Remarks by

GAZİ ERÇEL

GOVERNOR

THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

at the

JP MORGAN CONFERENCE

İSTANBUL

OCTOBER 23-25, 1997

EUROPEAN FINANCIAL MARKETS AND ITS IMPLICATIONS FOR TURKISH FINANCIAL INSTITUTIONS

Ladies and Gentlemen,

First of all I would like to express my gratitude to J.P. Morgan for giving me this opportunity to address you on such an important issue as “European Financial Market and its implications for Turkish institutions”.

The European Monetary Union (EMU) will be the most important change in the international monetary system since the creation of the IMF at Bretton Woods. The creation of a new currency, the Euro, is in fact a historical event for the European Union (EU). It marks a new stage in the process of European unification because it is the crown and capstone of efforts since 1958 to create a single big market in Europe.

The success of the Euro area will, of course, depend on further developments in the value of the Euro. The Euro, as we all know, has to compete with two strong international currencies--The US dollar and the Japanese yen. According to one school of thought, the Euro will have stable value. That is because the large stock of assets backing the Euro, held by official or private foreign holders and which were converted from other currencies, in particular the Deutsche mark, will not be converted into other currencies.

Besides, once the Euro has been introduced, there could be a significant shift of foreign exchange reserves out of the US dollar and into the Euro. Over time, this could boost the exchange rate of the Euro against the US dollar. The sheer size of the economy represented by the monetary union will encourage the use of the Euro instead of the US dollar in trade and foreign exchange transactions. This process will also be accelerated because the use of a single currency will eliminate a significant transaction cost. According to a study made by the IFO institute in Munich, “the transaction cost for the inter-European currency management may be on the order of nearly 60 billion ECUs, or almost 1 percent of the GNP of the European Union”.

Also it is likely that central banks will use the Euro rather than the US dollar in foreign exchange interventions. In turn, this will encourage non-EU central banks to convert an increasing share of their reserves into the Euro. These changes will take time and the Euro will not usurp the role of the US dollar in the short term. However, the trend is likely to persist until eventually the present dominance of the US dollar in the foreign exchange markets is replaced by the joint dominance of the US dollar and the Euro. One factor that will affect the speed of this change is the outlook for the Euro based on the fundamentals of the monetary policy of the European Central Bank (ECB). Moreover, the creation of a monetary union will prevent exchange rate volatility from arising within the united Europe, for the reason that the Euro area as a whole will be much less dependent on foreign trade. It is estimated that the share of foreign trade in the trade of the Euro area will be only about 10 percent of GNP, compared with around 30 percent for Germany today. And over the long term, the Euro should become almost as widely used as the US dollar is today.

One conclusion to be drawn from this is the following: Since Turkey has close trade, service, and financial links with Europe and is the only country connected to Europe by a Customs Union (CU), which I hope in time will evolve into full membership, EMU will create entirely new conditions in Turkey’s European and international relations. Therefore, what happens in Europe will be decisive for Turkey as well in the years ahead. This will be a challenge for Turkey’s authorities as well as for her bankers and businessmen.

One of the most important prerequisites to a successful monetary union is a sufficient degree of economic convergence among the potential members. From this standpoint, the degree of convergence among the EU countries is remarkable, particularly with reference to such convergence criteria as stable prices, stable exchange rates, low long-term interest rates, and healthy public finances. In addition to these criteria, the Maastricht Treaty requires that all EU member countries must grant independence to their central banks before the Monetary Union and the establishment of the European Central Bank (ECB). The reason for requiring independence for national central banks is threat fixing exchange rates and unifying currencies will require a common monetary policy.

For a currency union to function “smoothly and in a sustainable way, it is absolutely necessary for all participants to agree on either a single common policy or closely coordinated policies”. All costs and benefits of the union must be shared equally. Any member acting with a “free rider” mentality and seeking to benefit from the system at the expense of the others will eventually cause the system to disintegrate. Therefore a single common currency requires a single monetary policy with a clearly defined target, which is price stability. This basic principle of monetary policy has already been embedded in the Maastricht Treaty, and the European System of Central Banks (ESCB) has been made responsible for achieving it.

In order for the ESCB to carry out this task, it must be able to act in full independence form national governments and European institutions. The ECB Governing Council, which is composed of the Board of Management of the ECB and the governors of the participating central banks, will not be representing their separate national interests. Though there are some differences between the two systems, the ESCB resembles the Federal Reserve System of the United States. For the ECB at act independently, the individual national central banks must already be acting independently of their governments, because the ECB will be built on the foundation of the individual national central banks. This is why the Maastricht Treaty made it obligatory for national governments to grant independence to their central banks in the period leading up to the formation of the ESCB.

The advent of EMU is an event with far-reaching consequences: in one way or another, all countries will be affected by it. Unlike a currency area, a customs union, or a free trade area, a monetary union can affect all countries to some degree, whether they beyond to it or not. This general characteristic of monetary unions, together with Turkey's signing of a Customs Union (CU) Agreement with the EU, make the EMU more important for Turkey than for other countries outside the EMU. I therefore believe that the Turkish Central Bank has a leading role to play in informing and educating all Turkish entities about the implications of the EMU for Turkey and the choices Turkey must make in this respect.

As you all know, Turkey is one the potential candidates for EU membership. I would say that our country's ultimate aim is to become a full member of the EU. This will require that we first adapt to European standards in many areas. The steps Turkey took by joining the CU are also steps toward ensuring full integration into the EMU. Having made these general remarks, I would like to look at the issues from Turkey's perspective.

So far, the measures taken to support the independence of the Central Bank of Turkey (CBT) have been remarkable. The Central Bank law was recently amended and limits have now been set on the so-called "short-term advances" that the Treasury is legally entitled to obtain form the Central Bank. Beginning in 1994, the Treasury's use of short-term advances is to be reduced gradually, over five years, from 15 percent to 3 percent of each year's incremental budget appropriations. By 1998, the Treasury will be entitled to short-term advances totaling not more than 3 percent of that year's incremental budget appropriations over the previous year.

In addition, the Treasury and the CB have signed a seven-point protocol of cooperation in the fight against inflation. The official aim of this accord is also to give the CB more independence. Thus, an important step towards full independence for the CB has been initiated as required in the Maastricht Treaty.

However, we have engaged in preparing a new Central Bank Law in parallel with the corresponding institutions in the EU. The work is already complete and we are ready to submit it to the government when the political environment is appropriate.

In another area, in addition to the already installed electronic payments clearing system, the Central Bank has signed a contract to develop and install a modern national securities settlement system. The new system will enable the Bank to increase the efficiency with which Turkish government securities are traded on the capital markets and to ensure that the payments system will meet the standards of those in the EU and other Western nations. The new system will also be connectable to the TARGET network. At the same time, the system will strengthen Turkey's links with the European member countries and enable it to trade in the same currency as other members, a requirement for participation in the EMU. As far as technical infrastructure is concerned, Turkey is ready to integrate itself into the EC.

Let me remind you that Turkey has been pursuing a series of liberalization policies since 1980, which are broadly in line with world economic trends. A wide range of measures were implemented which were aimed at restructuring the economy. Changes in exchange rate and trade policies were the main instruments in this process. This program has radically altered Turkey's development strategy by increasing its reliance on market forces. The fixed exchange rate policy was replaced by a flexible rate policy. Restrictions on imports were abolished. Protectionism was gradually reduced. In like manner, foreign exchange transactions were thoroughly liberalized, free trade zones were established, foreign investments were encouraged, and public enterprises were privatized. As a result of these new policies, there have been spectacular changes in the Turkish economy. Exports and investments have responded strongly to the structural adjustment process, within which the Turkish lira has become fully convertible and restrictions on capital movements have been effectively removed.

Even though the liberalizing policies were adopted independently of the EU requirements, they have helped facilitate Turkey's attempt to apply for full membership, by providing a solid basis for lasting progress.

On the other hand, members countries of the EU have tried to adapt their banking regulations in order to integrate their financial systems with one another. Competition among them has increased. A universal banking system is accepted. Banks have either increased their assets or merged with other banks in order to be strong in a market where competition has intensified. New financial products are created every day. Technology is used intensively in order to reduce costs and serve customers better. In parallel with these developments, many reforms have been made in order to upgrade the Turkish banking system. Some amendments have been made to the Turkish Banking Law to harmonized it with European standards, and we are now in the process of preparing a new Banking Law. These changes will require some banks to strengthen their financial situation and bring their credit risks and equity participation rations closer to EC norms. As it becomes more deeply integrated with the European financial markets, the Turkish Banking System will face new competition. The CU Agreement has naturally affected Turkish Banks and changed the dimensions of competition. Bu in many ways, Turkish banks seem ready for this new and larger competitive environment. Today, Turkish Banks have been made more dynamic by a high technology infrastructure, high quality services, and well trained staff. What we need is to integrate our legal and institutional systems in parallel with those of the EU Banks.

With the introduction of the Euro, there will arise a number of technical issues which must be immediately dealt with.

As of today, Turkish banks are allowed to maintain foreign exchange positions in 23 foreign currencies, of which 17, including the ECU, are European currencies. With the advent of the Euro, the CB and the Turkish Banks will no longer have to deal in these currencies, but only in Euro.

Of course, initially there will be some currencies, like the British pound and a few others, that will continue to exist for a while. But before the process is complete, all foreign assets and liabilities denominated in the currencies of the countries participating in the monetary union will have to be converted into Euro.

Turkey presently follows an exchange rate policy based on a basket consisting of the US dollar and the Deutsche mark. It is assumed that since the other European currencies are related to the Deutsche mark through the European Exchange Rate Mechanism (ERM), the basket also reflects the weight of other European currencies through the Deutsche mark. With the advent of the monetary union, the share of the Euro area in Turkey’s overall trade in goods and services will exceed 50 percent. But this will not change the picture from the standpoint of exchange rate policy. Therefore the Euro could easily take the place of the Deutsche mark in the present basket.

Within the CB’s foreign reserves, some positions are being held in the currencies of countries that are candidates for monetary union membership. These positions consist of securities and money market placements. It is expected that the security investments will be converted to Euro as of January 1, 1999. Money market placements, on the other hand, will continue to be traded in their original currencies until July 1, 2002. The fixing of the Deutsche mark rate against the Euro, the Euro’s value against other currencies in the international money markets, and the depth and performance of the Euro bond market will be important factors in terms of our reserve management policy. In the Euro market, there will no longer be any cross-currency risk and cross-currency induced interest rate differentials. However, it is possible that country risk induced differentials will become more pronounced. For this reason, investors must pay attention to which country’s securities they are buying when investing in Euro-denominated securities.

There are also issues to be considered by the real sector. Firms that are very active in trading across borders are especially likely to adopt the value of the Euro in their dealings rather quickly. For this reason, in order to make comparison possible, firms competing in European markets should set their prices in Euro.

As I have already mentioned, the CB and the commercial banks have to convert the foreign exchange denominated accounts into Euro. This is no easy task and involves changes in accounting systems and data processing. Therefore due attention must be given to ensuring that these infrastructure changes are made prior to the introduction of the Euro.

The fact that the EC is Turkey’s most important trading partner heightens the implications of the EMU for the Turkish economy. On the other hand, the EC has the largest share of foreign investments in Turkey and the invisible earnings in the Turkish balance of payments have a significant European content. Furthermore, most of our correspondent banks are in the Euro zone. Turkey has close trade, service, and financial links with Europe as the only country joined with Europe in a CU, which it is to be hoped will develop over time into a full membership.

In conclusion, I would like to point out that time is getting short for launching the Euro. The time remaining must therefore be used efficiently. Those who have prepared and made ready will be those who derive the greatest benefits. I do believe that we are moving in the right direction.

Thank you for your attention.