Market Pressures, Membership Conditionality, and EU Accession: Turkey's Convergence Tale

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Abstract: This article investigates the incentives for policy changes generated by the prospect of European Union (EU) accession. Specifically, we focus on the role played by private investors in the exercise of membership conditionality by international institutions. Focusing on the case of Turkey, we argue that, even though accession is a distant and uncertain prospect, bond market actors already have begun to reward the Turkish government for its moves toward membership. As such, these actors reinforce the EU's use of membership conditionality, in which accession governments pursue a variety of policy changes in order to improve their membership prospects. We identify several important trends in the market for Turkish bonds; in general, foreign investors have increased their investments in Turkish public debt. As a result, the Turkish government benefits from reduced borrowing costs and a longer term perspective on the part of investors. We discuss the implications of bond market behavior vis-à-vis Turkey, in terms of its implications regarding the joint importance of international institutions and private markets as influences on governments' behavior, and in terms of the consequences for Turkey, both in the short-run (positive) and in the long run (depending on the outcome of EU accession negotiations, positive or negative).

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Introduction

Turkey's potential accession to the European Union (EU) occupies a central position in discussions of current EU politics. With the beginning of formal accession talks in October 2005, many observers expressed optimism that membership would be achieved, albeit not until 2015 or 2020. More recent events, however, have tempered this optimism: in September 2006, the European Parliament voted to approve a report on Turkey, noting insufficient progress in several areas. In November, the Commission followed with its own critical assessment. And, in December, the EU's foreign ministers declared the talks to be partially on hold, with the proximate issue being Turkey's refusal to open its airports and ports to Cyprus. Several individual EU governments also have warned that, should Turkey's membership talks progress, they would approve only after holding national referenda.

Much of the attention to Turkish accession has focused on the role of European Union governments, and on the role of the EU itself. Observers suggest that, by virtue of their use of membership conditionality, the EU and its members may effect various changes in Turkish behavior and policy. But, while member governments and the EU's various organs definitely play central roles in the process, such accounts leave out a key part of the accession process. For Turkey specifically and for aspiring EU members generally, private capital markets can make important contributions to the leverage of international institutions.

This article explores the role played by private sector actors in the exercise of leverage – in this case membership conditionality – by international institutions. Doing so provides important insights regarding the conditions under which international institutions succeed in promoting policy changes within nation-states. Our investigation focuses on the linkages between potential EU membership and government policy in accession countries, with a particular focus on Turkey. We explore the extent to which private capital flows in reaction to expectations of future membership have played a role in the Turkish case. In doing so, we investigate the degree to which this market-based benefit – greater access to capital, at lower interest rates and with longer time horizons -- has created additional pressures for changes in Turkish policies. We situate our argument in two literatures, one that considers market-based pressures on government policy choices, and another that focuses on direct pressure from international organizations, particularly the EU.[1] We suggest that, in the case of Turkey, both pressures are at work: the EU has linked eventual Turkish membership with policy changes. But the EU's, and Turkey's, ability to effect such changes relies, to some extent, on private market reactions to convergence expectations.

We use the actions of international bond market investors as one example of the private sector's reaction to prospective EU membership (foreign direct investment is another). We posit that the activities of these private market actors represent an important component of the overall incentive for change in Turkey as part of the accession process. Market participants both react to and reinforce the EU's political decisions regarding future Turkish membership. As a result, the Turkish case demonstrates the interconnectedness of private market pressures and international institutional influences. Indeed, private market pressures often help to strengthen the incentives generated by international organizations. Our conclusions are relevant to questions regarding the influence of international institutions generally, the EU and its enlargement specifically, and for Turkey itself.

[1] While we use "international organization," to refer to the EU, we recognize that the EU is a *sui generis* framework of institutions with supranational and intergovernmental characteristics.

Mechanisms for Policy Convergence: Private Markets and International Institutions

Private Markets. In recent years, a large literature has explored the impact of economic globalization on government policy outcomes (see Garrett 1998, Bardhan et al 2006 for reviews). Much of this literature takes as its starting point the notion that, facing pressures to compete in capital and product markets, national governments will engage in policy reforms. Given common external pressures, the result of such reforms will be cross-national policy convergence, either toward market liberalism (a "race to the bottom" view; see Drezner 2001) or toward some intermediate level of policy (e.g. Hallerberg and Basinger 2004, Hays 2003). Various causal mechanisms for this convergence exist: in some cases, it is competition to attract investment (Jensen 2006, Mosley 2003, Simmons and Elkins 2004). In other instances, the chief mechanism is trade openness (Rudra 2002) and, in still others, firm-level incentives play a central role (Prakash and Potoski 2006).

Despite these pressures for convergence, recent scholarship also points out that global market pressures do not override the influence of domestic institutions and politics. In many instances, domestic institutions generate persistent divergence in production regimes, welfare states and monetary institutions (Hall and Soskice 2001, Iversen and Soskice 2001, Iversen 2005). Moreover, the global economy may generate demands for enhanced welfare state provision, rather than reductions in social protection (Brooks 2005, Huber and Stephens 2001). At the same time, however, evidence exists that short-term capital market pressures have some influence over national policy choices, and moreso in transition or emerging market nations. If governments want to reduce their -- and resident firms' -- borrowing costs, they may opt for a set of market-friendly policies. These policies, including lower inflation, smaller fiscal deficits, and reduced levels of government debt, generate reductions in the risk premiums on government bonds. Where local capital markets are less developed or public spending requirements outstrip tax revenues, private market pressures are likely to be greatest (Rudra 2002, Wibbels 2006).

Therefore, one mechanism for policy convergence – and, specifically, for neoliberal-oriented policies consisting of reductions in inflation, public debt, and fiscal deficits– is private capital market pressure. Because capital market participants are interested in measures that reduce currency, inflation or default risk, they create incentives for governments to undertake neoliberal economic reform.[2] Markets exert leverage over governments by means of a straightforward price mechanism: to the extent that governments enact desired policies, market actors will respond by lowering sovereign borrowing costs. As a result, national borrowing costs will converge with the lower yields prevalent in developed countries. Private market pressures, of course, are not the only mechanism for policy convergence. A second type of pressure may emanate directly from international institutions.

Membership Conditionality and International Organizations. While private market pressures may prompt governments to enact particular economic policies, international institutions also can generate incentives for national policy changes. International institutional pressures could operate through rationalist, material channels, or via constructivist, ideational ones. Despite debates on the relative importance of each channel (e.g. Johnston 2005, Keck and Sikkink 1998, Slaughter 2004), most scholars agree that, under certain conditions, institutions affect state behavior (e.g. Keohane 2002, Koremenos et al 2001, Simmons and Hopkins 2005).

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[2] Admittedly, there is no simple measure of what exactly "converged economic policy" entails. The ratio of government debt to gross domestic product, for example, varies substantially among developed countries, and often is higher than in many developing nations.

One mechanism for these effects is the direct threat of exclusion, often from some or all of the benefits of membership in an organization (e.g. Pevehouse 2002). For instance, borrowing nations that do not comply with the terms of International Monetary Fund (IMF) loan agreements often are denied further tranches of credit. This type of conditionality directly links a benefit (loan dollars, as well as the IMF's seal of approval) with government behavior. Many empirical studies, however, suggest that this sort of conditionality has mixed results, in terms of achieving policy changes (Stone 2002). Another type of exclusion is from membership: countries that do not meet a given set of standards are unable to join a particular international body. This variety of conditionality rests on the benefits that accrue to members of an institution, as well as on the ability of institutions credibly to threaten states with exclusion, achieved more easily *ex ante* than *ex post* (Kelley 2004).

Europe is the region where the "club" model of international organizations is most advanced and, therefore, where membership conditionality has been used most extensively. The EU has exercised conditionality with respect to membership expansion (Greece, Spain and Portugal in the 1980s; Austria, Sweden and Finland in the 1990s; and most explicitly and systematically, the ten new members in 2004), as well as for Economic and Monetary Union (EMU). During recent instances of expansion, the European Commission, as well as some individual European heads of state, drew explicit connections between membership and national practices, as embodied in Copenhagen economic, political, and *acquis* criteria (June 1993). These criteria covered issues ranging from the treatment of minorities and the existence of liberal democratic practices, to the reform of trade, industrial and agricultural policies.

Under what conditions is such explicit conditionality effective? The EU should be better able than most international organizations to deploy conditionality. First, EU accession often occupies a central position among the aspirations and policy promises of national governments. For instance, recent data from the 2004 accession states suggests that, in all but one candidate country, national political parties ranked European integration as the single most important policy issue, ahead of economic policy, cultural issues, or immigration (Benoit and Laver 2006). Additionally, the EU offers clear material incentives for membership, including market access, regional development funds, and agricultural subsidies (e.g. Schimmelfennig and Sedelmeier 2004). Moreover, the EU has developed a detailed set of accession procedures, designed to assist accession candidates in the monitoring and implementation of EU-related reforms.

The explicit linkages between policy changes and membership render the EU better able to use conditionality than are the Organization for Security and Cooperation in Europe (OSCE), the North Atlantic Treaty Organization (NATO), or the Council of Europe; it has greater success in provoking policy changes in potential member states (see also Schimmelfennig et al 2003). Hence, Vachudova (2005) suggests that, once eastern European states formally became candidates for EU membership, making the incentives for membership more immediate, the EU's leverage over their domestic politics expanded markedly. Similarly, Kelley's (2004) study of ethnic minority policies in Estonia, Latvia, Slovakia and Romania further suggests that international organizations have much more influence, even in the face of strong domestic opposition, when they combine normative pressure with conditionality (institutional membership), as the EU did. Furthermore, the gradualist, "reinforcement by reward" (Schimmelfennig et al 2003), nature of the process allows the EU to maintain its credibility: if a potential member fulfils its obligations at one stage, it will advance to the next stage. But if a potential member fails, future benefits will not be forthcoming.

The Copenhagen criteria, which specify required policies for new EU members, cover a wide range of policy areas for new EU members. These include a fairly specific set of political and social liberties, such as the elimination of the death penalty, the provision of equal rights for women, and the protection of minorities. In the economic policy realm, the Copenhagen criteria ask that new members demonstrate that they have a functioning market economy[3], as well as the capacity to deal with the competitive pressures that freer markets generate. For states that have formally applied for EU membership, as Turkey first did in 1987, or that have been formally invited to initiate membership negotiations, as Turkey was in 2005, the linkage between policy and admission is clear. For Turkey, the hurdles appear greater on the political and social side; but given that the EU has established a firm connection between economic and political convergence (so that both are necessary for EU membership), progress in the political and social realms also can generate a response in private markets.

Linking Private Market and International Institutional Pressures. Both private markets and international institutions, therefore, create incentives for policy convergence. The former type tends to be strongest for countries that are in greater need of external financing; the latter are most effective when the organization is able to clearly link the material benefits of membership with a specific set of behaviors. We hypothesize that, as a potential EU member, Turkey fulfills both of these conditions.

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[3] The existence of a functioning market economy requires broad consensus as to the essentials of economic policy, macroeconomic stability, price and trade liberalization, no significant barriers to market entry or exit, a legal system that ensures laws and contracts can be enforced and a financial sector which is sufficiently developed to channel savings towards productive investment (European Commission 2005).

First, when the substantive policy interests of private actors and international institutions overlap substantially, they are more likely to succeed. In the case of Turkish EU accession, private investors and the EU bureaucracy share many interests. Private investors are fundamentally concerned with economic reform, and with EU membership as a means to anchor such reform in Turkey. The EU's bureaucracy and its leadership, on the other hand, are interested in a broader set of changes, relating to various aspects of domestic social and political life. As such, the EU ultimately wants Turkey's domestic institutions and practices to reflect a broad acceptance of liberal democratic ideals. Given the linkage that the EU has consistently drawn between economic and political reform, these pressures overlap considerably. Private market actors realize that locking in economic reform via EU membership will require political consolidation in Turkey. And EU actors are aware that economic reform, which generates clear and immediate benefits (lower borrowing costs) for the Turkish government, may well be an early step on the road to broader domestic changes. This international institution-private market nexus means that political and social reforms – as well as economic reforms – can generate a market response. As a result, the range of issues of concern to private market actors is broader (Mosley 2003) than it would be without the involvement of an international organization.

Second, from the point of view of national governments in accession countries, linkage effects operate in reverse as well. When political reform slows, so might the benefits of economic reform. Improvements in Turkish borrowing costs may cease, or reverse, even if economic policies do not change. Therefore, although the EU itself may follow a policy only of "reinforcement by reward," withholding further rewards in the event of non-compliance but not withdrawing existing rewards, bond market investors may employ "reinforcement by punishment," in the form of higher borrowing costs (Schimmelfennig et al 2003).

Private actors, therefore, can play a central role in the exercise of membership conditionality by international institutions. The material benefits that flow from membership include those over which the institution has control (e.g. market access or development funds) as well as those (capital flows) that come from the private sector. While extant studies of *some* international institutions acknowledge the importance of private sector reactions, this work covers a limited set of economic institutions. The responses of portfolio investors and bank lenders to IMF programs, particularly in crisis situations (discussed most dramatically by Blustein 2001; also see Stone 2002), is an obvious example. In the literature on regional integration, the attraction for Mexico of NAFTA membership as a signal to private sector investors is another (e.g. Haggard 1997). Analyses of the domestic politics of international trade and finance, particularly those in the pluralist tradition, also focus on the interests and preferences of various private actors, such as firms and investors (e.g. Frieden 1991, Frieden and Jones 1998).

Yet private actors play a role in reinforcing and expanding the incentives for institutional membership in a wide variety of contexts, economic and non-economic alike. Their role, however, remains insufficiently recognized and inadequately theorized. For instance, the literature on EU enlargement pays little, if any, attention to the private sector's reaction to the prospect of membership, either when modelling the material incentives offered by the EU (e.g., Schimmelfenning and Sedelmeier 2004, 2005), even when considering reforms such as central bank independence (Epstein 2005).[4] Our contribution, therefore, is to draw attention to the role of private actors in the exercise of leverage by international institutions. We do so by

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[4] Schimmelfennig et al. 2003 are a partial exception. They consider, but dismiss the significance of, the reaction of some private sector actors in Latvia, Slovakia and Turkey.

demonstrating the interaction between one international organization, the EU, and a specific set of private actors, bond market investors. Our demonstration of the way in which Turkey benefits from this reaction, despite the uncertainty regarding the timing and the occurrence of EU membership, strongly suggests that private sector actor responses deserve much greater attention.

Moreover, in our analyses, private investors react not only to formal institutional decisions (e.g. the granting of an IMF loan), but also to the *possibility* of such decisions. This is a further, and an important, way by which particular private sector actors provide incentives to governments in their negotiations with international institutions. These incentives may be provided far in advance of, and with great uncertainty surrounding, actual membership. Even before governments enter the later, more “active” phase (Vachudova 2005) of membership negotiations, these pressures play a role. Hence, Turkey has experienced such pressures periodically since its official application in 1987; with the formal opening of membership talks in 2005, these pressures play an even greater role, despite the long time horizon for EU accession. As national governments begin to reap the economic benefits of anticipated accession, they may become more committed to the accession process, and they may be more able to garner support for accession, and for the changes it requires, domestically. In the next section, we explore the role of private financial market pressures in the EU generally; we then consider the specific case of Turkey.

Private market pressures: the case of bond markets. Our examination of government-financial market relations in the Turkish case illustrates the role of private capital markets in the EU accession process. In general, private capital markets reward candidate countries not only for general economic reforms, but also for their specific status as EU accession candidates. Private investors expect that, as the likelihood of a nation’s joining the EU improves, so will its treatment by private capital markets. Moreover, investors also expect that joining the EU (and then EMU, presumably) will lead to a series of economic policy changes (greater trade openness and monetary stability, for instance), again reducing investment risk.

For bond market investors, such countries are "convergence plays": as their policies converge with the requirements of EU accession, the yields on their government debt will converge with the (lower) yields of existing EU members. The result is profitable opportunities for those who invest ahead of this yield convergence. Capital market participants, then, attempt to predict which countries will be invited for EU membership, and when. To do so, they look to the EU and potential accession candidate countries' actions, using political events as cues for changes in investment strategy and as signals of new investment opportunities. Their investments come well in advance of the increases in credit rating we would expect if investors were reacting only to improvements in actual creditworthiness.

The current provision of market-based rewards for government behavior is similar to the one that operated in the run-up to the single currency. In 1996 and 1997, investors in the government bond market were very interested in predicting which EU members would be part of the first round of EMU, in 1999. The economic criteria for EMU were – as were the Stability and Growth Pact's fiscal criteria – established and enforced primarily by EU member governments. But because private sector actors also were interested in who would qualify for EMU, or how the euro performed in world markets, they rewarded governments, at least in part, on the basis of their compliance with EU rules[5]. The Maastricht rules, then, had extra bite that

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[5] While we focus here on bond market investors, other investors who influence the foreign exchange markets were also obviously central to this process.

flowed from the private sector, giving governments further incentives to adopt certain behaviors (Mosley 2004).[6]

Turkey is in a similar situation: both the EU, by virtue of the accession process, and private financial markets, by virtue of their interest in low inflation, fiscal rectitude and economic liberalization (and their linking of these economic reforms with the broader accession process), should pressure and reward Turkey for economic reforms. The pursuit of economic policies convergent with those in EU member states not only makes Turkey's future accession more likely, but it also generates a reduction in interest rates on government debt, thereby lowering overall public financing costs. We set out below the different ways in which convergence investment already has improved the ability of the Turkish government to finance itself, even so far ahead of actual EU membership. We also discuss the varying motivations of the investors involved. While almost all investors look favorably on Turkish accession, we differentiate between those market participants who invest only because of the accession process, and those for whom the EU accession process itself is not a requirement for investment, but an important fillip (or policy 'anchor') for positive reform in Turkey.

Our analyses demonstrate a key mechanism by which private markets help to reinforce the pressures applied by international institutions. By lowering borrowing costs, private investors expand the incentives for the Turkish government. Private sector reactions should be seen very much as part of, and often working in parallel with, the influence of the EU on neighboring countries. We therefore demonstrate one of the incentives for Turkey of the EU accession

[6] For a discussion of the conditions under which private market pressures are effective at enforcing international rules, see Schneider 2005.

process, but also one of the costs (higher interest rates on government borrowing) of any breakdown of the process.

The Turkish Case

Our empirical analysis focuses on the case of Turkey, because Turkey represents an exceptional test – a “most difficult” case -- for the claim that private market pressures reinforce those emanating from the public sphere. A marked private market reaction to EU membership, rather than to membership in other international institutions, or to the conclusion of IMF stabilization programs, is not surprising: EU membership represents a more profound transformation of accession-candidate countries than do other sorts of institutional memberships and programs. Yet Turkish accession remains far off and uncertain, entailing a far-reaching set of social, political and economic changes; and membership could be materially, and possibly uniquely, different from that of other EU states (see below). Even in such a case, private market rewards serve to further motivate continued participation in the EU accession process. As evidence for this argument, we consider the extent and nature of financial market interest in and pressure on Turkey, as well as the incentives this creates – in parallel with incentives from the EU – for policy change in Turkey. To find a positive reaction from private market actors to this prospect would, we argue, suggest that the role of private market reactions in reinforcing the pressures from international organizations generally, and from the EU in particular, deserves an increased research focus.

On the basis of our examination of private capital market behavior vis-à-vis Turkey, we conclude that Turkey is experiencing – and benefiting from – both types of “convergence” pressures, for improved economic policy specifically and EU accession generally. These effects have obtained in recent years, despite the long time horizon of the Turkish accession process, and despite the fact that the process is still very much a contentious one. Indeed, Turkey is less likely than other recent accession candidates to benefit from, or to be affected by, pressure related to EU accession from private investors, given the nature of the Turkish accession process (Mehmet 2004b; Ediz 2005b), and the resulting reluctance to see Turkish membership as a foregone conclusion. Not only is Turkish membership not expected until 2014 at the earliest, but unlike previous rounds of accession negotiations, Turkey's talks with the EU are "open-ended," and there is no guarantee as to the final outcome. This, combined with difficult issues such as Cyprus and the likelihood of referenda on Turkish accession in some EU countries, means that there is greater uncertainty regarding the success of these negotiations. In addition, the EU has indicated permanent safeguard clauses are possible, in areas such as free movement of labour, structural or agricultural policies. As a result, it remains a possibility that Turkey will not, even upon entry, receive the full benefits of EU membership. Finding evidence of private market reactions to, and rewards for, the prospect of Turkish accession, then, supports our hypothesis that this pressure often operates, serving to reinforce official institutional efforts at membership conditionality.

Convergence Investment in Turkey. One means by which private investors have rewarded the possibility of Turkey's accession – and the reality of other countries' accessions – is via their use of convergence investment strategies. The convergence investment strategy originated with the movement toward EMU among most of the fifteen pre-enlargement members of the EU (EU-15), and it continued in the wake of the EU's eastward expansion. It was driven by the expectation that policy convergence would lead to yield convergence. Prior to the move to EMU, interest rates had diverged markedly across Europe, the result of varied fiscal and monetary policy, and, for cross-border investors, markedly different perceptions (and, most notably at times of crisis such as September 1992, the reality) of foreign exchange risk. EMU promised a single monetary policy across Europe, convergence of fiscal policy and, for Eurozone investors, the removal of foreign exchange risk. As the result, the expectation among many bond market investors was that interest rates among the future members of the Eurozone would converge, presenting possible profitable investment opportunities.

Investment strategies based on this expectation were highly successful in the mid to late 1990s, as the yields of the Mediterranean EU members relative to Germany fell dramatically.[7] However, convergence trades obviously are profitable only before interest rate convergence actually occurs. Once Italian government bonds, now denominated in euros, yielded little more than German government bonds, the strategy would not yield significant profits. As a result, investors began to look for other ways to deploy this new investment technique. This included both those investors who had made high returns by investing in the pre-EMU period, and, importantly, those who had seen the strategy succeed but had not themselves participated.

The eastward EU enlargement process presented the opportunity to take the yield convergence strategy to new markets, most notably the Czech Republic, Hungary and Poland, all of which had reasonably liquid domestic bond markets, and, in the case of Hungary and Poland, international borrowing, including bonds denominated in euros. In starting to make convergence-related investments in these three countries, investors followed the same overall strategy, with two significant changes. First, the original convergence-related investments were in countries which were already part of the EU, and which had stated the intention of adopting the euro on its launch in 1999. The central European destinations were not yet members of the EU, and the

[7] Yield differentials continued to fall after the euro was launched (see European Central Bank 2004: 13), but, having fallen so far, did not represent such a profitable opportunity.

adoption of the euro remained (and largely remains) an uncertain issue for the future. Second, these countries had not entered the Exchange Rate Mechanism (ERM), and the volatility of their currencies was likely to remain relatively high. While the original convergence trades were not without risk, as the Italian lira's forced removal from the ERM in 1992 amply demonstrated, investors were now prepared to invest in anticipation of more distant events.

In addition, the yield convergence between 2004 entrants and existing EU members was completed earlier in the process of EU accession (and prior to joining the euro) than the fiscal and monetary convergence that occurred in the EU-15 in the 1990s. Admittedly, different investors will have different opinions as to the completion of convergence, influenced in large part by the alternative instruments allowed under the investment rules of the funds they manage.

Figures 1 and 2 demonstrate the compression of yield differentials between convergence country bonds and the market benchmarks. These effects, which show a clear pattern in each case, are manifest in a variety of government bonds – those issued in local currencies, US dollars and euros. The yield differential (or spread) shows dramatic compression, followed by greater stability of the differential. Once this period of greater stability has been reached (although it is not irreversible), it appears reasonable to consider convergence as having taken place. The exact spread at which this would occur will vary with a large number of factors, including the maturity of the bond in question, the overall level of interest rates (spreads will tend to be higher when absolute interest rates are higher) and the monetary and fiscal policies, and creditworthiness, of the country in question.

Insert Figures 1 and 2 here.

It is clear from Figure 1 that the largest part of convergence can be seen to have occurred well in advance of Poland joining the EU on 1 January 2004. Prior to EU membership, the Polish government already was benefiting materially, in the form of lower borrowing costs. In this way, the convergence investment strategy helped strengthen the incentives for and rewards of EU accession. As EU membership for the 2004 entrants neared, and spreads on their sovereign bonds fell further, investors faced declining opportunities in the central and east European countries they had targeted. Again, they looked further afield, investing in countries with more distant timing for or prospects of EU accession. The next beneficiaries of this process were Bulgaria and Romania, which have seen a dramatic improvement in their yield differentials. Both are now regarded, as far as their international bonds are concerned, as largely converged (see Figures 1 and 2), despite EU entry not being until 2007.[8] "Romania and Bulgaria are 50 [basis points, 0.5 percent, in spread over German government bonds] because they will be part of EU".[9]

The latest beneficiary of investors' convergence strategy is Turkey, despite EU membership being far more distant. In each iteration of the convergence investment strategy, investor interest has occurred longer in advance of the actual date of entry, or even of that date being agreed. Therefore, despite the most optimistic date for Turkey's EU accession being 2014,

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[8] These two countries, like all of the EU 25, are also investment grade rated. Romania since September 8, 2005 (www.investromania.ro, accessed March 10, 2006) and Bulgaria since June 26, 2004 (www.minfin.government.bg, accessed March 10, 2006).

[9] Investment bank trader interview, June 21, 2005. The interviews cited here, conducted as part of a broader study, asked traders, research analysts, syndicate managers and fund managers, in London, New York and Turkey, to comment on the factors that influenced investment in Turkey. Overall, 40 market participants were interviewed in London and New York, and 24 in Ankara and Istanbul. The London interviews were conducted at various times during 2005 and 2006, the interviews in Turkey took place in November and December 2005.

and significant opposition within Europe to it happening at all, the country is already enjoying the benefits of investors' convergence expectations, increasing the incentives to maintain the accession process.

In using yield differential data to assess convergence, we can consider a variety of bonds, both local (domestic) and foreign-currency denominated (international). For local currency bonds, the reduced foreign exchange risk is more important to investors; but tighter monetary policy to achieve lower inflation might increase yields temporarily. So, in considering the case of Turkey, we look at both the quantity of investment in domestic bonds, as well as at yield convergence for international bonds. For these international bonds, the availability and liquidity of the various securities guides our analysis of the data, as it does in Figures 1 and 2. Both US dollar and euro-denominated bonds issued by Turkey show a similar convergence, despite the fact that US$ bonds would not benefit from the removal of currency risk in the event of a country joining the euro.

The Roots of Private Sector Rewards: Economic Reform and EU Accession. Investors' interest in Turkey is driven by two factors – a general response to economic reform and a specific interest in Turkey's newfound status as an accession candidate country. First, Turkey is carrying out various economic reforms, which improves the perception of its creditworthiness. Some reforms overlap with Turkey's commitment under the IMF program, while others are generally desirable to international investors. Regardless of the EU accession angle, these policy changes would be perceived positively by investors; as such, they represent "real convergence" (Simsek 2004a). Table 1 displays some of the economic indicators that reflect the achievement of such "real convergence," comparing the situation at the end of 2001 (immediately after Turkey's financial crisis) with the end of 2005. The improvement, in all but the current account deficit, is marked.

Insert Table 1 here.

Another measure of this resulting "real convergence" is improvement in Turkey's sovereign credit rating, particularly relative to Bulgaria and Romania. In the case of Bulgaria, Standard & Poor's awarded an investment-grade long term foreign currency rating of BBB- in June 2004, and this was raised to BBB in October 2005. Romania was awarded a BBB- rating in September 2005.[10] Turkey has seen some improvement in its credit rating in recent years, with Standard & Poor's upgrading the long term foreign currency rating to BB- in August 2004 and Moody's raising its rating to Ba3 in December 2005, but Turkey is not yet on the path of rapid, multiple upgrades, and the resultant convergence with current EU members' investment grade ratings. Indeed, the last change in Turkey's ratings outlook, by Standard & Poor's in June 2006, was to reduce the outlook from 'positive' to 'stable'. Investors, however, are buying bonds in the expectation of future upgrades, helped by reforms that have occurred in Turkey already.

Second, yield convergence also is the direct result of Turkey's recent classification as an EU accession country. There are many investors who only now can buy (given restrictions on assets they manage), or only choose now to buy, Turkish bonds because of EU accession, regardless of ratings.[11] Such bond market investors, both more general investment funds and

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[10] Such investment grade ratings will further increase the number of investors which can purchase a country's bonds, as many funds cannot buy securities rated "speculative" (below investment) grade.

[11] Exactly when in the accession process a fund considers Turkey as a candidate for membership varies according to the investment mandate of an individual fund. An interviewee at the Turkish

more specialized "convergence funds," are investing in Turkey explicitly because of the EU, not because of a more general expectation of an improvement in the Turkish credit in future years. This investment is a less well recognized part of the EU accession process; it illustrates a direct overlap between EU conditionality and private market pressure in potential accession nations.

Indeed, we find that the accession process itself – rather than the specific economic reforms that accompany it – has an independent impact on Turkey's bond spreads. The prospect of EU accession has both changed and improved Turkey's financing. For investors who care ultimately about the reality of economic reform, the EU accession process is important largely because it provides the Turkish government with an additional, powerful incentive to pursue these reforms. For those investors whose investment fund mandates allow investment in Turkish bonds only because of EU accession, the continuation of an EU accession process, and the expectation of its ultimate successful conclusion, is central to their bond purchases.

A similar analysis has been conducted with respect to Italy's membership in EMU (see Favero et al. 2000, Lund 1998, Butler and Cooper 1997; and Bates 1999 for a discussion of the different approaches). Favero et al. (2000: 1623) find that the majority of the effects on Italian interest rates were due to improved economic fundamentals, rather than to EMU membership specifically. They conclude that until March 1997, of the 214 basis points (2.14 percent) fall in the Italian forward spread (relative to Germany for January 1999), "149 basis points can be attributed to the direct effect of fundamentals, while 65 to the probability effect of joining the Euro." For the forward spread for January 2001 (i.e., assuming a later Italian entry into the euro), Favero et al attributed 109 basis points to economic fundamentals, and 72 basis points to the euro

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Treasury (interviewed November 30, 2005) reported interest from funds in different countries at different stages of the process.

effect. After the summer of 1997, "convergence depends almost entirely on the market assessment of [EMU] probabilities while relative fundamentals remain virtually unchanged."

Such conclusions, applied to the Turkish situation, so far temporally from EU accession, might suggest that the improvement in relative Turkish yields can be explained far more, if not entirely, by Turkey's improving fundamentals rather than by the market's assessment of EU accession. Yet the interview data, and the evidence of investors who can only purchase Turkish bonds because of the EU accession process (see below) refutes this suggestion. Moreover, a hypothetical application to Turkey of Favero et al's "EMU calculator" model leads to very different conclusions.[12] Unfortunately, the full application of Favero et al's model is impossible, mainly because the maturity (time horizon) of outstanding Turkish government bonds or swaps[13] is insufficient to reach the point of likely EU accession, let alone membership of the single currency.

A more informal analysis of the movement of bond spreads (similar to the data on instantaneous forward rates presented by Bates 1999: 9, and on forward rate spreads by Lund 1998: 325-327), however, leads to very different conclusions than in the Italian case.
Favero et al., in common with all such models, must make assumptions as to Italian economic policy if the country were outside the euro – estimating a counterfactual economic policy

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[12] A model for Turkey also would have to remove the effect of overall market risk appetite, but this could be done by measuring Turkey's performance relative to a market benchmark, such as the JP Morgan EMBI, absent the index's Turkish component.

[13] Butler and Cooper (1997) use data on foreign exchange option prices, but are limited to only one year forward, even with the most widely traded European currencies. Bates (1999: 5) considers this the main disadvantage of such models.

(Favero at al. 2000: 1620. See also Bates 1999: 17-21). They assume that such policy (which, because of the model used, concerns the Bank of Italy's likely reaction to macroeconomic variables) would resemble that actually in place during 1987-1996. But, as Bates notes, (1999: 20-21), "an alternate hypothesis is that the Bank of Italy might revert to its policies of the 1980's…[with] higher steady-state real interest rates, and lower long-run sensitivity to Italian inflation, Italian output, and German interest rates. If this were used as the non-EMU scenario, inferred EMU probabilities would be quite different."

The relevance of the Italian case for Turkey, then, hinges on the question of likely Turkish economic policy in the event of the EU accession process irrevocably breaking down. Favero et al.'s assumption is that, regardless of EMU entry, Italian interest rates would remain relatively low (2000: 1620). There are a number of reasons to suggest such an assumption may not be appropriate to the Turkish case. We suggest below that some investors would be unable to hold Turkish securities without an EU accession process, suggesting higher yields without the EU accession process. More importantly, the interview data (see below) supports a more general expectation among financial market actors that policy would be less market-friendly without the EU process; this is found in the importance ascribed to the EU as a policy "anchor". For the anchor to be significant, Turkish policy without the EU accession process (the equivalent of Italian policy outside the euro[14]) must be seen by market actors as likely to be materially worse,

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[14] Because the calculator models look to the period where Italy was part of the ERM to calculate "non-EMU" yields, they implicitly maintain an important element of policy anchor (Bates 1999:20). Although in the short term, Turkey might revert to its IMF program as an alternative anchor, in the medium term it would appear reasonable to assume no anchor as strong as ERM membership would have been for Italy. In addition, the Favero et al. model removes the impact

making "non-EU" yields higher. In Favero et al.'s model, higher assumed Italian bond yields outside EMU would increase the probability of joining EMU implied by then-prevailing interest rates, and therefore the greater the proportion of the fall in relative interest rates which would be attributed to the probability of joining EMU rather than the improvement in Italy's economic fundamentals. Given the lack of forward interest rate data, we do not make precise claims as to how much of the improvement in Turkish spreads can be seen as the result of Turkey's EU accession process rather than improved economic fundamentals. But if Turkey's "non-EU" policy is assumed to involve markedly higher interest rates than currently prevail, a similar model to Favero et al.'s would suggest that a higher percentage of the fall in Turkish yields should be attributed to the possibility of EU membership, rather than improved economic fundamentals, as compared with pre-EMU Italy. This supports our claim that the expectation of EU membership forms a significant part of the explanation for the fall in Turkish yields.

Investment Trends in Turkey. Many investors in Turkey have arrived as a result of the country's status as an EU accession candidate. In this section, we detail the increase in the presence of these investors, and the resulting changes in borrowing costs for the Turkish government. One prominent group of new, foreign-based investors in Turkey is specific "convergence funds", established with an investment strategy designed to take advantage of the convergence in yields between accession countries and the lower yielding EU countries. These funds were generally established from the late 1990s onwards. The exact investment mandates of

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of the "interest rate outlier" of the 1992 ERM crisis. It is difficult to argue that, in Turkey's case, a period of dramatic foreign exchange market pressure could be similarly discounted as a one-off outlier.

these funds vary; one fund, Kredietbank's Euro Candidate Fund, established in May 1999 (after the euro's launch), explains its policy as investing:

> "primarily in bonds denominated in the currencies of countries which can be considered candidates for European Monetary Union (EMU) [so an even more distant event than EU accession]. It also invests in euro bonds issued by such countries. This sub-fund takes advantage of the convergence process of these countries, enabling it to achieve a higher return than possible on EMU-country bonds. Volatility is limited by the wide geographical spread."[15]

Other examples of these funds include Germany's DWS Europe Convergence Bonds, a fund of €821m established in February 2000[16] and Deka-ConvergenceRenten CF, established in August 2001[17]. In Luxembourg, Kredietbank's Euro Candidate Fund is €198m in size[18]. All of these funds have seen opportunities reduced in their initial target markets, primarily Poland, Hungary and the Czech Republic, as yields have fallen; they have expanded the countries they will consider, now including Turkey. Similar, smaller funds also exist in convergence countries themselves, such as the IAM Euro Convergent Fund in Slovakia[19], with assets of SK320m

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[15] www.kbl.lu, accessed April 21, 2006.

[16] www.dws.de, accessed April 21, 2006.

[17] www.deka.de, accessed April 21, 2006.

[18] www.kbl.lu, accessed April 21, 2006.

[19] www.iam.sk, accessed April 21, 2006.

(€8.5m)[20]. Of the funds listed above, as of March 31, 2006, 5.0 percent of the DWS fund was invested in Turkish lira, as was 10.3 percent of the Kredietbank fund, and, at the latest update (accessed April 21, 2006), 7.0 percent of the Deka fund. Investment in Turkey has not entirely displaced the countries originally targeted (the exposure to the Polish zloty in the three funds is between 18.0 and 28.0 percent, and to the Hungarian forint between 8.6 and 14.0 percent, with Czech crown exposure smaller), but investment in Turkish assets now constitutes a substantial portion of their investments.

Turkey benefits from this investment both because of its attractive yields, but also because of the large size of its bond markets, domestic and international. Turkey's domestic market, with outstanding bills and bonds of over US$150 billion equivalent at the end of 2005[21], is larger than that of any of the fifteen new entrants (although turnover is higher in Poland), and dwarfs the US$4.4 billion size of Bulgaria and Romania combined.[22] The large scale of the Turkish market, however, means that the specialized convergence funds themselves do not have a material influence on yields. They are a positive, but do not explain on their own the extent of yield improvements.[23]

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[20] Funds also exist that invest in Eastern European equity markets, and are sometimes also called "convergence funds."

[21] www.hazine.gov.tr/english/kaf/CG-Stock-Curr-Int-2005Q4.htm, accessed August 2, 2006.

[22] As of the end of March 2006; http://dsbb.imf.org/Applications/web/sddscountrylist/, accessed August 2, 2006.

[23] One research analyst interviewee (June 23, 2005) reported that a Belgian bank was planning a fund targeted specifically at the Turkish bond market. This could increase the amount of funds

A number of the convergence funds cannot buy non-investment grade bonds and, therefore, cannot directly purchase Turkish domestic bonds. For these investors, their main investment vehicle is the Eurolira market. This market attracts not only some of the specialist convergence investors, but also some generalist bond funds, and individual investors across Europe. The Eurolira market consists of bond issues denominated in Turkish lira, but launched outside Turkey, and governed by the laws of countries other than Turkey (usually English law). The borrowing entities in the Euro lira market are not Turkish, but either supranational (e.g. European Investment Bank, World Bank) or well-known European borrowers. Few, if any, of these issuers are actually aiming to borrow in Turkish lira. Rather, their objective is to raise attractively-priced funds in a major currency. This is achieved by means of a cross currency "swap," whereby a swap counterparty (usually a major international bank) will pay the bond issuer Turkish lira amounts to match the principal and interest on the bonds and an initial amount in the major currency (for example, US$). In exchange, the counterparty receives the initial Turkish lira amount raised by the bond issuance, interest payments in the major currency throughout the life of the transaction, and at the maturity of the transaction, the return of the initial amount in the major currency. In such a transaction, the counterparty hedges their risk by purchasing Turkish government bonds, expanding foreign demand for domestic bonds as well as the lira. Perhaps most importantly, the Turkish bonds used for this hedging activity have been of longer maturities than the Turkish authorities have historically been able to issue.

The development of the Eurolira market has therefore played an important role in helping the Turkish authorities ameliorate the short maturity of domestic debt. Issues of three and five

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invested in Turkey, because investors may be attracted to the higher returns of the dedicated Turkish fund as the more diversified convergence funds see their yields fall.

year domestic bonds have been purchased predominantly by foreign investors; a Turkish Treasury official (interviewed December 1, 2005) estimated that as much as 80 - 85 percent of the first auction of five-year Turkish lira government bonds was bought by international banks hedging swap positions. These longer maturity issues also have been at lower interest costs to the government than some shorter maturities, leading – in concert with monetary policy reforms -- to an inverted yield curve beyond 18 months. Additionally, although the purchasers are swap trading desks, they have tended to be "buy and hold" investors, content to take the margin from the swap transaction rather than actively trade the government bonds.

Moreover, the ultimate investors in the Eurolira bonds are also primarily "buy and hold" investors. Around 60 percent of the bonds are sold to individual (retail) investors, buying through European banks.[24] Another segment of Eurolira investors (8 and 20 percent in two issues discussed by a Turkish Treasury official, interviewed November 30, 2005) are fund managers domiciled in Europe. Interviewees (for example, London-based fund manager, interviewed October 21, 2005) suggest that these are investors who are not able, for various reasons[25], to buy domestic Turkish government bonds, but who want exposure to the Turkish currency and interest rates. Again, they represent an additional source of financing for the Turkish government, one

[24] Turkish Treasury official, interviewed November 30, 2005, based on his discussions with the banks arranging the transactions.

[25] Some investment mandates that preclude investments in non-investment grade rated securities, or in bonds which cannot be settled using the Euroclear settlement system, or which do not allow investment in securities that are governed by Turkish (or other emerging country) law. For some smaller investors, the more time-consuming process of buying domestic securities also acts as a disincentive.

that would not directly enter the Turkish domestic Treasury bill and bond market. The Turkish Treasury estimates Eurolira issuance between the start of 2005 and September 21, 2006 to have totalled US$8.8 billion (€6.9 billion).[26] As a comparison with more direct material incentives from the EU, European Investment Bank lending to Turkey for 2000-07 is planned to be €6.425 billion (Dononsoro 2004).

Some of the purchasers of the Eurolira issues are "generalist" funds, which, for various reasons, could not buy Turkish lira denominated assets prior to the creation of this market. Distinguishing among the motivations of more generalist investment funds – Turkey's EU accession versus Turkey's overall attractiveness – is difficult without a comprehensive survey of fund mandates, many of which are not publicly available.[27] Interviews with market participants, however, suggest that both investment motivations are important, and that many of these investors, both in the Eurolira market and more generally in Turkish bills and bonds, are new to Turkey. Research analysts point out the changes in the types of investors interested in Turkey as a result of EU accession. One observed:

> "in the last six to eight months I have talked more to people [to whom] I never talked before. These are … pan-European accounts[28]. They usually invest into continental Europe; not interested in emerging markets. But they know what's happening in let's say

[26] Data given in e mail communication, received September 21, 2006. Currency conversion based on $/€ exchange rate as of September 21, 2006.

[27] A large investor may well negotiate an individual, tailored investment mandate with a fund manager.

[28] Investors whose investment mandate covers all European bond markets.

> Portugal or Spain or Italy or Greece or central Europe for that matter, and they want … not to miss the train or boat this time in Turkey.” [29]

Another interviewee observed that, “years ago,” a German fund manager

> ”sat me down with everybody, heads of all their departments; all they wanted to talk about was Turkey and EU, when it would be a convergence story, because they were all going to put money in…the high grade guy [i.e., the manager of funds that could only buy investment grade assets] and the head of fixed income [bond investment], and the head of equities[30], and they’re all there and they’re all going to put a bit …in all their funds, they’re going to allocate something to Turkey. Which would have added up to a couple of billion dollars [or approaching one percent of Turkey’s outstanding government debt].’[31]

Central to these investors’ interest is the fact that the process of the accession country yield convergence had occurred already in the run-up to 2004. In this sense, Turkey was ”the next big thing” in European bond market investment, attracting both those investors who had

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[29] Research analyst interview, February 16, 2005. The interviewee was talking about investors who could not buy debt related below investment grade, and so bought EuroLira issues.

[30] Although the focus of this article is the sovereign debt markets, this comment, supported by other interviewees, supports the view that investment in Turkey more generally has also been positively influenced by EU accession.

[31] Research analyst interview, June 23, 2005.

made attractive returns from investing in previous accession countries, but also those who had seen, with hindsight, that this had been a successful investment strategy:

> "It is attracting interest from people who would have traditionally invested in European governments…Since the EU-15 went to EU-25, in May 2004, I think a lot of investors missed out on that process, you know people who were just investing in Europe, and then suddenly these countries, ten new countries came in and a lot of the convergence had already happened… I think they missed that but then they saw the benefits and what happened is then they looked for the next market, and then Turkey obviously, even though still quite risky and low rating… I think some investors just took Turkey as the next market… and that drove a lot of interest."[32]

Some of these market participants are investors whose main area is investment grade-rated EU assets, such as Germany, France and Italy. With Turkey now as a formal accession candidate, however, a fund that markets itself to investors as a *European* bond fund also can place a small part of its investment in Turkey. Exactly how – in which Turkish securities, denominated in which currency, and via which market -- this investment is made will, again, depend on the exact mandate of the fund,[33], at least until Turkey's credit rating reaches investment grade.

[32] Research analyst interview, October 17, 2005.

[33] Another investment alternative is credit-linked notes. These are structured bonds, issued by, for example, an investment grade rated bank, but with the return the investor receives being determined by the performance of another bond, like a domestic Turkish government bond.

The above section details the growth in new investment in Turkey, from both general and specialist funds, and from direct as well as indirect (Eurolira) purchasers of government securities. Additionally, existing investors, international and domestic, both react to, and help reinforce, Turkey's movement toward EU accession. The evidence again supports our hypothesis that market interest in the accession process, even from investors who had previously invested in Turkish assets, creates an additional, material incentive for the government's continued movements toward membership.

International investors who have traditionally bought Turkish bonds, or who have investment mandates which would allow such investment, are dominated by specialist emerging market bond investors. For these investors, the most important potential positive changes in Turkey are the actual policy changes themselves, rather than eventual EU membership. However, like recent literature on membership conditionality, they view the EU process as creating a powerful, long term incentive for those economic policy changes. The following representative interview responses (from investors themselves as well as the market players who deal with them) make this view clear: "Turkey is of course special because it was…a convergence play" (research analyst interview February 16, 2005); **"**Turkey the past year has all been about EU accession**"** (fund manager interview October 21, 2005); "I think of Turkey as a convergence story" (hedge fund manager interview June 23, 2005); "for Turkey the biggest thing driving spreads [the difference between the yields of Turkish bonds and a market benchmark] … for the last two years has been this anticipation that they will get a date from the EU to start negotiation of their membership, and the general thought is that that process is designed to succeed" (investment bank trader interview, February 17, 2005); and "Turkey is…now an EU story and…so it trades seemingly very rich [i.e., at a lower spread] to its credit analysis and comparable countries" (hedge fund strategist interview February 18, 2005).

Indeed, investors with an emerging markets focus would respond positively to many recent economic policy developments in Turkey, such as those that have come as a result of the IMF program and the stability of the AKP government. We would expect such responses even without a move toward EU accession. Again, though, the EU plays a significant role in reinforcing and strengthening these market reactions: specialist investors view potential accession as a policy "anchor" that gives the government a strong incentive to continue reform:

> "It keeps Turkey on track… so the risk of deviation declines. What we cared [about] is the risk of deviation from some kind of target, be that fiscal target or some kind of monetary target or world policy predictability. So as a result of the EU, I think the policy predictability has improved."[34]

Investors like the conditionality attached to the accession process, as the incentive of membership means that the government's hands are tied, to some extent, and will remain so. While most international market actors consider the process as "designed to succeed"[35], "there's a bit of a divergence between guys who think that [the] EU story is a bit dodgy now to those who think that EU is going to be an up and down process but will still go towards accession."[36] The final outcome may not matter even for the skeptics, as long as the accession process provides the incentive for the "real convergence" about which they care. "In ten, fifteen years time, who will

[34] Research analyst interview, February 16, 2005.

[35] Investment bank trader interview, February 17, 2005; Ediz 2004a: 2.

[36] Research analyst interview, June 23, 2005.

care whether Turkey joins EU or not?”[37] The majority view among this group of investors, then, is that the important phenomenon was not EU accession, but the improvement in Turkey’s creditworthiness that would result from reforms related to the accession process – the EU as policy anchor.

Both the IMF and the EU offer direct material incentives in return for changes in Turkish government policy. Both also positively influence the attitudes of private market actors. However, despite being a more distant and uncertain prospect, private investors view EU accession as creating a greater sustainability for reform than the existing IMF program. EU membership is the greater “prize” for Turkey, and an incentive which influences government policy choice over a much longer timeframe. Some investors also see the EU accession process itself as a potential source of political stability, despite the difficulties represented by EU demands regarding Cyprus and minority rights (Ediz 2004a, Simsek 2004a 2004b):

> ”It [EU accession]’s a bigger project; it is a project with a history. Turkey applied for [associate] EU membership in 1963, so it has been one of the ultimate foreign policy objectives for this country for five decades. So from that point of view, [the] IMF is here today; it will not be here in three years time. But [the] EU will always be here. So from that point of view, the EU is overvalued, the much stronger anchor for policy developments.”[38]

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[37] Research analyst interview, February 16, 2005.

[38] Research analyst interview, February 16, 2005; also Turkish Treasury official interview, November 30, 2005.

A final group of investors that have long purchased Turkish debt, but who also are influenced by the accession process, is Turkish-based investors who buy their own government's bills and bonds. Although there is much debate about the reliability of the figures, domestic investors are generally thought to own well over 75 percent of domestic government bills and bonds, and around half of international bonds. Turkey has a small, if fast developing, pension fund system and mutual fund industry, but domestic investment is dominated by commercial banks and individual investors. From the perspective of international market actors, local investors have underestimated the importance of the convergence story:

> "going into the December 17, 2004. [the decision to open accession talks with Turkey] … if you talk to locals they would say … don't touch Turkey, right, this is a great opportunity to take profits. Well look at what markets have done since then… because they really … mismeasured the importance or the power of convergence, what that implies."[39]

The result was that it was international investors who were responsible for yields falling after December 17, and the local investors followed (investment bank trader interview, June 22, 2005; research analyst interview, June 23, 2005; Ediz 2005). For domestic investors, the EU accession process was important because of the increased interest from international investors that resulted.

There is, however, another way in which EU accession has affected domestic investors' confidence – their willingness to hold local currency. Empirical evidence confirms this mechanism, which generates yet another reward – in terms of increased demand for local

[39] Research analyst interview, February 16, 2005.

currency – for the Turkish government. Turkey has historically been a highly dollarized economy, as investors held foreign currency assets as a protection against high inflation and currency devaluation. Periods of uncertainty see marked increases in the rates of dollarization; conversely, falling levels of dollarization can be seen as an indication of increased confidence in the local currency[40]. Turkey's rate of dollarization has fallen steadily since the economy began to recover after the 2001 crisis. One measure of the dollarization ratio is the investment by residents in foreign currency assets as a proportion of total investments. According to the Turkish subsidiary of Fortis Bank (Burumcekci et al. 2005), this ratio climbed in the two months leading up to the December 17 decision, but immediately resumed its declining trend until July 2005. The ratio then remained stable until the October 3, 2005 confirmation that negotiations would start, at which point a decline was again evident.[41]

Implications of Material Incentives from Private Actors. The above empirical evidence implies that the possibility of EU accession has increased investor interest in Turkey. This improves the financial environment for the Turkish government, as well as for Turkish firms. Specifically, there is increased access to financing; debt maturities have increased, particularly in the domestic bond market; and investors are increasingly attentive to EU-related

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[40] Note, however, that hard currency deposits are mainly with Turkish banks, and hard currency assets include US$ and euro-denominated Turkish government bonds, so even high dollarization does not represent a total lack of confidence in the country.

[41] It is, however, noteworthy that domestic investors do not appear, from this measure, to have positively anticipated either reaction, as international investors in hard currency bonds did for the December 17 decision (Simsek 2004b: 1)

issues when making asset allocation decisions. We consider the implications of each of these for the Turkish government.

First, the tightening of Turkey's spreads over time is a clear indication of a more positive view on the country's creditworthiness. The Turkish government's issuance strategy for international bonds is "around 5 to 6 billion a year plus some prefunding [i.e., borrowing in advance for the following year] if [the] market will be there."[42] The tightening in spreads, therefore, indicates increased investor demand. Even in the face of the strong recent demand for emerging market securities (driven by low returns in developed markets), Turkey has managed to outperform other markets. Many interviewees link this performance with the EU accession process. Additionally, in the market for domestic bonds, we also see increased international interest. Figure 3 reports data from the Central Bank of Turkey on bond holdings of non-residents[43]. Purchases of domestic bills and bonds by international investors have risen dramatically, with the fastest rate of increase occurring around the December 17, 2004 announcement.[44]

Insert Figure 3 here.

Second, Turkey benefits from the lengthened maturity of its inward investment. The country runs a substantial current account deficit, much of it funded by flows into the domestic debt market (Simsek 2005 and Ediz 2004a). But, while the EU accession process has increased

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[42] Treasury official interview, November 30, 2005.

[43] www.tcmb.gov.tr/yeni/eng/index.html, accessed April 27, 2006.

[44] Increased international interest in the domestic bond market also has generated substantial profits for domestic holders of these securities, potentially fuelling domestic consumption.

the volume of flows and the government's access to financing, it also has increased investors' time horizons, in the Eurolira market, and across both domestic and international debt generally. Previously, the main international investors were investment bank trading desks and hedge funds, both of which were very short term traders. These have now been joined (and, some interviewees believed, superseded) by longer-term investors such as pension funds and other "real money" (non-leveraged) accounts, with positive implications for the Turkish government (Maxfield 1998). These investors are less likely to react to short term fluctuations. For instance,

> "There is a tax issue [that] just came out[45], and most of the hedge funds, they started selling, they just all are offloading. But the real money accounts, they just stayed because the real money accounts, pension funds actually…they just buy and hold, they don't care about days... okay they will not wait until the crash, but the fluctuations doesn't matter for them."[46]

"Two years ago, nobody cared about what would happen after 3 months…Last year it has moved,…in my view, to around 1 year. Now, after the December 17th decision, obviously it has moved to 5 years. So people have a longer view on Turkey."[47] Turkish banks which trade the domestic market also see the change in terms of different types of investors becoming involved

[45] The interviewee is referring to uncertainty surrounding the new tax treatment of domestic securities.

[46] Istanbul-based economist at US investment bank, interview December 5, 2005.

[47] Research analyst interview, February 16, 2005.

in the market, buying with a longer term perspective.[48] EU accession also raises the hope that more stable sources of inflows, particularly foreign direct investment, may replace these portfolio inflows (Simsek 2004b), but even within portfolio investment, the time horizons of investors have increased, to Turkey's benefit.

Finally, the evidence suggests strongly that the prospect of EU accession has changed the factors that influence investors' decisions. The more traditional measures of creditworthiness, including the current account deficit, remain influential (Ediz 2004a, b, c, d, and 2005a, b; Simsek 2004a, b and 2005). But the "anchor" of EU accession has meant that factors related to the accession process also matter for investors: "Turkey the past year has all been about EU accession,… what's the latest development, what's the latest rantings of a French politician,…coming up to October 3rd, all the discussions about what the Austrians had in mind etcetera"[49] . A Turkish analyst therefore considers it worthwhile to make a trip to Paris prior to December 17 to assess French attitudes to Turkey (Ediz 2004d), and Turkish bond prices fall when it is feared that the December 17 EU decision will make unacceptable demands regarding the recognition of Cyprus (Simsek 2004a)**,** or on fears that a "no" vote on the EU constitution will also be a "no" to Turkey[50]. This change serves to increase the pressures on the Turkish government: not only are the demands of the EU important for the continuation of accession talks, but they also are grounds for reward – or punishment – from international capital markets.

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[48] Turkish bank traders, interviewed December 5, 2005, December 7, 2005 (three interviews), and December 8, 2005.

[49] Fund manager interview, October 21, 2005.

[50] Turkish Treasury official interview, November 30, 2005.

Overall, the "breadth" of investor influence (Mosley 2003) has increased, to include accession-related factors that would not be included in the analysis of nearly all other emerging market countries. Because of the linkages drawn between EU accession broadly and economic reform specifically, the non-economic elements of the accession process have come to affect assessments of Turkey. For instance, "[T]his year … the [Turkish] prime minister [was] talking negatively on adultery…that really made foreign investors very … nervous and they thought that this would jeopardize relations with [the] European Union."[51] Similarly, for one investor interviewed,[52] the accession process represents an additional, relatively short term, market risk, as he felt the Turkish government would be unable to meet EU demands regarding Cypriot shipping access to Turkish ports by the end of 2006. For the Turkish government, this implies that setbacks in the negotiations may result in higher borrowing costs. For the EU, on the other hand, pressures from private markets give additional bite to membership conditionality, with the potential for reinforcement by punishment.

Conclusion

This article investigates the role of private market actors in the exercise of influence by international institutions. We test the claim that private investors contribute important, yet understudied, leverage to the demands of international organizations. As such, when private market actors embrace the demands and preferences of international institutions, the influence of such institutions is strengthened, and the likelihood of successful membership conditionality

[51] Turkish bank Treasurer, interviewed December 7, 2005. Also Turkish Treasury official, interviewed November 30, 2005.

[52] Fund management company research analyst, interviewed May 31, 2006.

expands. We test the existence of this mechanism with regard to the European Union, and Turkey's potential membership in that institution. We find that, although Turkey is a least-likely case for the presence of market-related incentives – particularly given the uncertainty and long time horizon of the accession process – there is still pronounced evidence that private market pressure plays an important role. Specifically, capital market pressures enhance the Turkish government's incentives for EU membership, while they also increase the costs of failing to complete the membership process.

Our findings strongly suggest that the study of international institutions should devote greater focus to the reactions of private market actors. Any external incentives model, of international institutions in general or EU enlargement in particular, should address the material rewards provided by private market actors. Of course, this should be in addition to, not exclusive of, the material benefits offered by the international institution itself. The balance between the two will vary across cases; the Turkish case highlights the relative importance of private market actors. In the case of the EU-10 enlargement countries, Hallet (2004: 8) estimates the net payments to the new member states from the EU budget, per annum 2004-2006, at between 0.87 and 1.62 percent of their GDP, on average. In Turkey, the net interest payments in the consolidated public sector – fell from 22.2 percent of GNP in 2001 to a projected 8.4 percent in 2005 (IMF 2006: 33). Clearly, both kinds of material incentive – as well as others, such as opportunities for access to broader goods and services markets -- require attention.

Moreover, the material incentives offered by bond market investors are not only reinforcement by reward, as the EU's incentives have been seen in the accession negotiations (Schimmelfennig et al 2003). The ability of investors to sell bonds, as well as to not purchase additional instruments, gives the potential for reinforcement by punishment. This changes the calculations for policy makers in accession candidate countries by increasing the costs of non-compliance. External incentives models should be updated accordingly

For Turkey specifically, the country is already benefiting from the EU accession process through reductions in financing costs and increases in the maturity of that borrowing, most importantly for the government, but also for all other borrowers. This does not make Turkey invulnerable to the pressures suffered by other emerging market countries, as its position as one of the main victims of the market weakness of May 2006 indicates, but it creates further incentives for the government to ensure the negotiations continue, overcoming difficulties such as the current impasse over Cypriot access to Turkish ports. When the process is not going well, whether problems are the result of Turkish, EU or individual EU states' concerns, a potential new source of vulnerability may be revealed, via increased borrowing costs. When the process goes well, however, Turkey stands to reap both material and policy rewards.

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Table 1:
Selected Economic Indicators, 2001-05

	2001	2002	2003	2004	2005
Real GNP Growth (%)	-9.5	7.9	5.9	9.9	7.6
CPI (12 month end of period (%)	68.5	29.7	18.4	9.4	7.7
Net Interest Payments of Consolidated Public Sector (% of GNP)	22.6	17.6	15.4	11.7	8.4
Net Debt of Public Sector (% of GNP)	90.5	78.6	70.4	63.5	55.8
Current Account Balance (% of GNP)	2.4	-0.8	-3.4	-5.2	-6.4

Source: IMF (2006: 35)

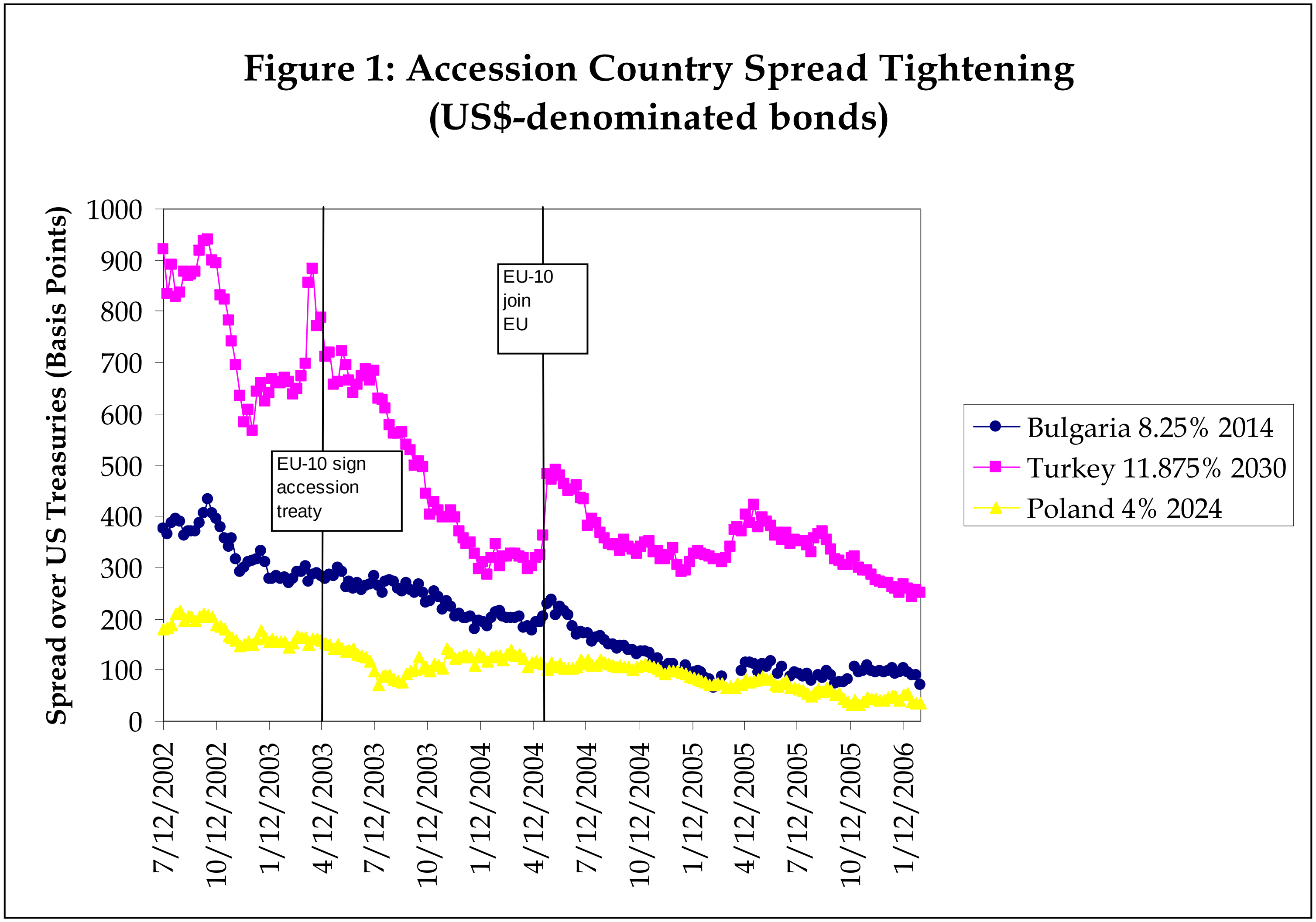
Figure 1: Accession Country Spread Tightening
(US$-denominated bonds)
Spread over US Treasuries (Basis Points)
1000
900
800
700
600
500
400
300
200
100
0
7/12/2002
10/12/2002
1/12/2003
4/12/2003
7/12/2003
10/12/2003
1/12/2004
4/12/2004
7/12/2004
10/12/2004
1/12/2005
4/12/2005
7/12/2005
10/12/2005
1/12/2006
EU-10 sign accession treaty
EU-10 join EU
Bulgaria 8.25% 2014
Turkey 11.875% 2030
Poland 4% 2024

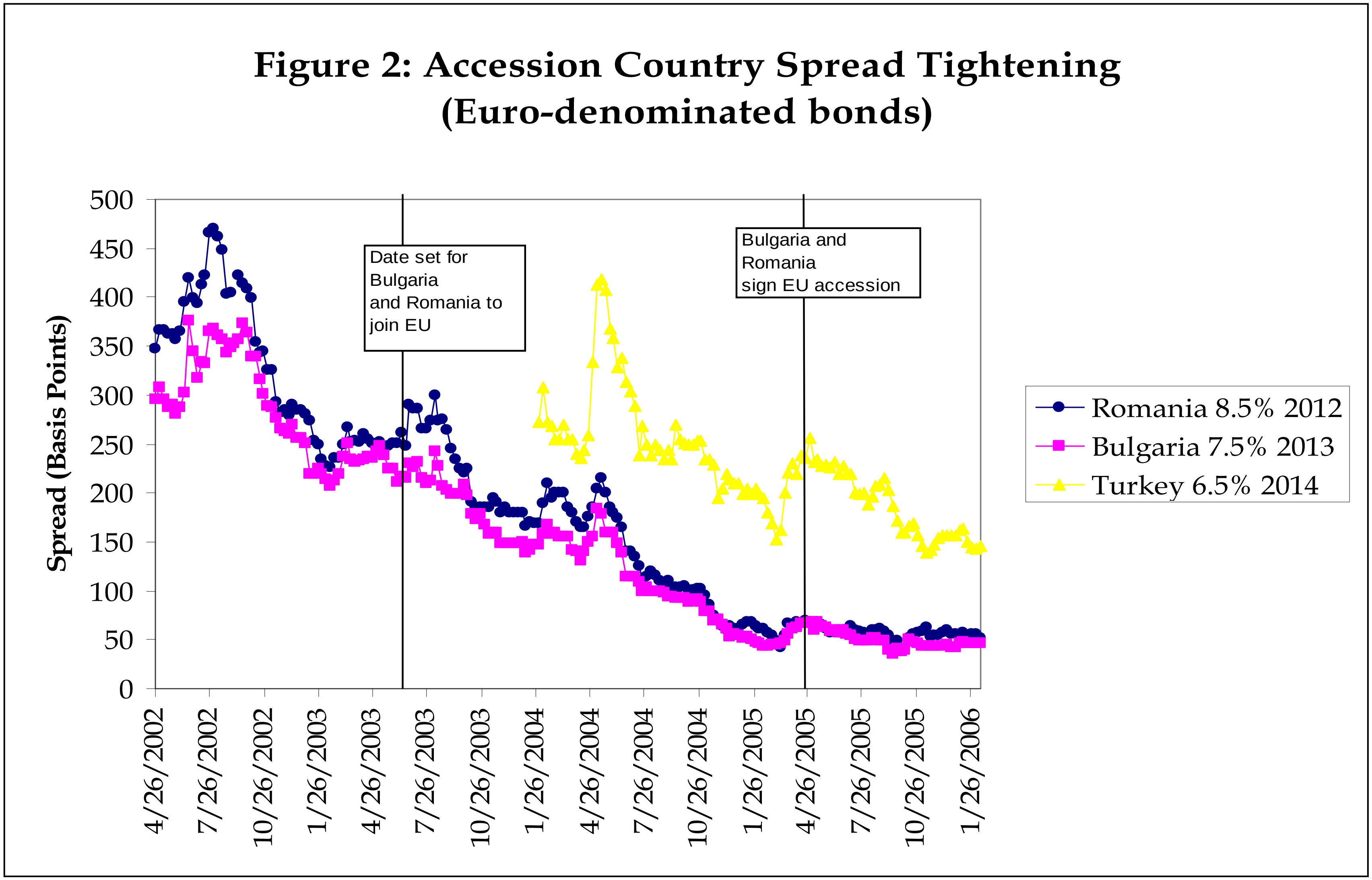

Figure 2: Accession Country Spread Tightening
(Euro-denominated bonds)
Spread (Basis Points)
500
450
400
350
300
250
200
150
100
50
0
Date set for
Bulgaria
and Romania to
join EU
Bulgaria and
Romania
sign EU accession
4/26/2002
7/26/2002
10/26/2002
1/26/2003
4/26/2003
7/26/2003
10/26/2003
1/26/2004
4/26/2004
7/26/2004
10/26/2004
1/26/2005
4/26/2005
7/26/2005
10/26/2005
1/26/2006
Romania 8.5% 2012
Bulgaria 7.5% 2013
Turkey 6.5% 2014

Figure 3: Nonresident holdings of Turkish Domestic Debt (Weekly)