TURKEY'S FINANCIAL STRUCTURE

Money, Banking, Fiscal Policy, and Capital Markets

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A number of developments are converging to force increasing attention to Turkey's overall financial structure, institutions, practices, and problems. Heavy governmental expenditures for economic development and other purposes during the First Five Year Plan resulted in virtually a doubling of the Turkish national debt and the national money supply between the beginning of 1963 and the end of 1967. The heavy financial outlays of the government put severe strains on the available sources of funds--taxes, long-term borrowing, and bank credit. Competing with the government for the nation's supply of financial resources is the private sector, also in the throes of rapid expansion and requiring large funds for fixed investment and perhaps even more working capital. With the Government receiving the bulk of Central Bank credit as well as exercising prior claims - through taxation, compulsory borrowing, and other measures - upon major sectors of the economy, the private sector has begun in recent years to turn its hopes to the development of a viable capital market in Turkey. A properly functioning capital market would serve both to expand the volume of savings and to promote greater efficiency in the allocation and flow of such savings into productive investments.

Accordingly, a number of studies were launched during the First Five Year Plan period for the purpose of developing measures leading to the establishment of a viable capital market in Turkey. In 1967 these efforts culminated in the preparation of a lengthy draft proposal for a capital market law which is now pending before the Turkish National Assembly. This proposal, summarized in Section E (hereafter), is concerned essentially with the raising of long-term capital, through the sale of stocks and bonds in improved capital markets, to facilitate the establishment and expansion of private industrial and commercial firms.

In addition to providing financial resources for the private sector, it is considered by many that the establishment of a viable capital market would also stimulate general reforms in Turkey's banking and financial system as a whole. As indicated in the following discussion, such reforms are badly needed in order to improve Turkey's overall industrial and economic efficiency.

A. The Turkish Payment System

Large areas of Turkey today are emerging from centuries of barter to a money economy. The rising demand for hand-to-hand currency for transactions purposes in these developing areas, as well as the expansion of economic activity elsewhere in Turkey, has absorbed a substantial portion of the rapid increase in currency which has taken place in recent years. This total increase in demand for currency has been associated with a gradually increasing shortage of coins, especially since inflation and high costs have slowed down the minting of coins relative to the printing of paper currency. As a result, both the public and the Central Bank are hoarding coins, and making small change is often difficult.

Elsewhere in Turkey, even in the large metropolitan centers of Istanbul, Ankara, and Izmir, the people have not progressed beyond the use of hand-to-hand currency as a means of payment. The use of personal checks, drawn against personal bank accounts, is virtually unknown, and only a very rudimentary and inefficient checking system is available to business firms.

The general non-acceptability of checks as a means of payment creates major inconveniences in the day-to-day lives and activities of people in Turkey. The simple act of paying a utility bill--gas, water, electricity, telephone--requires that the subscriber (or his agent) be home on the particular day of the bi-monthly period when the bill collector makes his appearance If no one is at home or if the subscriber does not have adequate cash at hand, the collector leaves a note stating thereon the subsequent date, approximately two weeks thence, when he is scheduled to make his second and last appearance Failing this, the subscriber must go in person or send his agent to a duly established collection office which may be several miles away and closed at the only convenient time for the subscriber to make the trip.

At annual income tax payment dates Turkish employees of USAID/Ankara, in company with hundreds of other Turkish taxpayers, must take time off from work to go to the tax office, spend hours in line awaiting their turn, and be prepared with cash in hand to pay their tax as thereupon determined. Not infrequently a second trip to the tax office is necessary. The greatest single barrier to the elimination of this mass inconvenience and inefficiency, entailing much personal frustration as well as the loss of thousands of man hours, is the absence of an established and widely recognized system of payment by check

These and hundreds of other instances and kinds of inconveniences the Turks accept in their stride, partly because their familiarity with the situation enables them to minimize the disadvantages, but mostly because they have never known a practicable alternative. The simplicity and advantages of dispatching deposits and payments in exact amounts by cartel (Banks Association of Turkey) under the close control of the Ministry of Finance and operating without price competition either from within or from outside the system.

Both the prices (interest rates) paid by banks to depositors and those charged by banks to lenders are controlled and inflexible. Interest paid to depositors is below, and that charged to borrowers is probably above, the rate which would exist if competition in money markets had existed over the past decade. The result is an extremely high mark-up (averaging more than 500 percent) of the price of liquid funds as they move from depositors through the banks to users (borrowers). Only a part of this great spread represents profits to the banks; the larger part is dissipated in excessive multiplication of branches, lottery payments, high-cost operations, and the 20 percent bank transactions tax.

The low interest rates (averaging 2.97 % for the Agriculture Bank, which held 31.4 % of all bank deposits in Turkey at the end of 1965) paid to depositors discourages saving and diverts a sizeable portion of private savings into the unorganized or "black" market, as well as into the most rapidly expanding industry in Turkey, the construction of so-called "luxury" apartments. Despite this diversion, the monopoly position of the banks as receivers and holders of deposits is sufficient to guarantee that the bulk of private liquid savings, representing the less agile and venturesome funds, are held in the form of bank deposits. Total bank deposits have more than doubled during the First Five Year Plan, outpacing both the growth of the public debt and the growth of money supply.

The standard, legally fixed rate of interest (10.5 %) charged for ordinary short-term bank loans becomes some 15 to 18 percent by the time the bank transactions tax, commissions, and fees are added. The proliferation of fees, commissions, and charges is encouraged by ceilings on interest rates, despite the legal prohibition of any other charges as direct substitutes for interest. Nevertheless, these high rates are still below the equilibrium rate under current artificial market conditions, with the result that there is a general, persistent shortage of loanable funds, requiring various allocation devices and practices by individual banks as well as credit rationing by the Central Bank.

Government intrusion into the banking field and manipulation of interest rates has compartmentalized credit and distorted the basic rate structure, with artificial differentials between various sectors of the economy and a perverse relationship between short-term and long-term rates. A disproportionate share of credit has gone into the agricultural sector for price support and other redistributional activities, and into the public sector for governmental expenditure programs. A high proportion of nominal short-term credits allocated at artificially low rates to privileged groups have become frozen and converted by constant renewals into de facto long-term loans.

The entire banking structure is characterized by a high degree of liquidity. This reflects the high liquidity preference of savers, who hold some 66 percent of total bank deposits in Turkey and whose liquidity preference is nearly as high as that of official, commercial, and interbank depositors combined. As a result, at the end of 1967 some 76.3 percent of total bank deposits were payable at sight (see table below). At the end of 1967, 72.4 percent of total deposits classified as savings deposits were held in the form of sight deposits and only 27.6 percent

Turkish Bank Deposits Classified by Maturity, end of 1967

	All Deposits		Savings Deposits	
	%	TL Million	%	TL Million
Total	100.0	21,716	100.0	14,344
Demand	76.3	16,562	72.4	10,391
0 to 4 months	4.7	1,019	5.7	812
4 to 12 months	10.0	2,184	12.1	1,739
over 12 months	9.0	1,951	9.8	1,402

as time deposits. This high proportion of deposits payable on demand forces the banks to maintain a high cash liquidity position, especially since the banks cannot rely on rediscounts or borrowings at the Central Bank to maintain or restore their cash position. Apart from other factors, there are three major reasons for this high liquidity preference which are attributable to Turkish economic policies: (1) the high annual rate of depreciation in the value of money, in the face of which savers are unwilling to commit savings to long-term lending; (2) the willingness of banks to pay savers 3 percent interest on demand deposits; (3) the absence of any competing institutions, whether depositary-type financial intermediaries or a viable capital market, providing for safe long-term investments at attractive rates. The high cash requirements thus forced on Turkish banks prevent the efficient utilization of funds and contribute to the general shortage of bank credit in Turkey.

The Turkish banking system is characterized by great inefficiency and high cost operations, most of which are forced upon the banks by Turkish traditions, laws, and governmental policies. Because of the absence of interest rate-competition, individual banks attempt to attract depositors by lavish advertising programs, lottery prizes, and competitive multiplication of branches. The latter practice is especially costly, leading to very high permanent overhead costs resulting from excessive personnel, duplication of facilities, and inability to exploit economies of scale. Archaic accounting methods, the necessity for multiple signatures at different echelons to accomplish a simple cash transaction, and many other antiquated conventions require excessive personnel and slow down operations. The 20 percent bank transactions tax and a variety of stamp and documentary taxes add further to already excessive paper work and operating costs.

Because of the lack of an established system of payment by check, the mobility and fluidity of funds between banks, as well as between the banking community and the business community, is grossly impaired. With some qualification for transfers between branches of the same organization, and for the three clearing houses in Istanbul, Ankara, and Izmir, the transfer of funds is not accomplished primarily by offsetting debits and credits under a system of bank clearings but by the archaic method of physically transporting bundles of hand-to-hand currency from one place to another. This radically impairs the efficiency of banking operations, over and above the considerations of convenience to the public described above. Thus, instead of an integrated banking system in Turkey there tends to be a series of isolated banks prevented by law from truly competing and by technological backwardness from truly cooperating, to provide a maximum of community service.

Both the Turkish government and leaders in the banking community are aware of the need for banking reform. The <u>Second Five Year Plan</u> called for a reform of the Turkish banking system, and the 1968 <u>Annual Program</u>

announced that a technical working group to study the banking system would be formed. The working group was established under the direction of Bülent Yazici of the Industrial Development Bank and started functioning in the spring of 1968 with the arrival of an American adviser from the International Monetary Fund who is acting as rapporteur. The working group is preparing a set of short-term recommendations on banking reform to be included in the 1969 Annual Program. Hopefully, these recommendations will include essential reforms of the Central Bank, whose operations and policies are an integral part of the Turkish banking system as a whole.

C. The Turkish Central Bank

Although there are some indications of improvement, the Central Bank acts excessively and primarily as the hand-maiden of the Ministry of Finance rather than as a true central bank. Too large a portion of its activities and its credit facilities are devoted to financing the expenditures and policies of the Central Government and various state economic enterprises. Too small a portion of its activities and credit facilities are accorded to the general banking and economic community. After the massive Central Bank debt consolidation of 1961, in which five-sixths of all Central Bank credits (loans to the GOT, SEE's, and agricultural cooperatives) were assumed by the Treasury, total Central Bank credit to the public and private sectors stood respectively at (TL billions) 540 and 604. At the end of 1967 these figures were respectively 4,926 and 3,565. Of the latter (loans to the private sector), well over half were loans to agricultural sales and credit cooperatives, to finance price-support and loan activities. In other words, the basic instrument for expansion of the nation's money supply is Central Bank credit translated into expenditures of the Government, SEE's, and agricultural coops. Secondarily and subsequently, the banking system provides credits to other sectors by expanding loans and deposits on the additional reserve base created by expansion of Central Bank credits.

The Central Bank does not use the normal instruments of broad quantitative and flexible control for regulating the nation's banking system and money supply, but resorts to qualitative and arbitrary controls involving the rationing of rediscount credit to banks and individual firms. The following paragraphs summarize briefly the status in Turkey of the more important traditional Central Bank instruments of control over member banks and the money market.

(1) Rediscount rate. Two basic rediscount rates, 5.25 percent for agricultural and export bills and 7.5 percent for other bills, have remained unchanged since July 1961. These are associated with the corresponding fixed interest rates charged by commercial banks to borrowers: 9 percent for agricultural and export credits, 10.5 percent for other credits.

No attempt is made to vary rediscount rates, as such, in response to changing money market conditions. However, as a result of Decree No. 143 of August 25, 1964, upon the recommendation of the State Planning Organization, the preferential 9 percent rate to final borrowers has been extended to most branches of the mining and manufacturing sectors of industry. All such loans are rediscountable by the Central Bank at the 5.25 percent preferential rate.

Banks in Turkey, as elsewhere, prefer to obtain their funds from depositors instead of from the Central Bank since average rates paid for deposits are substantially lower than even the preferential rediscount rate. Nevertheless, there is constant pressure to expand borrowings from the Central Bank since expansion of operations of the banking system as a whole depends on expansion of Central Bank credit. It is therefore necessary, given the governmentally established regime of fixed interest rates, for the Central Bank to establish ceilings on the total volume of rediscounts. It has done this not only for the economy as a whole but for each bank and for the rediscounted paper of individual firms.[1] Under these circumstances the rediscount rate, as such, is not an instrument of monetary policy in Turkey, having been replaced by administrative decisions at the Central Bank and cabinet level.

(2) Open market operations. Given the lack of a developed banking and money market tradition in Turkey it is not surprising that the Turkish Central Bank does not conduct open market operations. In addition to other problems, there are basic difficulties connected with the marketability of Turkish Government securities. Government bonds are issued at artificially low interest rates and sold at par to state economic enterprises and other institutions. As evidenced by recent experience with government savings bonds (which pay 6 percent interest and whose purchase, up to a specified percentage of income, is obligatory upon white collar workers and others), these securities cannot be traded in free markets except at a heavy discount, which tends to prejudice the

[1]Rediscount of individual firm paper involves, however, only some TL 300 million out of total Central Bank credit of TL 3 to 4 billion in the private sector.

sale of new issues or to require their issuance at market rates of interest The payment of market rates on all its obligations would multiply several-fold the Government's annual interest outlays

Similar disabilities exist with respect to short-term issues: Treasury bills (bonolari) held by the Central Bank are for all practical purposes frozen and non-negotiable· their total amount has remained at TL 348 million since 1963. Treasury notes (plasman bonolari), held by various other banks in total amounts varying between TL 250 and TL 550 million in recent years, probably carry more realistic and flexible rates and maturities. They would appear to offer possibilities for the initiation of genuine open market operations with significant potentialities for the future. Considerable study is needed in this area, but fundamental changes in GOT fiscal and monetary policies are required before open market operations can become significant in Turkey.

Legal reserve ratios. Legal reserve requirements against bank deposits, now 20 percent, are applied only to new deposits, rather than to total deposits. This makes the legal reserve ratio requirement a much weaker instrument of credit control in Turkey than it is in the United States. Offsetting this is the fact that the Central Bank is not obligated to rediscount eligible paper or to lend to banks under a specified set of conditions. Since the Central Bank thus does not act as a dependable lender of last resort, the application of reserve ratio requirements to marginal deposits is probably as much as is needed or acceptable under existing circumstances. Any fundamental changes in reserve requirements of banks should probably be accompanied by a basic reclassification of deposits, in which demand deposits, especially if

TABLE 3

Effects of Price Level Changes on Real Interest Rates
(Actual interest rates adjusted by annual price level increases)

Years	Annual Price Changes (Cost-of-living Index: Istanbul)		Real Interest Return at		Real Interest Cost at	
			(Assumed actual rates)			
	Index 1/	Average %.Incr.	3 %	6 %	9 %	15 %
1949	97	8.9	-5.9	-2.9	0.1	6.1
1950	93	-4.1	7.1	10.1	13.1	19.1
1951	91	-2.2	5.2	8.2	11.2	17.2
1952	97	6.6	-3.6	-0.6	2.4	8.4
1953	100	3.1	-0.1	2.9	5.9	11.9
1954	110	10.0	-7.0	-4.0	-1.0	5.0
1955	119	8.2	-5.2	-2.2	0.8	6.8
1956	136	14.3	-11.3	-8.3	-5.3	0.7
1957	152	11.8	-8.8	-5.8	-2.8	3.2
1958	171	12.5	-9.5	-6.5	-3.5	2.5
1959	216	26.3	-23.3	-20.3	-17.3	-11.3
1960	229	6.0	-3.0	0.0	3.0	9.0
1961	236	3.1	-0.1	2.9	5.9	11.9
1962	245	3.8	-0.8	2.2	5.2	11.2
1963	261	6.5	-3.5	-0.5	2.5	8.5
1964	263	0.8	2.2	5.2	8.2	14.2
1965	275	4.6	-1.6	1.4	4.4	10.4
1966	299	8.7	-5.7	-2.7	0.3	6.3
1967	341	14.1	-11.1	-8.1	-5.1	0.9
~~12~~ 19-yr. Average 2/		7.5	-4.5	-1.5	1.5	7.5

1/ Index numbers shown represent yearly average. End-of-year figures are typically higher than the average for the year.

2/ Arithmetic mean of annual percentage changes in price level, subtracted from assumed actual interest rates.

9 percent, and even the 15 percent model in Table 3 may be considered on the low side for the period under observation. Borrowers at 9 percent paid real interest charges averaging only 1.5 percent annually while those at 15 percent averaged only 7.5 percent. Given the shortage and high real marginal productivity of capital in Turkey during this period, a 7.5 percent real cost of funds could be considered a favorable borrowing rate.

There is every prospect that GOT fiscal policy under the Second Five Year Plan will be more inflationary than under the First. The bold public expenditure program called for in the Second Five Year Plan contemplates the expansion of total public expenditures (in 1965 prices) from TL 23.3 billion in 1967 to TL 37.4 billion in 1972 (see Table 4 for details). This 60.5 percent increase compares with a 55.7 percent increase called for in the First Five Year Plan. As highlighted by the following comparative summary there will be a shortfall both in budgetary revenues to meet budgetary expenditures and in overall receipts to match total public expenditures unless measures are taken to increase receipts or cut expenditures.

(TL Billions)

	First Plan		Second Plan	
	1962	1967	1967	1972
	(1961 prices)		(1965 prices)	
Total Public Expenditures	13.04	20.03	23.3	37.4
Less: Self-financed exp. of SEE's, etc.	1.89	3.11	4.2	7.7
Total GOT Budget Expenditures	11.15	17.19	19.1	29.7
Less: Budget Revenues	8.63	13.99	16.2	24.3
Budgetary Deficit	2.52	3.20	2.9	5.4
Less: Savings Bonds & Counterpart	2.52	2.09	2.6	2.9
Unfinanced Gap	-	1.11	0.3	2.5

(Source: Plan I, Tables 53, 54; Plan II, Tables 42-44)

TABLE 4

Public Expenditures, Receipts, and Unfinanced Gap, 1967-72
as Contemplated in Turkish Second Five Year Development Plan

(TL Billion in 1965 Constant Prices)

	1967	1968	1969	1970	1971	1972	Average Annual % Increase
Public Expenditures	23.3	25.4	27.6	30.6	34.4	37.4	9.9
Current	10.9	11.9	12.9	14.0	15.2	16.4	8.5
Investment	9.0	9.9	10.9	12.2	13.9	14.7	10.3
Transfers	3.4	3.6	3.8	4.4	5.3	6.3	13.1
Public Receipts	23.0	24.8	26.8	29.4	32.4	34.9	8.7
Direct Taxes	4.5	4.5	5.0	5.5	6.1	6.7	8.3
Indirect Taxes	10.4	11.3	12.3	13.4	14.6	16.1	9.2
Other Budget Revenue	1.3	1.3	1.3	1.4	1.4	1.5	2.8
Counterpart Funds	1.9	1.9	2.0	2.0	1.9	1.7	-
Savings Bonds	0.7	0.8	0.9	1.0	1.1	1.2	11.4
SEE & Other Sources 1/	4.2	5.0	5.3	6.1	7.3	7.7	12.9
Unfinanced Gap	0.3	0.6	0.8	1.2	2.0	2.5	52.6

1/ Estimated Breakdown:

	1967	1968	1969	1970	1971	1972
Total SEE & Other	4.2	5.0	5.3	6.1	7.3	7.7
Local Administrations	n.a.	2.2	2.4	2.6	2.8	3.0
Social Insurance Fund	"	1.1	1.3	1.6	2.0	2.3
Civil Service Pension Fund	"	0.4	0.3	0.3	0.3	0.3
State Investment Bank	"	0.9	0.8	0.8	0.8	0.6
Provincial (Iller) Bank	"	0.2	0.2	0.2	0.2	0.3
Operating SEE's	"	0.2	0.3	0.6	1.2	1.2

Source: Second Five Year Plan, 1968-1972, Tables 42-44, and supporting studies.

The budgetary deficit is expected to rise to TL 5.4 million in 1972, and the residual unfinanced gap, after partial financing by savings bonds and counterpart funds, will rise to TL 2.5 billion. While these figures are proportionately not much higher than the corresponding estimates at the beginning of the First Plan, it should be noted that the First Plan started from a smaller base, a period of relative price stability, and a viable exchange rate. The Second Plan begins in an era of high prices and serious doubts as to the continued viability of the exchange rate, and with public sector expenditures relatively as well as absolutely more important than before. Perhaps more serious, the prospects for external assistance on the scale contemplated by the Second Plan are much less likely to materialize than those of the First Plan, with the likelihood that both the real resources and the counterpart funds therefrom will not be forthcoming. In the absence of adequate measures to augment revenues the attemlt to carry out, in full, public expenditures contemplated by the Second Five Year Plan could result in serious inflation.

In a milieu of rapid deterioration in the value of money, it becomes more and more difficult to develop a viable capital market in which life insurance, pension funds, savings deposits, corporate and governmental bonds, and other fixed obligations can play a significant role. The several issues of 5-year industrial bonds paying 12 and 13 percent interest annually, which were successfully marketed within the past year by the Industrial Development Bank, probably represent the maximum maturities for fixed obligations acceptable under current conditions in Turkey. The real interest return on these issues approximates

5 or 6 percent. Further erosion of the price level will make difficult or impossible future bond issues of this type, to say nothing of issues genuinely qualifying as "long-term" in the traditional sense of the word.

Perhaps the most important aspect of GOT fiscal policy is the very real danger of irreversibility in the trend involved in moving the economy further and further away from a market oriented system, which maximizes individual incentives and freedom of choice, to a system of collectivism in which bureaucratic decisions at the top determine individual and social levels and patterns of saving, investment, and consumption. This trend is clearly revealed by the increasing share of GNP allocated to the public sector under the First and Second Five Year Plans. The following figures are taken from the Second Five Year Plan document (Tables 10 and 42):

Turkish Public Expenditures as Percent of GNP

	1962	1967	1972
Public Expenditures - Total	22.5	27.4	31.3
Current	14.8	12.8	13.7
Investment	7.7	10.6	12.3
Transfers	-	4.0	5.3

This increasing drift toward etatism is probably inevitable, given the basic orientation of Turkey's official bureaucracy, together with the great impetus in the same direction afforded by "comprehensive development planning" of the kind which has been in vogue throughout the period under discussion. Nevertheless, it is at variance with the professed objectives and purposes both of the elected government now in power in Turkey and others who believe, on the basis of experience, that genuine economic viability and economic development of the desirable kind (improvement both qualitatively and quantitatively) requires greater freedom, flexibility, and individual incentives than are possible under etatism. A resolute decision on the part of the Turkish Government to hold increases in public expenditures in the next several years to a level of 8 percent annually could slow down this undesirable trend and reduce the dangers of inflation without real impairment of the true objectives underlying the formulation of the Five Year Plan.

E. Proposed Capital Market Liquidation

1. Background.

The proposed capital market law now before the Turkish Grand National Assembly (GNA) is the result of some six years of conferences, studies, discussions, and proposals involving a number of private as well as governmental groups and organizations.

In 1962, the Economic and Social Studies Conference Board, with financial assistance from the Ford Foundation, held its first annual conference during a 2½-week period in Istanbul. The papers of participants, including those specifically concerned with capital market problems, were published in a full-length volume bearing the same title as the conference: Capital Formation and Investment in Turkey. Both the conference and the book stimulated interest in the subject. The following year a five-man AID financed team of American experts conducted a survey and a series of seminars in Turkey on the subject of requirements for the development of a capital market in Turkey. Also, in 1963, the SPO requested a small group of Turkish experts to study the basic economic, legal, and tax aspects of the capital market problem in Turkey.

Following their report in 1964 the SPO set up a subcommittee to prepare draft legislation to facilitate and promote the development of a capital market in Turkey. Because of disagreements on the legal and financial aspects of the proposal, a high-level interdepartmental meeting was convened, and it was recommended that the Turkish Union of Chambers of Commerce and Industry undertake the task of putting draft legislation into final form. This was done in several months of intensive work and the resulting draft was reviewed by a group of forty experts from government, business, banks, and the academic community in a 4-day conference held in Istanbul. Following the conference, the draft bill was put into final form and submitted to the Ministry of Finance on January 30, 1965.

The Ministry of Finance made substantial changes in the draft and after receiving comments from interested ministries and other agencies, transmitted it on April 3, 1967, to the GNA for enactment. The MOF revision was strongly criticized by the Union of Chambers which subsequently (July 3, 1967) issued a brochure containing complete texts of both versions together with the Union's comments on the issues.

2. Basic Provisions of the MOF Draft.

In a brief introductory section, "Rationale," the draft points to the need for increased saving and investment in Turkey and notes that existing legislation does not encourage the development of "real capital companies" (corporations open to the public). It proposes to remedy this by authorizing and encouraging the formation of new institutions whose shares can be traded in an improved capital market. It stresses two prerequisites for success in this undertaking: (i) adequate incorporation standards, audits, and other regulations to protect the public; (ii) the assurance of liquidity of investment by means of a smoothly functioning securities market.

The central feature of the proposed draft is the establishment, in law, of a new type of business organization known as "joint stock company open to the public" (JSCOP). Such new companies would be required to have at least 50 shareholders - in contrast to the closely held, family-type corporation which dominates Turkey's commercial and industrial scene at the present time (regular joint stock companies in Turkey can have as few as 5 shareholders). All of the authorized shares of stock in JSCOP's would be officially registered and made a matter of public record. The nominal value (original issue value) of each share would be at least TL 100 or a multiple thereof, but the establishment of nominal values less than TL 100 or limitation of such value to TL 500 could be done by the appropriate regulatory agency. Also, at least 51 percent of the shares of such companies would be inscribed "to bearer," presumably to facilitate negotiability and other objectives under Turkish law. To promote the formation of JSCOP's and the marketing of shares two other types of joint stock company would be authorized: (i) underwriters and (ii) open-ended investment companies.

The basic task of controlling the issuance and marketing of securities and of supervising the general operation of the capital market would fall to a 5-man Capital Market Auditing Commission (CMAC), to be established under the Office of the Prime Minister. The CMAC staff, including experts on contract and full-time personnel, would be determined by the Council of Ministers. All expenses of the organization would be defrayed in equal measure by the Central Bank and the Union of Chambers.

a. Procedure for Organizing a New JSCOP. Under the draft proposal, new JSCOP's may be established by natural or legal persons, who must prepare a company charter and prospectus and submit these to the CMAC for approval. The charter must meet basic conditions required by Article 279 of the Turkish Commercial Code, which specifies procedures and requirements for organizing traditional Turkish joint stock companies (anonim şirketleri). In addition, it must state the intended amounts of registered and initial capital and the number of members of the board (at least five, each of whom must invest at least TL 10 thousand in the firm).

The prospectus must specify:

(1) amounts of initial capital sought and the proposed uses thereof, separately identified as: (a) founding expenses; (b) underwriter's fee (not to exceed 10 % of stock offered to the public); (c) fixed capital, including intangibles, as competently appraised; (d) working capital needed to begin operations.

(2) time schedule, not exceeding 6 months, for raising initial capital.

(3) summary of underwriter's contract provisions.

(4) names and qualifications of directors and any benefits they are to receive.

(5) names of auditors serving until first meeting of stockholders.

In addition to submitting the proposed charter and prospectus., founders must also submit an underwriting agreement (if an underwriter is used) specifying that founders and/or indicated underwriters will purchase all unsold stock at the end of the subscription period. This commitment and other obligations are secured by a TL 100,000 founders' deposit. The CMAC reviews the application and either grants permission to establish or requests that specific defects be rectified within a specific time.

After permission to establish has been granted, the new company must then be registered in the Commercial Registry as a legal person. Thereafter, it lists its stock on the Exchange and offers shares to the public through a circular which must append a copy of the charter and prospectus. Sales proceeds are held in a special bank account subject to CMAC control until all initial capital has been raised, at which time the CMAC issues to the company the document authorizing operations to begin. If any shares remain unsold the underwriter must endeavor to transfer them to the public as soon thereafter as possible, reporting to the CMAC every two months until all shares have been transfered. In the meantime, all shares held by underwriters or founders entitle them to a maximum of only one-fifth the voting power of all outstanding shares.

b. Conversion of Existing Firms to JSCOP.

Existing joint stock companies already established under the Commercial Code may convert to JSCOP status, using a modification of the above procedure. Shareholders of existing firms may either expand the company capital by the issuance and sale to the public of a specified number of new shares, or they may offer to sell a specified number of their existing shares. New share offerings must observe time periods and underwriter provisions similar to those for new companies. Sale of existing shares need not involve a time period or underwriter's commitment. However, in either case, the CMAC may specify that the 50-shareholder requirement be met by a certain date.

c. Other Organizational Requirements and Provisions.

Other provisions of the draft cover such matters as the role of auditors, underwriters, investment companies, qualifications required of JSCOP board members, rights of minority stockholders, preferred stocks and bonds, dividends, etc. There are also a number of financial provisions conferring tax and other advantages upon JSCOP's, amendment of existing laws to permit holding of JSCOP shares by worker's insurance, government employees' retirement funds, etc. Following is a brief summary.

Auditors. All JSCOP's are subject to continuing audit by two or more auditors selected by the company from a panel supplied by CMAC. Such auditors cannot be related to company directors or associates nor be connected with other firms having participating relations. Auditors serve only for one year with the same firm but may be rechosen after an interval of one year. Their basic responsibility is to determine whether the company's property and production are correctly reflected in the books and that the latter otherwise conform to the law. They must certify to the stockholders annual meeting the correctness of the annual report. The company's annual report, together with operating statements and balance sheets and auditor's report must be submitted to the CMAC within 15 days after the annual meeting. Other duties of auditors may be assigned by the company charter or the general stockholders meeting. Auditors have power to summon a general stockholders meeting and to hear stockholders' appeals against board members.

Underwriters. Underwriters must obtain an underwriter certificate from the CMAC before they can operate. The specific duties and responsibilities of underwriters are to be determined in a separate statute.

Investment Companies. The commercial title of all such companies must include the phrase "Investment Company with Variable Capital," indicating the open-ended nature of the organization. The initial capital of such companies must be at least TL 10 million, and not more than 5 percent of its capital can be invested in the securities of one firm. Likewise, the investment company may not participate in more than 12 percent of the capital of any one company, nor have voting rights in excess of 9 percent for any one company. The operations of investment companies would be subject to the Turkish Commercial Code and to such new legislation as may be adopted.

Qualifications of JSCOP Directors. The majority of the members of the board of a JSCOP must be Turkish citizens. They must also possess the competence and knowledge, as well as the moral and other qualifications, necessary to administer the company. Thus, a person convicted of fraud, embezzlement, and other crimes may not become a company board member until the statute of limitations, which varies according to the crime, has run.

Preferred Stocks and Bonds. Article 3 of the draft proposal provides that up to 10 percent of the issued capital may be in the form of stock carrying no voting rights but enjoying special dividends and rights at liquidation. Article 38 provides that bond issues, if so authorized in the charter, may be made upon decision of the Board of Directors. Such issues may not exceed the amount of issued capital plus net reserves. Provision is made in Article 35 for the issuance of convertible bonds whose conversion may be required at a specific time by the General Committee or the Board of Directors, provided that the value of shares received in exchange for the bonds may not be lower than that stated in the agreement. This provision and other matters in the same article are somewhat obscure.

Dividends. Article 40 states that "the proposal" (previously unmentioned) "to distribute dividends shall show": balance sheet, amount of dividends to be distributed, profits to be carried to the following year, reserves provided for by law or otherwise, and expenses required in the distribution of dividends. The article also states that the decision to distribute dividends may not result in changes in the balance sheet or profit and loss accounting. The significance of these provisions and their necessity is somewhat obscure but may be related to other requirements of Turkish law.

Appraisal of Fixed Capital Acquisitions. Article 42 appears to provide that major capital assets or institutions to be acquired by a newly established JSCOP, if amounting to more than 10 percent of the initial capital, must be appraised by competent persons and approved by the CMAC.

3. General Financial and Economic Provisions. A number of revisions in existing tax and other laws are made in the new draft law in order to provide tax benefits to JSCOP's, to permit investment of social

insurance funds in JSCOP securities, and for other purposes.

a. Tax Provisions. The following tax provisions are proposed in the draft law.

Exclusions from Income. Article 46 amends the existing income tax law to provide that up to TL 250 received in dividends, interest or bonus from the stocks and bonds of a JSCOP in any calendar year (or tax payer's fiscal year) may be excluded from tax payer's declared income.

Withholding of Taxes. Under existing Turkish law corporations and similar organizations are subject to a regular 20 percent corporate income tax plus a withholding tax of 20 percent of remaining income. The withholding tax is in effect collection at the source of taxes on personal incomes derived from corporate earnings and is creditable on a proportional basis in individual income tax returns of shareholders. The draft law provides that withholding in the case of JSCOP's will apply only to income actually distributed. At the same time it raises the rate of withholding on total distributable profits of other firms to 30 percent.

Other Taxes. Tax Law 5422 on associations is amended to relieve investment banks not accepting deposits and investment companies from rate and time period qualifications required for exclusion of capital participation earnings from tax. Also, these institutions are exempted from taxes on income from JSCOP securities.

b. Investment of Public and Bank Funds in JSCOP Securities. The draft law includes JSCOP securities in the list of eligible investments of the State Pension Fund and the Workers' Insurance Fund, and also amends the Banking Law to provide more liberal loan ceilings to JSCOP's in key sectors of the economy.

State Pension Fund (Emekli Sandigi). This fund covers retirement contributions for employees of GOT agencies, State Economic Enterprises, and other government organizations. At present, Fund balances, after provision of normal reserves, may be invested in real estate, other variable-income activities (SEE's and other approved items), and fixed-income instruments (GOT and SEE bonds). The existing law also sets maximum percentage limits for certain of these categories. The new draft proposal adds JSCOP securities as eligible items in both the variable and fixed income categories. However, the new draft qualifies the eligibility of JSCOP common stocks (in contrast to the lack of any such restriction upon investment in SEE's, etc.) by stating that investment in such securities shall be both safe and profitable as well as effective in terms of national economic growth. The draft law likewise qualifies investment in JSCOP bonds by stating that "such bonds are to bear at least as much interest as state bonds." The new draft law also changes maximum allowable investment of Fund balances to the following figures:

Type of Investment	Present Law	Draft Proposal
Real Estate	40 %	40 %
Stocks (SEE's, JSCOP's, etc.)	40 %	20 %
Bonds (GOT, SEE's, JSCOP's)	NO Limit	No Limit

Workers' Insurance Fund (Işçi Sigorta). This represents social security retirement and other insurance funds established by employers' contributions and payroll deductions from earnings of workers throughout the private sector in Turkey. This fund is growing rapidly as a result of increased rates, increased coverage, and generally expanded economic activity throughout Turkey. Under existing law a maximum of 10 percent of fund balances may be invested in industry for working capital purposes. The new draft proposal does not change this percentage but changes the collateral requirements and provides that the funds may be invested in bonds of development and investment banks if they bear as much interest as government bonds.

Bank Credit for JSCOP's. Bank Law 7129, Article 38, currently limits loans by commercial banks to individual firms to 10 percent of the bank's paid-up capital and surplus, except that this limit may be raised to 25 percent for firms in specified industrial sectors. The law also exempts from any such limitation loans to an organization whose capital is at least 25 percent owned by the lending bank. The new draft proposal specifies that JSCOP's concerned only with exports, manufactures, power, and tourism shall have the benefit of both the above 25 percent provisions, as well as similar privileges specified in Article 48 concerning bank participations. As the draft is written it appears that JSCOP's in the above fields will replace the previously indicated firms and sectors enjoying the special exemptions.

Abolition of Reserve Requirements for Certain Private Firms. According to the Turkish Commercial Code and other legislation various forms of business organization were required to set aside a specified portion of earnings as reserves and invest these in Turkish Government bonds. The draft law proposes that these provisions be repealed in the interest of capital market development so that such firms in question can have free use of such reserves.

4. Preliminary Observations on Draft Law.

The draft proposal represents a long-awaited and needed attack upon the problem of capital market development in Turkey. It recognizes two basic and important gaps in Turkey's financial system and structure: (1) the inadequacy of capital funds available for expansion, development, and operation of the private sector in Turkey; (2) insufficiency of existing outlets and opportunities for savers in Turkey. It proposes to meet these two needs by permitting and actively promoting the development and use on a large scale of the corporate form of organization and financing. The essential element in this endeavor is the creation of an efficient market for corporate securities which will permit an optimum combination of high investment return and individual liquidity.

The draft law recognizes that most savers and potential investors in Turkey do not have the time or the knowledge to permit dependable investment in the securities of new and untried Turkish enterprises. It therefore proposes new procedures and regulations for the incorporation, auditing, and supervision of such firms, and the marketing of their securities. These rules and procedures are designed to protect the investing public and impose high standards of financial integrity on the part of the enterprises concerned. In addition to these basic provisions governing the organization and operation of individual companies the law provides for new institutions--underwriters and investment companies and a new regulatory agency designed to promote the efficient and orderly marketing of corporate securities

While the basic provisions governing the incorporation, auditing, and regulation of individual firms appear in principle to be adequate, the provisions in the draft law for the successful and orderly marketing of securities are not euqally developed The essential nature of the underwriting task, and the important distinction between the marketing of new issues and the assurance of an orderly and efficient market for the trading of outstanding issues, do not appear to be adequately realized Thus, JSCOP's are not required to demonstrate a period of successful operation and earnings before their securities are permitted to be listed and traded on the Turkish stock market Rather, their listing immediately upon incorporation is compulsory under the draft Provisions governing the operation and regulation of underwriters are omitted and left either to existing or future statutes

Similarly, the Capital Market Auditing Commission, officially created to exercise supervision over the capital market as a whole, is given no clear mandate or guidance for regulation of the Turkish stock exchange. While it would be premature to provide detailed regulations long in advance of need, a statement of basic principles and objectives, and recognition of the need to prevent the development of undesirable market operations and manipulations, would seem to be desirable The whole area of stock exchange operation, expansion, and development in Turkey appears to require additional study

It is appropriate to raise questions concerning various specific provisions of the draft proposal Thus, the provision to increase the rate of withholding to 30 percent of total disposable corporate income for non-JSCOP's, while limiting the withholding for JSCOP's to 20 percent of only that portion of earnings actually distributed to shareholders, would effect a double discrimination against existing firms. Since this discrimination would presumably stimulate the conversion of many existing firms to JSCOP status it would serve the useful purpose of making available to public investment the shares of established firms with a proven record of successful operation.

A basic inconsistency also appears in the provisions to make JSCOP securities eligible for investment by the State Pension Fund while reducing the allowable total for all variable income securities, including JSCOP issues, from 40 to 20 percent of the Fund total. Similarly, for investment by the rapidly growing Workers' Insurance Fund, the draft proposes only that 5 to 10 year bonds of development and investment banks be made eligible. No common stocks, or even bonds, of individual firms are eligible. While it is desirable to provide maximum security for basic social security funds, it is interesting to note the high degree of security and liquidity enjoyed by real estate in Turkey, as evidenced by the fact that real estate and deposits in national banks are the only two categories permitted unlimited investment by the Workers Insurance Fund. Given the preferential tax treatment of real estate, its preferred position as legal investment for public funds, and the high prestige of real estate mortgages as collateral for all manner of loans and investments by banks, public institutions, private firms, and individuals throughout Turkey, it is not surprising that a substantial and apparently rising percentage of Turkish GNP is moving into real estate and related apartment and building construction. Real estate thus continues to be a formidable competitor to industry in the allocation of funds in the total money and capital market in Turkey.

Other specific provisions will no doubt be the subject of debate before the draft law is enacted. The requirement that JSCOP's have a minimum of 50 shareholders appears to be gratuitous and potentially troublesome for the CMAC. If firms have need of additional capital, and if there exists an adequately functioning capital market, they will automatically expand the number of shareholders. Moreover, the requirement of 50 or a similar number of shareholders does not per se accomplish any significant result in terms of corporate control, income distribution, or other desirable objective. Likewise, a limitation of investment companies to "open-ended" firms, is an additional undesirable limitation upon Turkey's freedom to adapt her institutions and economic activity to actual conditions and circumstances. Pakistan has recently made successful use of the closed-end mutual fund and this form would appear to be equally desirable for Turkey.

No doubt there are other shortcomings in the present proposal. It is, however, neither possible nor necessary to obtain a "perfect" capital market law. The essential task is for Turkey to make a beginning, to keep unnecessary limitations and strictures in the initial law to a minimum, and to make it clear that the development of efficient capital markets as well as legislation suitable thereto is a dynamic and continuing process. To this end there is much to be said for incorporating in the introduction to the statute as the Union of Chambers endeavored to do in its draft, a positive statement and reminder of the philosophy behind the development of capital markets, the prerequisites to their existence, and the continual need to change laws, institutions, practices, and policies in order to achieve a truly viable, market-oriented economy capable of providing the public with a maximum of goods and services at a minimum of real cost.