

# **RISKS AND RETURNS IN TURKEY**

**GAZİ ERÇEL**  
Governor  
The Central Bank of Turkey

Deutsche Bank Annual Emerging Markets Conference  
Prague, September 23, 2000

I very much welcome the opportunity to share with you today some thoughts on the subject of risks and returns in Turkey.

At the outset, I wish to emphasize that in emerging market economies, risks and returns mainly depend on two factors. These are the fundamentals, and the external environment. Sound macroeconomic policies, a healthy banking sector, and transparency in governance are the basis for sound fundamentals, which of course are the key to increasing revenues and reducing risks in any country.

A favorable outlook for the global economy also reduces risk and positively affects emerging market economies.

I do not want to debate the relative importance of strong or weak fundamentals compared with a favorable or adverse external environment, or their effects on risk calculations. I do want to emphasize the importance of prudent macroeconomic policies. If an emerging country distinguishes itself by better macroeconomic policy implementation than the others, I believe the markets will expect from it higher returns and lower risks.

Being aware of these principles and wishing to optimize our fundamentals, at the beginning of this year we launched a comprehensive disinflation program aimed at reducing Turkish inflation to single digits within the next three years, and correcting the imbalances in the public finance.

The main goals and the overall strategy are:

- To eliminate inflation
- To achieve a sustainable fiscal position
- To establish a more equitable and efficient distribution of income
- To increase the growth rate of the economy's potential
- And of course meeting the conditions for full membership in the European Union

The program is achieving these goals through a number of policy changes. The primary fiscal balance has to move, in the first year, from deficit to a surplus position consistent with long-term fiscal sustainability, and will remain high until price stabilization in the economy has been achieved.

To increase program credibility and speed the fiscal stabilization, the program is frontloaded, with most of the structural elements at the beginning.

I am pleased to point out that good progress has been made during the first

nine months toward achieving the key economic goals of:

- Reducing inflation
- Strengthening the public finances
- Forwarding the ambitious agenda of structural reforms

The decline in inflation accomplished so far has been driven by an initial strong recovery in economic activity.

Interest rates came down much further than we initially expected.

Monetary policy has been anchored by a pre-announced crawling exchange rate path and quasi-currency-board rules introduced in early January.

Surveys by the Central Bank show that business confidence has remained strong.

The Turkish authorities have sent a number of key signals confirming their steadfast commitment to the program targets before, during, and after the implementation of the disinflation program.

In addition, we have been able to break the pattern of debt dynamics established over the years in the financial markets.

Turkey is doing better than other countries that are implementing successful exchange-rate-based disinflation programs. Data from Argentina (1991), Brazil (1994), Mexico (1988), and Israel (1985) show that cumulative inflation and real appreciation during the early stages of their programs lagged behind Turkey's.

Following last year's severe recession, Turkish output growth is projected to rebound in 2000. The recovery can be attributed to several

factors, including falling interest rates, a rebound of tourism, stronger growth in exports to Western Europe and Russia, and improving business and consumer confidence.

When evaluating risks and returns, it is useful to recall the lessons of the debt crises of the 1980s and 1990s. We are able to evaluate these elements in recent major financial crisis, I do believe that we will get most benefit as a country.

It is also useful to recall the lessons from the debt crises of the 1980s and 1990s. If we can apply these lessons to some recent major financial crises, I believe it will benefit us as a country.

The lessons learned from past crises pertain to six areas:

- 1) The exchange rate regime
- 2) Weakness in the banking and financial sectors
- 3) Total short-term foreign indebtedness
- 4) Short-term government debt
- 5) Current account deficit
- 6) Fiscal sustainability.

What have we done in these six areas?

First, we believe that an overvalued pegged exchange rate is a major factor leading to balance-of-payments deterioration and depletion of reserves, which is the perfect setup for a crisis. In Turkey we pursued a managed exchange rate policy from 1996 to 1999 that prevented the Turkish Lira from appreciating. We started the present program with a relatively strong real exchange rate.

When it came time to reduce inflation, there was a broad consensus in Turkey that an anchor would be an effective way of interrupting the cycle of public expectations based on the past. And along with our strong commitment to follow a pre-announced exchange rate path for the next one-and-a-half years, we simultaneously announced our intention of moving to a gradually widening band-based mechanism that will provide greater flexibility, beginning in the middle of 2001.

We prefer to avoid exchange rate regimes based on extreme or "corner" solutions, whether floating or of the currency board type.

And in fact, over the last eight months, appreciation of the Turkish lira has been quite limited, ranging from 0.3 percent to 3.9 percent depending on the price indices used for calculation. In addition, labor productivity increased by 11 percent in the first six months of this year.

Second, in order to build a sounder banking system, Parliament enacted a new banking law in 1999. It was aimed at enabling the banking system to recover its efficiency and soundness. In this framework,

- Most of the Basel Committee's 25 core principles for effective banking supervision were embodied in the new legal framework
- A new independent supervisory board was created
- Principles for avoiding moral hazard are being applied
- Rules of transparency have begun to be observed
- Risk-based systems have begun to occupy a more important place in supervision

Third, we have tried to keep up with developments in trade-related

short-term debt, such as Letters of Credit, acceptance credits, etc., and very liquid "hot money" movements. The Turkish economy has never seen more than \$5 billion to \$10 billion in very short-term international liquidity. We have sometimes discouraged them by increasing the volatility of interest rates, and more recently by more comprehensive stabilization programs.

In addition, we have kept our official reserves liquid at higher levels than hot money. Over the last four years we have kept an average of \$20 billion in reserves, equivalent to five months of imports.

The ratio and amounts of trade-related short-term debt have been acceptable. I may say that these kinds of short-term capital flows averaging around \$10 billion level are useful for partially financing Turkey's \$50 billion import bill.

Fourth, the Treasury has kept as long as possible the longer-term maturities of government debt. At certain difficult times during the late 1990s, despite the longer maturation of external debts, the average maturity of domestic public debt was 6 months. Now we have gradually lengthened this maturity to 16 months.

Also, we plan to reduce the GNP ratio of total public debt from 61 percent to around 50 percent by the end of 2002.

As to the fiscal deficit, the program envisions a dramatic increase in the primary surplus and the whole public sector. It is expected that the GNP ratio of the primary surplus of the consolidated budget will be 5.4 percent, up from 1.5 percent in 1999, not counting privatization revenues, which will amount to around 2 percent of GNP in 2000.

And at the same time, we have been implementing a comprehensive budget reform together with a reform in social security spending.

Turkey is not a country with a chronic current account deficit. Since 1950, the average GNP ratio of the current account deficit to GNP ratio has been around 1 percent. Turkey experienced balance-of-payments difficulties twice, in 1978 and 1994. Each time the economy recovered in a relatively short time.

And even though the current account deficit of the balance-of-payments increased more than we expected in the first six months of 2000, I believe this is a temporary increase due to the combined effects of the oil shock together, a decline in domestic interest rates, and accelerating private consumption and investment. The reduction of uncertainties about the future doubtless also stimulated investment demand and imports.

I see no major risk in the current account mainly because of the competitive level of the Turkish lira, the continuing increase in labor productivity, and countermeasures that have already been taken or will be taken if necessary.

Taken all together, the factors explained above justify us in expecting higher returns than in the past.

We firmly believe that the Turkish economy is running less risk and is enjoying more stable conditions. But the other side of the coin--external conditions--is less helpful in further reducing the risks for emerging market economies. Specifically, these are the level of the euro, higher international interest rates, and high oil prices.

These three adverse developments have increased the pressure on domestic policy.

The external situation has led us once more to define the goals and challenges that lie ahead. Let me sum these up under six headings:

- 1) Improve macroeconomic fundamentals,
- 2) Increase productivity,
- 3) Distribute the benefits of economic growth broadly,
- 4) Continue structural reforms.
- 5) Enhance credibility, and
- 6) Prepare for EU membership.

By following these topics and policy directions, I believe that Turkey can obtain more returns with less risk from the international marketplace. At the same time, we will succeed in improving the living standards and quality of life of the Turkish people.