GLOBALIZATION
AND
INTERNATIONAL FINANCIAL ENVIRONMENT

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I am honored to participate in this meaningful organization and I would like to thank you for the opportunity to address this distinguished audience today.

I would like to begin with a quick review of the recent developments in the international financial environment, which I believe will give a clear idea why the issue of globalization is very crucial, interesting as well as challenging.

Beginning with an evaluation of the recent financial crises, I will then concentrate on the growing importance of globalization process and challenges brought by globalization.

I. <u>Developments in the international financial environment</u>

The 1980s and 1990s witnessed significant changes in the international financial markets.

With the advent of globalization and rapid integration of financial markets, the world we live in is getting smaller in every aspect of life. Nowadays, when international banking systems are experiencing significant changes, banking is being discussed at a global level. Therefore, from the global standpoint, what seems to be important for banking systems is not the size, but the level of compliance with the internationally accepted rules and standards, and their functionality.

In today’s financial environment, dominated by a dynamic, aggressive financial service industry, banks as major players operate with greater freedom. Market participants, however, are exposed to greater financial risks than before due to the appearance of more complex and dynamic transactions that have substantially increased uncertainties in the market place.

Furthermore, there exists more universal banking today than in the past. Advances in IT technology, capital movements and geographical extension of banking business have become the new engines of global integration.

The increased awareness of risk concept, together with the higher living standards and rapid technological development, has led to substantial change in the hedging strategies.

It certainly appears to be the case that the emergence of new markets, such as highly liquid foreign exchange and derivative markets, has provided essential financial transactions and contributed to the rapid expansion of global finance. However, the speculative uses of the new financial instruments in these markets have increased the diversity of risks. Consequently, the availability of a wider range of financial instruments and deeper financial markets has enabled banks, non-bank financial institutions, institutional investors and companies to better manage their risks by using complex hedging strategies.

II. Globalization

In this part of my speech, I will concentrate on the opportunities and challenges brought by globalization.

(A) Opportunities and challenges

We define globalization as more integrated financial markets, economies and trade, higher factor mobility, and spectacular change in information technology leading to the spread of knowledge throughout the world. I, personally, consider globalization to be both a beneficial and a challenging, inevitable, irreversible process for the world economy and the international financial system.

Globalization and liberalization of financial markets bring a variety of changes, presenting opportunities as well as risks both in economies and financial systems throughout the world. One fact is quite clear: the undeniable benefits of globalization are only available to the countries that best manage their economies.

(1) **One obvious benefit of globalization is that active international capital flows** improve the efficiency of the allocation of world financial resources. As the world market economy has become more globalized, we have witnessed rapid growth in **world trade,** leading to a higher standard of living during the 1980s and 1990s. In plain language, competition, productivity gains, lower trade barriers and lower cost of external financing on a worldwide basis are the key factors that have led to growth in world trade and rising standards of living.

(2) Globalization also has increased and enhanced competition worldwide. There are several factors behind this consequence.

(a) Firstly, the integration of world markets and rapid technological change led to efficiency gains and growth driven by the lower transaction and information costs. These in turn increased competition through lower costs and higher market efficiency, higher productivity, lower barriers to entry, and new investment opportunities. Geographic distance is no longer a factor that limits the provision of goods and services.

Hence, **competition both in the industrialized and developing countries has reached almost the same level.** At this point, it is worth noting that many developing countries, particularly emerging market economies, have actively participated in the world trade and global economy over the last two decades. The presence of emerging market countries, particularly the Asian economies, is growing, and their share in world trade has increased significantly.

(b) Secondly, the importance of non-bank financial institutions in the financial intermediation process has increased. The main examples of these institutions are securities firms, insurance companies and mutual funds.

Therefore, we can say that the higher the level of international competition, the higher the economic growth, the higher the income level, the higher the quality of products and thus the higher the living standards the globalization process would bring.

(3) Globalization reorganized some concepts such as stabilization, risk-taking, supervision and regulation of banking systems, market discipline, public guaranty on deposit, and moral hazard.

As I mentioned earlier, parallel to the development of new financial instruments and markets and the resultant more complex and dynamic transactions, **risk measurement** and **risk management techniques** have changed dramatically. Financial institutions have increasingly been using internal rating and other risk measurement systems and models such as VAR, stress and back testing, and scenario analysis.

As a result of these developments, every trading institution, including central banks, has become more exposed to changes all over the world economies and financial markets. Indeed, the recent Asian financial crisis revealed that the financial and economic stability of emerging market economies is extremely vital for global financial and economic stability.

(4) Banking business and banking transactions have become very complex. Development of off-balance sheet transactions and derivative markets had an enormous impact on the banks' balance sheet structure, level and variety of risks to which they are exposed. Based on these developments, the importance of derivative instruments in banks' risk profile has increased.

(B) Risks arising from globalization

If we evaluate the risks arising from globalization, we realize that there are losers as well as winners in the process of globalization.

It is a well-known fact that the process of globalization does not evolve equally worldwide. Some countries obtain great benefit from the process, mainly driven by their rapid integration into the global economy relative to other countries. In other words, the integrated global economy does not guarantee that the benefits of globalization are shared by the all countries involved in the process.

More importantly, opportunities provided by the globalization process are not always beneficial, as shown by the recent crises. Hence, the process of globalization always carries social, economic, financial, cultural, and even political risks in addition to the risk of contagion.

There are several reasons for this situation. Some of them are beyond the control of the countries involved such as external shocks and other unexpected changes in external environment. Indeed, most of these reasons are due to

- weak macroeconomic and financial policies implied,
- inconsistencies in domestic policies,
- increased vulnerability of national economies to external shocks,
- higher international capital mobility (i.e. higher sensitivity of international capital flows among economies),
- higher volatility of exchange rates due to integrated financial markets, which hits real sectors of economies.

As countries' economies become more vulnerable to external changes, they are exposed to shocks and crises with severe consequences both in financial and real sectors, as well as facing heavy social costs.

In this context, I would like to emphasize the importance of the **risk of contagion** in highly integrated global financial environment. As we have all experienced, instability emerging in one country can spread almost instantly to other countries. There is no doubt that every country faces its own challenges that are directly affected by their particular economic and social conditions.

Positions taken in one country are now being hedged in another and this so-called proxy hedging of country risks spreads shocks and crises across national borders. As a result of this, even a country with no direct exposure to the country in crisis could find itself in deep trouble. In fact, the most recent crises in East Asia and Russia have reminded us how rapidly and compellingly a financial crisis can erupt.

At this point, I would like to briefly discuss the progress of Turkey, particularly the Turkish banking sector ***in the globalization process***.

During the last two decades, the banking sector, which plays a prominent role in the Turkish financial system, has made significant progress in implementing structural changes towards a more financially liberalized Turkish economy. Combined with the effects of restructuring Turkish economy and the efforts for the integration to the modern world of finance, the Turkish banks achieved important changes in their institutional structures on the one hand, and in the quality of services and products on the other.

In this very outward-oriented and closely supervised banking environment, the need for highly qualified managers and specialized personnel is obvious. With this in mind, Turkish Banks became more effective in their utilization of human resources. The number of university graduates and postgraduates in the banking sector has steadily increased over the last two decades, as has the level of professional training.

The increase in the number of banks and qualified personnel, in turn, enhanced competition and contributed to broad utilization of new financial instruments and techniques. Furthermore, the banks were motivated to attain a dynamic structure through automation. During the last decade, Turkish banks became more automated and efficient, along with their foreign counterparts. For example, the number of ATMs in Turkey has increased from zero to over eight thousands in the last decade. Intense competition and a desire to integrate with global financial markets has driven banks to improve the quality and the variety of services through information technology and international payment systems.

As a result of this, Turkish banks have started to provide interactive banking services to decrease their costs and increase efficiency of banking transactions. They are also part of the Electronic Fund Transfer system for their internal banking transactions and of SWIFT for external transactions.

Parallel to the process of liberalizing the economy, Turkish banks have made significant progress in **investments and in organizations abroad**. They opened branches abroad and took important steps to increase their shares in international markets by acquiring financial participations and partnerships.

As of June 2000, Turkish banking sector, including branches abroad, operates with the total asset size of 140.4 billion dollar, more than 8.000 branches and almost 170.000 personnel.

The Turkish banking sector is also open to international competition. At present 25 foreign banks, including development and investment banks, constitute 31% of the total number of banks in the sector. The share of foreign banks has also increased during the past few years. While their share was 5.8% and 5.6% as the end of

1997 and 1998 respectively, it increased to 6.7% as of June 2000, representing the total asset size of 9.4 billion dollar. The majority of this share belongs to foreign commercial banks.

As of July 2000, Turkish banks have

- 83 financial subsidiaries in 24 different countries,
- 41 branches in 10 different countries and
- 62 foreign representative offices in 10 countries.

At present, the Turkish banking sector has up-to-date technology and is equipped with highly qualified personnel to compete in the international arena. The result is a more transparent and well-functioning banking sector whose players have been progressively modernizing their operations in line with the developments in the global banking community.

There is a significant growth potential in the Turkish banking sector. Banks will have to compete in an increasingly challenging environment. In the coming years, strategically and technically well-positioned banks will be able to utilize the growth potential of the sector. However, **increasing competition** and **squeezed profit margins** are expected to force banks to be more cost conscious. In order to increase profitability and efficiency, mergers and strategic alliances with foreign banks will be on the agenda of the sector.

The integration process with the EU will bring new challenges for Turkish banks to increase their efficiency and quality of their services by improving their distribution channels. Additionally, increasing compliance with the internationally accepted standards and other structural changes made in line with the integration process with the European Union will attract foreign banks, which in turn will intensify the competition in the sector.

Another significant step taken by Turkish authorities was the introduction of the recent **disinflation program** and **the other restructuring efforts**.

Turkey has suffered from chronically high inflation for years and our economy is the last high-inflation economy among the OECD countries. High level of public deficits and fiscal imbalances, together with self-fulfilling inflationary expectations are the main causes of the inflation process. Financing of these deficits has accelerated money growth and stimulated high real interest rates.

The most recent developments are a reflection of the fact that Turkey has dedicated itself to solve the above-mentioned problems. Turkey is fully aware of the fact that this chronic high inflation prevents the whole economy from settling on a sustainable high-growth path and from integrating with the global economy.

The ambitious disinflation program rests on three pillars:

(i) up-front fiscal adjustment

(ii) a firm exchange rate commitment supported by consistent income policies and

(iii) structural reforms

This program has been supported by the structural reforms in four fundamental areas; namely ***banking sector, social security and agriculture and public finance.***

With the awareness of the fact that the soundness of the banking system is of vital importance in an environment where banks are major players in the financial system and are involved in international banking activities, Turkey is continuing to take measures to improve both the quality and the effectiveness of banking surveillance system on basis of the EU directives and BIS principles.

The most radical change towards strengthening the supervision and financial structures of banks was the establishment of **Banking Regulation and Supervision Agency (BRSA).**

Additionally, **Central Bank of Turkey** has pursued the most independent monetary policy possible. More recently, **the first priority of the Central Bank** has shifted from maintaining financial stability towards achieving price stability. Regarding the monetary policy implementation, the main pillars of the Central Bank's approach are the its **transparency**, its **accountability** and its **predictability**. We, as a Central Bank, always favor a forward-looking approach.

Given the increasing importance of its economic presence and close relations with the countries worldwide, it is crucial that Turkey to improve its domestic markets to contribute to the efficient allocation of world resources. With this in mind, we will continue to implement structural reforms and our disinflation program to realize robust economic fundamentals.

Final thoughts

In closing, I would like to comment on what seems to be important in building a more robust and healthy global financial system and the world economy.

The on-going process of globalization, along with the revolution in information technology, is likely to continue in the future. One consequence of this trend is the intensifying competition at the global level. In this context, to benefit from this trend countries all over the world should react positively.

The soundness of individual financial systems clearly affects the resilience of the international financial system as a whole. We should devote our efforts towards creating a healthier global environment by minimizing the volatility of international capital flows and the risk of contagion.

More effective supervision and surveillance of banking systems is of the greatest importance in today's' international banking environment and the emphasis of the recent supervisory changes has been moving from the **"rules-based"** method of supervision towards a **"risk-focused"** supervision.

Additionally, the globalization of financial markets led to difficulties in auditing cross-border transactions mainly due to lack of cooperation between supervisory authorities. However, in recent years, care has been given to overcome inter-country problems and increase cooperation.

Success of countries in integrating into the global financial system and in fulfilling the requirements of globalization will depend on deeper international cooperation between national and international agencies. At present, there exist several countries and nations that are not yet benefiting from the globalization. Many obstacles stand in their way towards integration into the global economy.

In an increasingly globalized world economy, **financial sector stability** is most likely to be achieved when prudent international standards are met and when markets operate competitively, professionally and transparently, according to sound principles and practices.

Strengthening the supervisory and regulatory framework towards achieving a sound and efficient global banking system should be a universal goal. In this sense, the works that have been accomplished by the Basel Committee, FSI, Financial Forum etc. so far should be regarded as innovative and constructive in the process of harmonization of rules and standards internationally.

In my opinion, effective supervision combined with a multi-dimensional study of past experiences and all the micro and macro level indicators, will help us to find ways to handle what globalization brings us. I certainly believe that studies on platforms like the one we have here will help us to develop new ideas and ways for responding promptly and correctly to the challenges of globalization.

We have to look for solutions in the regulations that we impose on the financial sector and try hard to make them strict enough to prevent circumvention and excessive risk taking. We must also make sure that our system is liberal enough to promote innovation and growth.

I am sure that we will be able to confront the challenges brought by globalization in the new century if we clearly acknowledge the two issues;

- first; what globalization means for economies and particularly for financial systems and

- secondly; how we, as public and regulatory and supervisory authorities should react to the challenge of globalization.

I am of the opinion that only in this way can we extend the benefits of globalization to wider parties involved in the process. We must seize the opportunities to build a healthy global financial environment. The challenges are great, but the ways to confront them are quite clear. I would like to thank for the invitation and your audience.