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Financial deregulation and total factor productivity change: An empirical study of Turkish commercial banks

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Abstract

In January 1980, a new liberal economic policy was adopted in Turkey to promote financial market development and increase the efficiency and productivity of the financial sector by fostering competition among banks. As a result of this policy, the Turkish banking system witnessed a series of legal, structural and institutional changes throughout the 1980s. To enhance their competitive viability, Turkish banks responded by streamlining their operations and investing in new technology. Utilizing a DEA-type Malmquist Total Factor Productivity Change Index, we examine productivity growth, efficiency change, and technical progress in Turkish commercial banks during the deregulation of financial markets in Turkey. We found that all forms of Turkish banks, although in different magnitudes, have recorded significant productivity gains driven mostly by efficiency increases rather than technical progress. Efficiency increases, however, were mostly owing to improved resource management practices rather than improved scales. Our results also indicate that private banks began to close their performance gap with public banks in the new environment.

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1. Introduction

Almost all financial transactions taking place in both money and capital markets in Turkey are conducted by banks, which have been the key instrument of the government-orchestrated economic development policy for years. As anywhere else in the world, banking in Turkey has been a highly regulated industry, commensurate with its importance in the financial system. Market entry and exit, capital adequacy, reserve and liquidity requirements, asset portfolio allocation, number of branches, deposit insurance, interest rates on deposits and loans have been heavily regulated by the state. With these restrictions, the regulators tried to prevent "excessive competition" for funds, and thereby providing *rents* to banks. The rationale was arguably to enhance the safety and soundness of banks by increasing their profitability. Under such strong patronage and protection, Turkish banking has been traditionally and until recently a closed system, characterized and controlled by a few giant banks, immune to the disciplinary forces of competition, sluggish and careless in terms of innovations, and yet very profitable.

However, the Turkish financial system has undergone strong legal, structural and institutional changes in recent years. Throughout the 1980s, a series of financial reforms were introduced, whose main objectives were to boost the efficiency and productivity of banks by limiting state interventions and enhancing the role of market forces. Also, Turkey's determination to be a permanent member of the European Union (EU) has motivated its banking authorities to ensure that their regulations are in harmony with those in the union. In this context, interest and foreign exchange rates were freed. Starting in 1984, foreign exchange deposits could be opened by residents and non-residents, providing extra business for banks. New entrants to the banking system and new types of financial institutions and products were permitted. [2] The first attempt to sell treasury securities through periodic auctions started in 1985. The Istanbul Stock Exchange (ISE) and Interbank Money Market were established in 1986 to provide liquidity in the financial system. Most directed credit programs and preferential rates were eliminated, contributing to more efficient resource allocation (Denizer, 1997). The Turkish Privatization Law was enacted in 1986 to undertake the privatization of state economic enterprises in priority order (Altunbas et al., 1994). Open market operations, auditing of banks by independent external auditors, unified accounting principles and a standard reporting system were adopted in 1987. Foreign Exchange and Foreign Banknote Markets were established in April 1989. Banks enriched their service portfolios by asset-backed securities, mutual funds, interest and currency rate forwards and swaps, trading in government and private securities, repo transactions, consumer credits and financial consultation. Turkish banks also took an interest in doing business abroad either by purchasing foreign banks or opening branches and representative offices. [3]

[2] Special finance houses, doing business according to Islamic banking principles, were also welcomed to the system beginning in 1984.

[3] As of 1996, Turkish banks have individual or joint equity participations in 48 banks and/or other financial institutions in different parts of the world.