

# **MASTER THESIS**

## **ANALYSIS OF THE TURKISH FINANCIAL MARKET WITH FOCUS ON EU MEMBERSHIP**

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## 1. INTRODUCTION

The relationship, which has been going on between Turkey and the EU for fifty years, has reached an important stage especially in the period of 2000 – 2012 despite some distributions during the course of the years. After the Customs Union (CU) between Turkey and the EU came into effect in 1996, and Turkey was granted EU candidate country status in 1999, the economical and political integration relation between Turkey and the EU has gained a new dimension, and so Turkey achieved an important step to be full membership in the EU.

Turkey and the other candidate countries, which become a member country of the EU and join the economic and monetary union, has tried to fulfill the political and economical criteria, such as Copenhagen and Maastricht criteria. Due to the certain constraints and some concerns on certain subjects, the integration of Turkey to the EU has interrupted – especially following 2008 global financial crisis and 2010 – 2012 debt crisis in Euro Area. During the period of 2008 – 2012, there have been very important economic developments in Global and European financial markets. Turkey's objective to be full membership in the EU has become more important for political and economical interests of the EU. During this period, Turkey's economy has developed in contradiction to the Global and European financial markets. This indicates that Turkey and the EU are need in for each other's presence especially in economy to create a more effective and important global force. Therefore, this paper is prepared to examine and analyses the importance of Turkey for the EU due to in particular economical reasons.

Between the first part and the sixth part of this paper, the history of the EU and Turkey relations, and legal, political, social, cultural, and especially economical issues for the full membership of Turkey in the EU in order to show the economic–political structure and the integration ability of Turkey with the EU are discussed. In the seventh, eight, and ninth parts of this paper, the Global, European, and Turkish financial markets during the period of 2000 – 2012 are discussed, with a focus on the impacts to Turkey of the 2008 global financial crisis, and current structure analysis of Turkish banking sector and stock markets in order to show broadly the effects and comparisons of financial developments for Turkey and the EU on Turkey's Accession to the EU. The last part of this paper evaluates Turkey's possible accession to the EU given recent developments in Turkey's economy and financial sector.

## 10) CONCLUSION AND OUTLOOK

With the commencement of the CU on 1 January 1996, Turkey took important steps to fulfil the Copenhagen economic criteria. Turkey's accession negotiations with the EU had started to slow down prior to the debt crisis in the Euro Area, and the process of the negotiations entered a period of stagnation, regardless of the crisis. The arguments put forward against Turkey's membership in general are mainly political. There is not much more than economic reasons to oppose the membership of Turkey which has low public debt, fiscal discipline, higher capital adequacy of the banking sector, and high economic growth. On the other hand, the economic basis of views relating to reducing the attractiveness of membership of the EU crisis is not very strong. Despite the crisis in the EU, the rate of Turkey's GDP is still half the level of the rate the EU's GDP. Similarly, Turkey lags behind the EU average in basic statistics, such as education level, employment rate, labour force participation rate, income inequality, inter-regional differences in development and gender inequality. Therefore, the EU with the high level of development and prosperity still continues to be an attraction for Turkey.

The 2008 global financial crisis has led to most of the world economy entering into quite a deep recession. One Europe ideal of the 27-member EU is no longer seriously questioned in the face of severe economic devastation, combined with global economic crisis. The economic crisis led quickly to a decline in global economic growth, and the unemployment rate increased rapidly with the impact of the crisis. The young labour force has been the most affected by the global economic crisis. Despite this, Turkey has achieved significant economic developments during this period.

During the 2008 – 2012 period, growing economic imbalances in the international markets increased inflationary pressures throughout the world. In developed countries, measures to slow demand are taken to limit the growth of domestic demand in spite of inflationary pressures, and the interest rate is increased. These measures lead to changes in international portfolio preferences, and capital outflow from developing countries is experienced. The market responses and movements in the markets of the countries, which experience capital outflows, lead to re-determining the risk perception of these countries. This process in developed countries is expected to continue until inflationary expectations are recuperated.

After the 2008 financial crisis, the economic indicators of many European countries deteriorated due to the stimulus packages put in place to stimulate the European economy and increase public spending. After 2009, the ratio of the budget deficit of the GDP particularly in the Euro Area and countries such as Ireland, Greece, Portugal, and the United Kingdom was

well above the 3% limit of the Maastricht criteria. In some European countries, the debt ratio limit of 60% has also been exceeded owing to the deterioration in fiscal balances. In addition, the Euro Area, which grew by 1.4% in 2011, is forecast to contract by 0.3% in 2012 and grow by 0.9% in 2013. High public debt and deficits, lower potential output, and the growing tension in the European markets create pressures on the growth of the many developed European economies.

High public debts as well as high household and corporate sector debts in the EU make it difficult for the private sector to contribute to economic activity, and constitute an important risk factor on the growth of the EU. Low asset prices and depreciation of government bonds from the debt crisis in the Euro Area put pressure on bank balance sheets. Re-capitalisation of the European banks and balance sheets of these banks to reduce risky assets may also put pressure on financing costs in emerging and developing European countries.

After the debt crisis in the Euro Area, the EU made an effort to regulate more tightly the shadow banking system in Europe (which reached the size of about 46 billion Euro and caused the financial crisis), in order to again provide financial stability in Europe. The banks which had entered a period of difficulty of borrowing over the long term spread low interest loans of the ECB which, to a certain extent eased European financial markets. During this period, price stability was the main objective of the EU. Thus, the ECB has continued the policies supporting the European financial system and the countries with the debt problems. In this context, the yield spread of the Greek 10-year government bond, according to German bonds, reached high levels with the measures of the ECB in the first quarter of 2012. In the beginning of the second quarter of 2012, this yield spread decreased significantly with the effect of the measures for Greece.

The positive results of the measures taken by the ECB partly caused the relaxation in the CDS markets. With the effect of the measures taken by the ECB for Greece, the CDS rates increased in the other countries with debt problems, such as Portugal and Spain. Portugal and Spain have continued to adhere strictly to the fiscal program of the ECB despite their economic recession and high unemployment rates. However, Standard & Poor's lowered the credit rating of Spain for the second time in 2012 due to concerns over the financial support, which must be given to the banks during a contraction of the economy, will increase despite the measures taken by the government of Spain. Thus, economic developments in Spain following the developments in the economy of Greece led to increasing concerns in the Euro Area.

By the second quarter of 2012, the EU has undertaken the aid of the banks of Spain which have serious economic problems, and thus, the EU has taken an important step with respect to co-finance/debt. The inhibition of both a similar situation occurring in Italy and Greece and the expectation of the debt crisis in the Euro Area continue to be perceived positively by the global and European financial markets. With the effect of this positive stage, international stock exchanges, the Euro and commodity prices may mitigate the effects of their decline in the first six months of 2012.

Turkish financial markets are floating on the positive side of the financial ledger under the affects of their own dynamics. Thus, Turkey may not be able to participate in the same way in the EU upsurges. However, the developments related to the EU are important for Turkey in the short term. If the EU debt crisis subsides, Turkey's exports to the EU increase.

The EU is the number one trading partner of Turkey, and the EU's share in Turkey's total trade stood at 41.6% on average during the period of 2008 – 2011. In 2011, bilateral trade volume of the EU and Turkey reached a record level of 110 billion Euros. Due to the weight of the EU in Turkey's exports, Turkey's export performance is directly related to demand conditions in the EU Member States. The economic slowdown and recession in the Members of the EU negatively affect Turkish exporters and manufacturers in the form of market contraction. Although Turkey shows intense efforts to increase the diversity of the market, full substitution of the market loss of the EU by Turkey is not possible in the medium term.

Turkey's high ratio of savings deficit to the GDP makes itself one of the most important developing countries. The saving deficits and thus the reduction of the current account deficit have gained importance. Therefore, efforts were made to slow down the domestic demand of Turkish economy in a controlled manner. However, the important issue of the Turkish economy was ensuring stability in the markets within the short term. After 2002, capital inflows to Turkey have been above the current account deficit. At the same time, the surplus of foreign exchanges in the Turkish economy was used to increase the reserves. Thus, the reserves of the CBRT are very strong, and the demand on the capital outflow is at a level, which can be met.

Turkey's efforts to reduce the trade deficit and balance domestic and external demand conditions of the country, continue into 2012. Despite the increase in exports to third countries, stasis or the decrease in exports to the EU prevent the desired speed of Turkey's effort to correct the imbalance in foreign trade. Low domestic savings increase Turkey's dependence on external financing, and widen the current account deficit of Turkey. Turkey's economy shrank by 4.8% in 2009, when funding opportunities were restricted with the effect

of the global crisis. The abundance of global liquidity re-accelerated short term capital inflows to Turkey's economy, and so the growth rate of Turkey reached 8.5% in 2011.

With this positive economic performance, the credit rating of Turkey has improved and more importantly, Turkey made significant progress in becoming a country which is invested in having a positive credit rating. In the next year a constant flow of capital is expected in Turkey. An increase in capital inflows of Turkey's economy within the process of the contraction of the current account deficit will lead to the falling of interest rates and exchange rates, and the rising of the Turkish stock market.

By the second quarter of 2012, the CBRT increased short term interest rates in order to relieve the pressure of rising inflation on Turkey's economy. Thus, the CBRT gave a strong message to return inflation expectations of the medium term into the positive. But this message is not perceived to be complete due to instability in Turkish financial markets. For this reason, the primary aim of Turkey's economy should be to ensure stability in the financial markets as soon as possible in order to reduce uncertainty and be able to implement the decisions taken by economic agents. The decisions, implemented by the CBRT in order to reduce volatility in the foreign exchange markets, are indicated and should be resolutely pursued. For this reason, macro aggregates of Turkey's economy should be re-determined by taking the changing conditions into consideration. By revising the inflation expectation of Turkey's economy, all relevant financial institutions should make the necessary effort in order to achieve the target set. The measures to be taken in order to maintain stability in Turkish financial markets should complement each other, be a part of whole, be pre-designed, and be explained in a moment. A controlled deceleration policy in Turkey's economy should be monitored without disrupting the balance of the public sector, and expenditure management should be preferred to maintain the balance of the public sector.

The Turkish banking sector generally positively evaluates the decisions taken by the CBRT in order to reduce the volatility (caused by fluctuations in the international financial markets) in Turkish financial markets, and expects the efficient application of the decisions. Monetary policy decisions are expected to be supported by other decisions in order to ensure the stability of Turkey's economy in the medium term.

Three quarters of foreign funding provided by the Turkish banks originate from the EU. This case leads to the problems in the functioning of the credit system in the EU to be felt in Turkey as a whole. With the impact of the crisis, banks and the non-bank corporate sector experienced difficulties in accessing in particular long term financing and foreign funding on favourable conditions. Affiliates and subsidiaries of foreign banks in Turkey did not need

their main partners in terms of financing, and had high capital adequacy ratios in order to limit the negative effects of the crisis in the EU.

Turkey's dependence on external financing increases the impact of the EU crisis to the country's economy by investment. The investments from Gulf countries, as well as the USA and Russia to Turkey are at a much lower level than those of the EU, and Turkey is not yet an investment country for China. The economic crisis in the EU restricts the foreign investment of these countries. Thus, the economic crisis in the EU also negatively affected the potential of foreign capital in Turkey.

On the other hand, severe economic crisis is a fact that is known to strengthen extremist political movements, and cause an increase in xenophobia. The strengthening of the far right parties in Austria and Greece, and some of the anti-democratic practices followed in Hungary also negatively affect the view of EU enlargement in general. In the case of a possible collapse of the monetary union, the enlargement of the EU and Turkey's full membership in the EU is expected to continue to drag for a long time.

In terms of economy, there is no serious problem in the realisation of the full membership of Turkey in the EU. The main problem is the reluctance to fulfil the economic obligations arising within the framework of full EU membership against Turkey. For example, the EU wants to postpone for a long time the free movement of labour, and the EU does not want to give Turkey the benefit of structural funds. Economically strong Turkey will have positive effects in terms of the geography in both the EU and Turkey. Therefore, Turkey's full membership in the EU is an inevitable result of the general economic and political development.