Financial Stability and Financial Markets: Case of Turkey

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Abstract

Introduction: The purpose of the paper is to examine what is financial stability in the financial market. This paper is providing the condition of financial instability and connecting the concept with the aggregate economic activities.

Case Description: This paper investigates the case of Turkey which was faced by a crisis in the year 2001 and explains the intervention by the government to solve the issues related to the crisis.

Discussion and Evaluation: After the necessary amendments are done by the government to solve the devastating effects of crises, it is showing to having the well-functioning financial system is crucial for welfare into the country.

Conclusions: All the attempted did by the necessary institutions and governments effectively solved the issues related to the crisis, and as a result, improving and developing the necessary conditions into the financial system is an essential task to having a well-functioning financial system.

1. Introduction

Over the past decades, many central banks and monetary authorities launch periodic financial stability reports. Financial stability has become an essential concept for the policymakers that implies the expansion, liberalization, and subsequent globalization of financial systems, raising the possibility of more substantial adverse consequences of financial instability on economic performance (Huben, 2004:3). Huben et al. (2004) state that financial instability has been fueled by repeated financial turbulence in mature capital markets, regional financial crises in emerging markets and so on. As well as, many countries experience banking crises during the same period: the banking crises and the other type of crises having considerable costs for the countries. Therefore, the monetary authorities or central banks are concerns about the financial stability that they are showing full concentration to having confidence in the financial system.

There are significant trends in the financial system over the past four decades. These are the financial liberalization that is freeing the local financial markets for investments and access to capital, financial integration in the context of globalization, and financial deepening. With these attempts, financial markets have been mainly expanded and became complex compared with the previous period. In the meanwhile, financial development giving the chance to create new instruments and investment opportunities for changing the composition of the financial markets. Financial markets with the new instruments are now more sophisticated and profound. Moreover, also after the liberalization, countries are integrated. That is are also creating a discussion of the contagion effect of the financial instability period across the countries.

2. Definition of Financial Stability

Financial stability is having a central role in the well-functioning financial system. Stable a market providing a healthy environment for daily transactions and activities. Also, improve the rational decision-making activities for the market participants for the allocation of the financial resources. Thus, directly affects the climate of saving and investment activities. Crockett (1996) states that the absence of financial stability creates uncertainties that can lead to resource misallocation and reduce the willingness to enter into intertemporal contracts. If the uncertainty is increased in the financial system, this can provide adverse consequences for the intertemporal contract between the market participants like the asymmetric information problems, also uncertainty affecting all kinds of activities in the market. Disruption in the market can have severe adverse effects on the economy too. Therefore, maintaining financial stability in the markets is the core principle of having a well-functioning financial system for the authorities. When the uncertainty increases the risk in the financial markets, investors and market participants are accepting more risk and at the same time, hoping more return, but this can be lead to a loss of their investments. Generally, this can be resulting in fluctuation in the asset prices and directly affecting the economic environment in the country. High volatility in asset prices is increasing the fragility in the financial markets. Therefore, the stability of the functioning of the banks and the markets went to the risk in the financial system. Of course, minor fluctuations in the asset price and some difficulties that happen into the financial intermediaries' activities is not meaning instability in the financial markets. Crockett (1996) explains this situation that financial instability can manifest itself either in the fragility of financial intermediaries or excessive volatility in the prices of the financial assets. More specifically, Crockett (1996) defined financial instability as a situation in which economic performance is potentially impaired by the fluctuations in the price of financial assets, or in the ability of financial intermediaries to meet their contractual obligations. Mishkin (1999b) connect financial instability with the asymmetric information framework that is showing the international capital movements, and financial volatility can play a role in destabilizing the economy. Houben et al. (2004) define financial stability as a situation in which the financial system is capable of allocating resources efficiently, assessing and managing financial risk and absorbing shocks. Therefore, a stable financial system enhances economic performance and asset allocation.

Moreover, banks capital, for example, having a central role in absorbing the fluctuation in prices such as interest rates. Having sufficient capital in financial intermediaries are giving the chance to absorb the adverse fluctuations in the banking sector. Although, banks as a financial institution/intermediaries having a crucial role in the financial market for providing the necessary services to accomplished the high-level productive investment into the economy. Usually, banks are defined as delegated monitors that they are engaging in a good situation for producing the necessary information about their clients for servicing the scare funds. The available funds for the productive projects are limited; that is why banks with a well-suited information process, they can select better customers to increase the change that the funds are turning the origin. Mishkin (1999a) explains the condition of financial instability occurrence with a decline in the ability of financial institutions to engage in financial intermediation and make loans will lead directly to a decline in the investments and, therefore, the economic activities. This situation is usually happening with the shocks to the economy that is worsening the adverse selection and moral hazard problems into the funding process. It will reduce the loan amount into the financial market, and therefore, all the economic activities will be affected by this shock. Mishkin (1999a) explain four factors that lead to financial instability:

- Deterioration of financial sector balance sheets,
- Increase interest rates,
- Increase in uncertainty,
- Moreover, the deterioration of nonfinancial balance sheets due to changes in asset prices.

Deterioration into the Banks' balance sheet giving a sign that banks are weakened in their operations, and that might trigger panic for the clients and partners. Also, an increase in the interest rates is making it much more expensive to use the available funds. Uncertainty is curbing the activities for the nonfinancial firms because of the future is not bright for them to make more investments to expand their operation. All these affect banks worse to decrease their lending activities as in the credit rationing concept. Also, it can be explained with the asymmetric information problems if it is difficult to determine the ability of the credit customer into the market place, banks are naturally choosing to decline their credit activities. This is known as credit rationing that banks are declining their loans to the customer to eliminate the adverse selection and moral hazard problems. Consequently, when a shock happens in the financial market that creating financial instability, this is having an adverse influence on the aggregate economic activity via financial intermediation channels into the country.

The financial crises in the field of finance is a hot topic and well documented by the literature. The expectation for the future prices of the market participants is continuously affecting the prices in the financial markets. Regarding the efficient market hypothesis, when the new information comes to the market, the market participants' perceptions are changing, and therefore they revised their portfolio by buying and selling. It is creating a change in market prices. Also, Wyplosz (1999) stated that financial markets are inherently volatile because of expectations about future drive asset prices. Of course, the changes in the prices are not connected with the instability in the financial markets. Every new news as information already effecting on the decision of the market participants. Based on the asset pricing models the stock prices and returns are explained with the risk factors. Therefore the primary function of the financial markets is to price the risk factors. Theoretically, investors are expecting a return and addition related to the risk premium; that is why regular prices are showing changes over time. Based on the Wyplosz (1999) instability arises when the asset prices – which include exchange rates- display excessive volatility.

Crockett (2001) provided an explanation for the condition of stability that; (i) if the critical institutions in the financial system are stable, therefore, this means that there is a high degree of confidence that they can continue to meet their contractual obligations without interruption or outside assistance; (ii) the key markets are stable, market participants confidently transact in them at prices that reflect fundamental forces and do not vary substantially over short-term periods when there have been no changes in fundamentals. Stability in financial institutions and markets are connected with the confidence that the activities are continuous in the usual way. If there is stress might have the potential to cause measurable economic cost which is turned to harm the economic conditions, a large group of customers and counterparties. Especially, instability in the financial markets means the presence of the excessive price movements that cause more extensive economic damage. Financial instability, therefore, is very costly for the countries.

Banks have special attention in the financial institution regarding financial instability. Two subjects make banks unique in this regard: (i) Bank runs, (ii) contagion effects and (iii) self-fulfilling financial distresses. Lost of the confidence into the financial markets and institutions may exaggerate losses in deposits to make the banks vulnerable to the banks' runs. May this situation turn to the contagion that the losses spread to the other institutions. Moreover, bank deposits are subject to the insurance that the government provides deposit insurance scheme to protect the depositors. This scheme might have an extraordinary and broader budgetary cost on the government to protect depositors and bailout the insolvent institutions. This situation may have more expanded macroeconomic consequences to the economy and financial instability have an extended cost for the country.

3. Twin Crises as Case in Turkey

a. Introduction

End of the year 2000 and the beginning of the year 2001, Turkey has experienced a twin crisis. It can be an example of a turmoil case in emerging markets that observed a financial instability period. With the above explanation, we also observed the same conditions in the country's financial markets. Likewise, the interest rates rosed by 6200% in the overnight market because of the liquidity shortage. Also, the government announced a crisis that happened in the market and they left the pegged exchange rate system to the floating exchange rate system. After all, the exchange rate doubled in a day and the financial market affected by worse. All the institutions and participants, such as financial intermediaries, firms, and government, have foreign currency debt, and in a day, all these debts doubled against the local currency. Many companies and banks were affected by the changes in foreign exchange and interest rates. The changes in the prices caused an increase in uncertainty into the country, and many firms and institutions were affected by this uncertainty. Many of the firms' balance sheets were deteriorated and this was directly deteriorated also the banks’ balance sheets. The firms took many credits was bankrupt and the credit accounts of the bank’s also affected by these failure firms. In the first stage, the government dealt with the International Monetary Funds for a standby agreement to solved the problems in the country and bring the sound and healthy financial system with the help of the Fund. After that, the government followed the London Approach, namely the “Istanbul Approach” to solve the doubted credits into the banks' balance sheet to fill the accounts with the treasury papers and to helped the banks survived into the financial system. Approximately, the cost of the crisis for Turkey was 50 billion USD to solve the devastating effect of crises. All the conditions which are defined by the above explanation were observed with this case of Turkey.

b. Liquidity Crises as the first Phrase

With the earthquake in the year 1999, Turkey went to the stagnation period with the worse economic condition. End of the year 1999, the Treasury rates went to 106%, and the economic growth was minus 6.1% in the economy. With the worsening conditions, Turkey had a stand-by agreement with the IMF for three years. Also, that time, the inflation rate was 70%, and Turkey, with the new agreement by the IMF, announced a new program to reduce the inflation rate into the country with a dozen development into the exchange rate to using a pegged exchange rate system. After the new program and developments, the conditions into the economy got better, and Turkey started to receive capital inflows into the country. The participants' perception was to fast reduction into the inflation rate in Turkey, but the inflation rate did not reduce as expected by the participants. Therefore, the real interest rates started to gain value and imports were highly raised with concerns about the risky high current account deficit. With all these events, banks that were holding a huge amount of Treasury bills into their balance sheets' assets side demanded more liquidity, and this created a shortage in the financial sector. With the shortage of liquidity, the end of the year 2000, the interest rates rosed to reach approximately 200%, and this was named liquidity crises into the financial markets of Turkey.

c. Banking Crises as Second Phrase

After the liquidity crises happened at the end of the year 2000, in the new year also the same expectation about the economy was continuing. February 19, 2001, there was an unexpected event happened and the government announced a crisis into the economy. Meanwhile, the Treasury of the Turkish government had a considerable amount of foreign debt and to close to bankruptcy, it was created a panic into the financial market, and to defend the local currency the overnight rates were going up to the very high levels. Under these circumstances, to match the demand of the residents too had foreign currencies, the Central Bank of Turkey Republic was sold 5 Billion USD to the market to match the demand of the residents for the switch to the foreign currencies. The liquidity shortage was not met for the banks and the payment system went the stage that closes to stop. To prevent the vast amount of bank bankruptcies the government left the pegged exchange rate system to the floating exchange rate. With a day the exchange rate was doubled and the foreign banks which provided funds to the locals started to withdrawal their credits out of the country before the due day. Thus, the overnight rate at the interbank market went to 6200% at the date of February 21 and the country debt went to the high levels and the banking sector had a crisis. This is named the Banking crisis in Turkey.

In May 2001, the government announced “Shifting to the Strong Economy program”, the Republic of Turkey signed a new stand-by with the IMF and agreement with WB to having credits to improve the reduced production level into the economy to the healthy level. With the new government and the negotiations with the IMF, the country did a vast amount of legal development to provide the necessary conditions to improve the security level of the economy into the country. After all, the Central Bank of the Turkey Republic has new tools for applying necessary attempts into the economy to having monetary stability. Consequently, with the new amendments, the country’s economy starts to improve, and the imports in a short time went up with 14 percent, and the current account deficit declined.

4. Discussion and Evaluation

The international financial system is crucial for having more trade by the countries each other to deal with the prosperity of the world. The well-functioning financial systems are supporting the economic activities of the countries to create value-added activities. Without the financial system, countries cannot find the necessary funds to improve profitable projects to create the necessary welfare. The possible interventions would be taken place by the supranational institutions likewise International Monetary Bank, World Bank, and Bank for International Settlements with the governments to deal with cases that are related to any cries or instability. These interventions by these institutions are effective to solve the problems in the financial system. For instance, to deal with the liquidity problems which were faced into the United State crisis at the year of 2008, the Basel Committee proposed the new BASEL III that are included with the liquidity issues. Most of the countries are following the Banks for International Settlement’s committee to prevent any issues related to the banks which they faced in their operations nowadays. The most crucial task is to develop the necessary condition for the financial institution, for example, to include the new tasks related to the new BASEL III with liquidity to continue with the well-functioning financial system. Therefore, the benefits with the new condition would be the gain of the sound and well practices by the banks to founding the profitable projects to improve the welfare. All these examples are showing the importance of continuously improving the conditions into the financial system to ensure the health of the system. The interventions are well profounded to grounded the instability by the supranational institutions to deal with the common necessities into the financial systems. The nature of the improvement is the day by day developments in the financial system to guaranteeing the well-functioning ongoing.

5. Conclusion

Although explanations which are shown above supporting the view that stable a financial market is crucial for a healthy economy, therefore, the authorities should have the incentives to improve the condition for a stable financial system. The signs for worsening conditions in the financial market harming the economy because everyday operations are disturbed. In conclusion, financial stability is an essential agenda for policymakers to have a well-functioning financial system to allocate the scare sources to the most profitable project to create the necessary value-added activities into the economy.

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