposes two different instruments that require active participation of associations in processes of decision-making and implementation. These instruments are democratic participation and self-control. Associations can efficiently run two mechanisms that are vital for a stable economy. However, the current literature has not paid much attention to the importance of such mechanisms and the role of associations.

The remainder of the paper is organized as follows. Section 1 explains the efforts towards the economic and financial stability after the global crisis. Section 2 discuses the causes of ineffectiveness of public measures for stability in financial and economic system. Section 3 examines the efficiency of democratic participation and self-control mechanisms used

by associations. Section 4 analyzes the role of the Bank Associations of Turkey in providing financial stability. The last Section concludes the paper.

## 1. The efforts towards economic and financial stability after the global crisis

The global crisis has triggered a debate between new Keynesian economists and new Classical economists regarding the stability of global economic and financial system. While new Keynesians believe to be required public intervention, new Classical economists support the markets functioning freely. New Classical economists claim that the main reason of crises is markets not functioning freely because of interventionist government policies. In such case, the only solution is to eliminate the impediments for operating of markets efficiently (Mavroudeas and Papadatos, 2005). On the other hand, according to new Keynesians, the global crisis has shaken the basic assumptions of new Classical economic approach. According to them, the fact that many developed countries like EU members and U.S. have embarked on interventionist policies, including fiscal stimulus plans, credit facilities and bailout activities shows strong evidence for the return of Keynes. New Keynesians think that the root cause of the current global crisis is the adoption of the theoretical proposals of the Washington Consensus, coined in 1989 by John Williamson (2004) and are usual analyses advanced by new Classical economic theory. Instead of liberal policies in response to crises, new Keynesian economists propose the interventionist policies, including tighter regulatory and supervisory ones.

Conventional Keynesians have asserted that fiscal-policy multipliers are likely to lessen the aftermaths of crises. According to Keynes (2008), the cause of economic downturns is insufficient aggregate demand. When the total demand for goods and services declines, businesses' sales fall off. Lower sales induce firms to cut back production and to lay off workers. Rising unemployment and declining profits further depress demand. In such situation that total demand do not likely to increase, the only way is to step up the government spending. Higher government spending leads to a higher income, which causes higher consumption. New Keynesians argue that the global crisis has erupted because markets do not have any automatic mechanism to stabilize economic and financial system. In absence of regulatory and supervisory measures, recursive crises happen. Thus, economic and financial stability needs to be supported by countercyclical monetary and fiscal policy. Although new Keynesians have a number of minor disagreements about the politic instruments ranging from tax cuts to government spending, they accept that interventionist policies can be efficient to promote economic and financial stability.

Gregory Mankiw (2010), a believer in Keynesian theory and much of his researches is in that field, suggests that taxes are a better tool for fiscal stimulus. Tax policy may work better than spending policy at bringing an economy out of recession. Similarly, Andrew Mountford and Harold Uhlig (2008), by using vector auto-regression techniques, have also found that taxes have a more potent effect than government spending. Again, Romer and Romer (2009) found that taxes changes had an important impact on GDP. Paul Krugman (2009) claims that conventional policy responses were inefficient. According to him, it is vital to create enough demand to make use of the economy's capacity. If the global credit system works well, policy-makers around the world need to do two things: get credit flowing again and prop up spending. Similarly, Maurice Obstfeld (2009) asserts that having a bigger, more powerful and more effective lender of last resort raises the specter of moral hazard. Thus, more effective surveillance and regulation becomes even more important. Obstfeld suggests that while the lender of last resort has critical roles as a first line of defense versus global shocks, their longer-term powers are limited and at that point, fiscal authorities must step in. The global crisis has stemmed ineffective system of government prudential oversight (Obstfeld and Rogoff, 2009). Joseph Stiglitz (2009) asserts that most important lesson from the global crisis is unfettered financial markets do not work, and markets are not self-adjusting. Therefore, he focuses on deficiencies of regulatory framework contributed to the housing bubble. According to him, there will be fewer supporters of unfettered markets. There is a growing consensus on the need for reforms in the financial sector. In addition, according to Akerloff and Shiller (2009), in the event of a macroeconomic void, the government must fill it. Shiller (2008) argues that it requires taking fundamental steps to restructure the institutional foundations of the financial economy.

Many national and global policy-makers seem to be convinced by new Keynesians, accepting as liberal economy policies having been implemented since the beginning of 1980s responsible for the global crisis. Hence, the trend that has long been in favor of new Classical approach until the global crisis has switched to new Keynesian economic thought. This development is accepted as the resurgence of Keynesian economics by some academic and politic authorities. With global crisis, new Classical approach seems to having lost its influence.

Too many national and global authorities have embarked on Keynesian policies, including more gov-

ernment interventions. G20 countries, gathered four times so far, also have reached a consensus with regard to implementing Keynesian policies to reduce the crises despite of several disagreements. There is a belief among G20 countries that globally coordinated fiscal and monetary stimulus will play a major role in helping to restore private demand and lending. They accept that fortifying prudential oversight, improving risk management, promoting transparency, and reinforcing international cooperation will suffice to secure the global financial system. According to G20, a strong regulatory framework and an effective supervision are very vital pillars for a stable global financial system.

The G20, which includes 19 nations plus the European Union, was the locus of much of the coordination on trade policy, financial policy, and crisis response. Its membership is composed one most of the world's largest economies, both advanced and emerging-and makes up nearly 90% of world gross national product. The first G20 leaders' summit was held at the peak of the crisis in November 2008. At that point, G20 countries committed to keep their markets open, adopt policies to support the global economy, and stabilize the financial sector. Leaders also began discussing financial reforms that would help to prevent a repeat of the crisis.

The second G20 leaders' summit was held in April 2009 at the height of concern about rapid falls in GDP and trade. Leaders of the largest economies pledged to "do everything necessary to ensure recovery, to repair our financial systems and to maintain the global flow of capital". Furthermore, they committed to work together on tax and financial policies. Perhaps the most notable act of world coordination was the decision to provide substantial new funding to the IMF. U.S. leadership helped to secure a commitment by the G20 leaders to provide over $800 billion to fund multilateral banks broadly, with over $500 billion of those funds allocated to the IMF in particular.

In September 2009, the G20 leaders met in Pittsburgh again. They noted that international cooperation and national action had been critical in preventing the crisis and putting the world's economies on a path toward recovery. The leaders also focused on the policies, regulations, and reforms that would be needed to ensure a strong recovery while avoiding the practices and vulnerabilities that gave rise to boom-bust cycles and the current crisis. They launched a new framework for strong, sustainable, and balanced growth that committed the G20 countries to work together to assess how their policies fit together and evaluate whether they were "collectively consistent with more sustainable and balanced growth". Further, the leaders committed to act together to improve the global financial system through financial regulatory reforms and actions for increasing capital in the system.

It is not surprising that the G20 leaders agreed in Pittsburgh to make G20 forum as the premier forum for their economic coordination. This shift reflects the growing importance of major emerging economies such as India and China – a shift that was reinforced by the agreement in Pittsburgh to realign quota shares and voting weights in the IMF and World Bank (Economic Report of the President, 2010). The G20's highest priority is to secure and strengthen the recovery and lay the foundation for strong, sustainable and balanced growth so to strengthen the financial system against risks.

For the strengthened global financial system, they have focused on fortifying prudential oversight, improving risk management, promoting transparency, and reinforcing international cooperation. G20's reform agenda rests on two main pillars (The G20 Toronto Summit Declaration, 2010). The first pillar is a strong regulatory framework. G20 has supported the work of the Basel Committee on Banking Supervision (BCBS) towards a new global regime for bank capital and liquidity. Basel Committee has adopted the capital standards, including higher capital amounts and better capital quality. G20 has agreed to strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives. The second pillar is effective supervision. G20 countries agreed that new and stronger rules must be complemented with more effective oversight and supervision.

## 2. The causes of ineffectiveness of public measures in providing stability

G20 countries have agreed on the interventionist policies reforming and strengthening financial system. These policies include much more strict regulatory and supervisory measures, too much larger plans of monetary and fiscal stimulus and far more comprehensive support programs. According to this paper, public interventions are necessary but not solely adequate for stability. Moreover, these policies can also induce some side effects adverse. The following paragraphs explain why stricter measures of regulatory and supervisory and bigger packages of monetary and fiscal stimulus are ineffective to sustain long-term stability.

1. Asymmetric information is one of the most important factors that mitigate the efficiency of the public agencies. It is impossible to eliminate

completely asymmetric information. Asymmetric information in which one party often does not know all that he or she needs to know about the other party to make correct decisions (Mishkin, 1991). In other words, financial and non-financial actors always have more information about their own risky activities, value of their assets and their investment opportunities than public agencies do.

2. Because a regulatory and supervisory authority can not completely forecast what the other actors' intentions that are leading instabilities, it is hardly ever possible for them to apply simultaneously regulatory and supervisory measures associated with the stability.
3. The public agencies are not likely to curb the other actors which are having excess profit and benefit incentives via regulatory and supervisory policies.
4. The other actors, having these incentives, can act too much faster than the regulatory and supervisory authorities not having the same incentives. No matter how fast, the measures taken by the public agencies will be late.
5. Public measures, including bailout operations, can also bring about some adverse side effects. Bailout operations impose an enormous burden on taxpayers. As a result, whatever the purpose of these operations, outsiders, in other words taxpayers, pay for the irresponsibility of insiders, such as firms, banks, investors, credit rating agencies etc., private benefits turn into social costs. Thus, the sources assigned for special public services, such as education and health, disappear (Goldstein, 2003). Moreover, these debts stemming from huge bailout operations are also transferred to the next generations (Bonner and Wiggin, 2006).
6. In credit squeezes, governments are obliged to undertake open-ended bailout operations by other actors who need credit. As a result, it is imposed enormous costs on taxpayers. This is an unfair situation (Mason and Rosner, 2007). Although the triggers of the global crisis are banks, investors, credit rating agencies, debtors, the public agencies etc., the bailout operations have imposed an enormous debt burden on taxpayers who are not responsible for the crisis. This is definitely not consistent with justice principle that is one of the most primary principles of jurisprudence.
7. The bailout operations induce an unfair competition. Actors ensure their survival by public authority. When they got in trouble, they gain a competitive advantage among others by reaching cheaper funds.
8. The bailout operations, for example lender of last resort interventions, also lead to moral hazard problems. There is a trade-off between interventions and moral hazard problems (Mishkin, 2000). In addition, there is a trade-off between government policies aiming financial stability and other government policies that have other aims. The government policies, making economic and financial system stable, can contribute to reduce the risky activities. On the other hand, they reduce investment level and as a result the growth rate (Allen and Wood, 2006).
9. Other actors can experience a growing feeling of exclusion due to the lack of control over the measures. Thus, many firms, households, companies, banking etc. are pacified and become the objects of government policies, including regulatory and supervisory ones, rather than the active subjects of ones. Because the other actors are not a part of the decision-making and control processes, they usually become reluctant to adopt the measures. If the people think that the regulatory and supervisory measures taken by the public authorities serve their own interests, the case of dissatisfaction emerges and the measures cannot provide a long-lived stability.
10. Initially, a strict regulation and supervision constraining reckless activities may promote economic and financial stability. However, in following process, in order to exceed these barriers, the other actors start to seek new activities, including much more complex products and methods. Under intensive competition and excessive profit pressure, the set of regulatory and supervisory measures like Basel I and Basel II become increasingly inefficient (Felton and Reinhart, 2008). So far, the other actors have always tended to use methods that are far more complex to escape from tighter standards. Actually, tighter measures imposed by the public agencies, as long as the other actors do not participate in decision-making and implementation processes of the measures, generate instability. In the second half of 1980s, under the auspices of Bank for International Settlements (BIS), in Basel, the big economies agreed on common capital standards. The purpose was to build a regulatory and supervisory structure and to make the global financial system more resilient. To this end, it was determined the standards of the capital adequacy, Basel I, for the first time in 1988 (Tarullo, 2008). Because Basel I was

composed of quite simple standards, it also had a number of weaknesses. In following process, this frailty of Basel I allowed the banks to make use of business opportunities that were further profitable. As the banks adapted to Basel I, its efficiency started to fall. Thus, since the second half of 1990s, Basel II has sought to strike a different balance, by asking banks to be more sophisticated in assessing the riskiness of their assets and their capital requirements (Tarullo, 2008). In spite of tighter Basel II standards, the global crisis erupted.

## 3. The efficiency of associations via democratic participation and self-control mechanisms for stability

In order to eliminate the other actors' feelings of exclusion from the decision-making and controlling process, this paper suggests two different solution proposals, consisting of democratic participation and self-control mechanisms. If each economic actor can effectively participate directly in all stages of decision-making and controlling, the current policy is much more democratic. In an unstable economic and financial environment, these mechanisms are vital for activities that are more prudent.

Democratic participation and self-control mechanisms can greatly be efficient in solution of many economic and financial problems such as health care, education, housing, banking etc. Both the public agencies and the others (households, firms, banks etc.) must take part in all processes of decision-making and controlling for a more stable financial and economic environment. A collective decision-making and implementation, in other words multilateral approach, is able to make the economic and financial environment more stable than unilateral government policies are solely able.

By means of democratic participation, the other actors, along with public agencies, can get involved in the process of decision-making with regard to regulatory and supervisory measures. This is the first stage in which is determined regulatory and supervisory measures. In this stage, other actors must have the same vote as the public agencies. The second phase consists of the implementation and controlling processes of the regulatory and supervisory measures taken by all actors. The other actors, along with the public agencies, contribute this phase. Thus, self-control mechanism works far more efficiently. However, it is an important problem how democratic participation and self-control mechanisms can be used. This paper suggests that economic and financial associations can efficiently use these mechanisms. Thus, other actors via associations can take part in all processes.

Associations, also defined as "third sector", are in a place between public agencies and other actors. They are unions of persons in a company or society for some particular aims. They are one of the most important actors having social dialogue role in political, social, cultural and economical areas. The presence of them is seen as an indicator of a healthy economy in the level of local and national financial measurements. Especially, because neither other actors nor public agencies can solely fulfill all the needs of economic and financial system, associations are getting more and more important for economic and financial stability (Pestoff, 2009).

Associations are classified into different groups according to their aims, such as voluntary associations, professional associations, trade associations. Voluntary associations are group of individuals voluntarily working on a purpose. Trade associations are organizations founded and funded by businesses that operate in a specific industry. Professional associations are usually non-profit organizations working for the interests of specific profession and the public interests. The associations in this paper, striving to provide the stability of economic and financial system, are similar to both professional associations and trade associations.

Associations can play an active role between public agencies and others. They can build an information bridge between the former and the latter. Firstly, associations can allow other actors to take part in all decision-making processes. In decision-making process, public agencies and associations together take all decisions, including regulatory and supervisory measures. Secondly, public agencies and associations together implement the taken decisions. Therefore, a self-control mechanism can be activated in implementation process. If the associations are active partners of the current economic and financial system, then together they could function as co-regulators and co-supervisors for the stability. Figure 1 helps to depict the role of associations for the economic and financial stability.

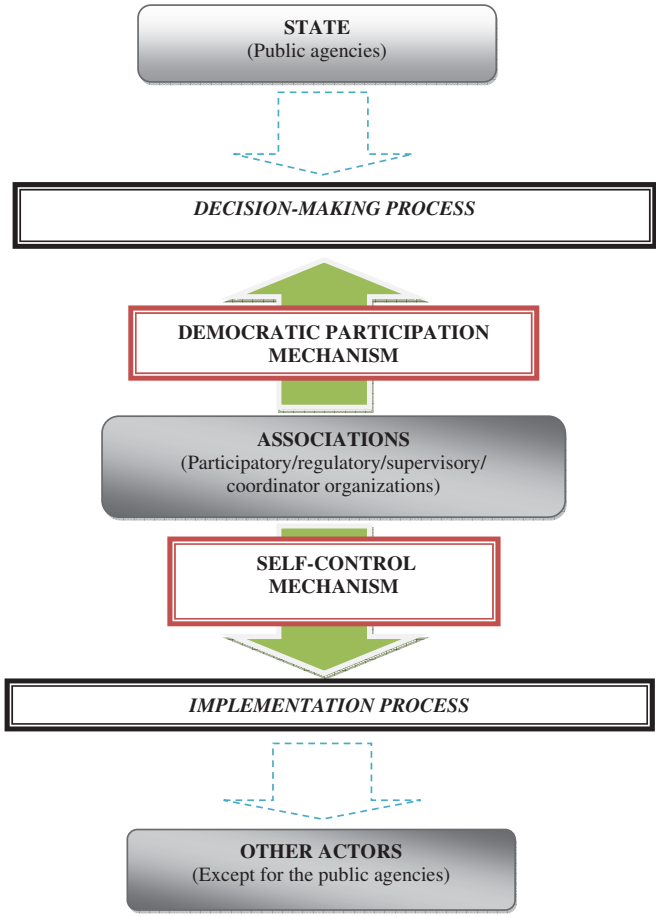


**Fig. 1. Use of democratic participation and self-control mechanisms through associations**

Associations can make financial and economic environment much more stable and flexible. The central authority can not solely supervise all activities of the other actors. Associations can act as a local supervisory authority in preventing the activities generating instability. In promoting economic and financial stability, the local supervision is as important as the central one. The households and the firms via the associations could become active participants (Pestoff, 2009). A direct participation in regulation and supervision processes will give them substantial influence and resolve their growing feelings of exclusion. Thus, it could result in positive contributes such as greater pluralism. On the other hand, the associations can efficiently overcome the market's challenges, which require the collective participation, and create a financial and economic future more sustainable and flexible.

However, many politic and academic environments have not devoted adequate attention to the contemporary role of associations. For ideological reasons some claim that the public agencies can solely provide the stability. Others claim that the market alone is best suited to provide it. Leaving these ideological positions aside, associations can effectively coordinate the efforts of stabilization.

Associations can effectively work for stability in all main sectors and sub-sectors. For example, farmers associations can undertake an active role, which includes training, instruction, market reviewing and education, to compete with farmers in other countries. In addition, they can participate in decisions taken by governments about the agriculture and control agricultural production and marketing processes with regard to a number of standards such as quality, pricing.

## 4. The role of the Bank Associations of Turkey in providing financial stability

Section 3 has analyzed how associations via democratic participation and self-control mechanisms can play a critical role in providing stability. In past, within Turks' traditional economic approach, it was employed far wider range of associations from agriculture to manufacture. For example, akhism, a guild organized as cooperation and solidarity in Anatolia, regulated and supervised tradesmen all respects. However, today in many sectors, one of which is Turkish banking system, it is hardly ever being benefited from associations despite of their many advantages.

The fragilities of Turkish banking sector had a key role in triggering both 1994 crisis and 2001 crisis. As a result, three banks in former and over twenty banks in latter went bankrupt. Whereas, in promoting stability related to banking system, associations could have worked efficiently as co-regulatory and co-supervisory actors.

Associations can also have a vital role for economic and financial stability, especially in banking system. Thus, the aim of this paper is to attract attention the stabilizer role of the Banks Association of Turkey (BAT). In Turkey, there are three public institutions regulating and supervising Turkish banking system. The first is the savings deposit insurance fund (SDIF), an association established for the protection of deposits. SDIF steps in through the resolutions written in the related legislation when the bank, in which deposits are invested can not repay the owner's deposit. It pays the total amount under the insurance to the depositor/s. In order to take back the totals it paid, it initiates the legal process about the bank having difficulty in paying.

The second is banking regulation and supervision agency (BRSA) having main objective ensuring confidence and stability in financial markets. To secure the rights and benefits of depositors and to create the proper environment, in which banks and financial institutions can operate with market discipline, in a healthy, efficient and globally competitive manner, BRSA is contributing to the achievement of long-run economic growth and stability of the country. Some of main goals of the organization are:

- to enhance banking sector efficiency and competitiveness-elimination of distortions created by the state banks;
- strengthening of the banks' capital base;
- to maintain confidence in the banking sector;
- making adequate, understandable and accurate information accessible to the markets;
- promoting international best standards in accounting and reporting systems;
- to provide a transparent environment in which information on risks is clear and accessible for all parties;
- to minimize the potential risks to the economy from the banking sector;
- developing early warning and prompt correction systems to prevent individual problems from causing systemic risk;
- to enhance the soundness of the banking sector.

The third is Central Bank of the Republic of Turkey (CBRT). The primary objective of the bank shall be to achieve and maintain price stability. The bank shall determine on its own discretion the monetary policy and it shall implement on the monetary policy instruments that it is going to use in order to achieve and maintain price stability. The bank, provided that it shall not be in confliction with the objective of achieving and maintaining price stability, shall support the growth and employment policies of the Government. CBRT takes precautions for enhancing the stability in the financial system and takes regulatory measures with respect to money and foreign exchange markets. In addition, CBRT monitors the financial markets.

This section only focuses how the associations are able to be efficient for more stable banking system in Turkey. In Turkey, the BAT has the potential to use the democratic participation and self-control mechanisms. Nevertheless, the BAT is not the authority for using these mechanisms. In other words, BAT can not participate in any processes of decision-making and implementation. Without the association's participation, only a few public institutions such as CBRT, SDIF and BRSA take all decisions and implement them.

The BAT, founded in 1958, is a professional organization, which is a legal entity with the status of a public institution. All deposit banks, development and investment banks operating in Turkey, are obliged to become members of this association at most a month after they get their permit of operation, and to comply with the provisions of this Statute, and to implement the decisions taken by the authorized bodies of the association.

Figure 2 shows the potential role of the BAT in providing the stability of Turkish banking sector. BAT can undertake a mission to bridge between the public agencies and the banks. Firstly, association by means of democratic participation mechanism actively contributes to all decision-making process regarding the banking sector on behalf of its members. In the process, BAT must have the right of vote as well as public agencies.

Secondly, in tackling reckless activities of banking system, public agencies are not an effectual supervisory. Moreover, public interventions can also induce a number of side effects adverse. Under the circumstances, BAT along with the public agencies, can achieve to a much more efficient role. Certainly, BAT can employ far more efficient control instruments on its own members than public agencies can. Thus, association can efficiently make the self-control mechanism possible.

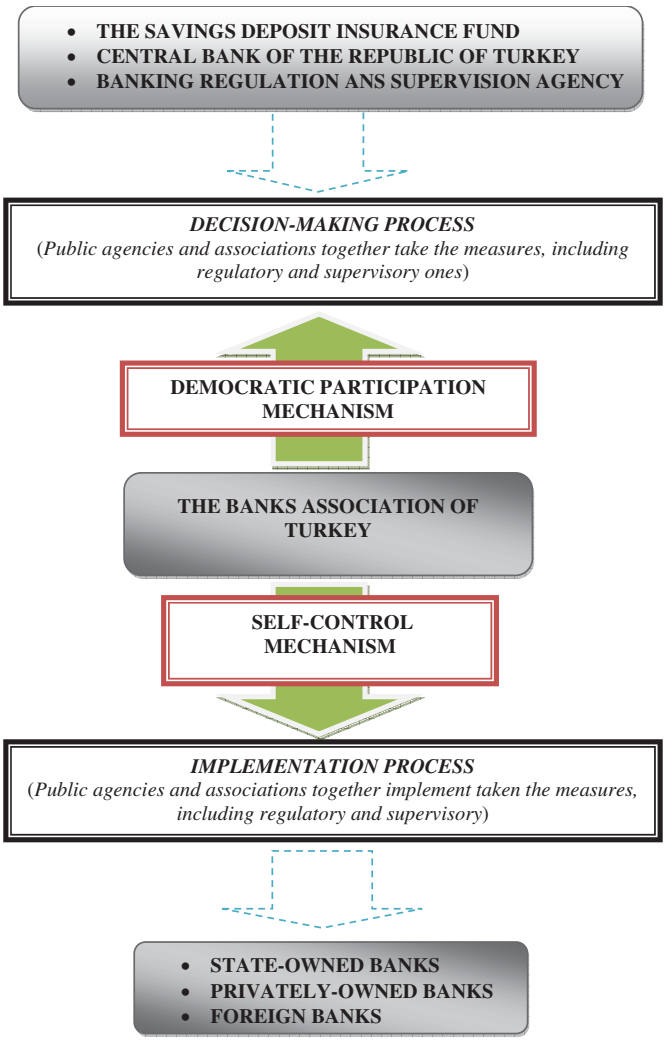


**Fig. 2. The role of the BAT in providing the stability in the banking sector**

## Conclusion

The approaches only re-regulating the financial markets will have a limited efficiency to solve financial instability problem. For a final solution, it needs more reforms than financial regulations. These reforms are vital to a sustainable growth rate. The measures that are focusing only regulatory and supervisory reforms, and that the packages of monetary and fiscal stimulus can restore the global growth rate in short term. However, in long term, it will be unavoidable to face other financial troubles having much more serious effects. Although the global crisis has deeply shaken the foundations of global economic and financial system, the main characteristics of current economic and financial structure have almost never changed. Therefore, there is a need for more radical steps to avoid a recurrence of crises.

Public interventions are necessary but not adequate for stability by themselves. Moreover, they induce a number of side effects adverse. Therefore, there is a need for more efficient instruments to provide stability. Leaving ideological biases aside, this paper proposes two different instruments, democratic participation and self-control mechanisms, that require active participation of associations in all processes of decision-making and implementation. However, owing to a number of ideological reasons, many politic and academic environments have not devoted adequate attention to the contemporary role of associations and the efficiency of democratic participation and self-control.

According to the paper, two instruments are vital for more stable economic and financial environment. Especially, associations can effectively coordinate the efforts of financial stabilization such as in the case of the BAT. If association is an active partner of the current economic and financial system, it could function as co-regulators and co-supervisor for stability. For the country having the experiences of many banking crises, strengthening financial stability and reducing likelihood of crises ultimately requires a collective participation in all processes.

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