CRISIS MANAGEMENT AND PREVENTION

GAZI ERÇEL
GOVERNOR
THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

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First of all, I want to thank Mr. Müezzinoğlu very much for the initiative taken by the Turkish Economic and Financial Foundation, of which I am also a founding member, and for its timing.

When I first came to work at the Treasury at the beginning of 1978, Mr. Müezzinoğlu was Minister of Finance. I learned many valuable things from him about the concepts of state and statesmanship.

Our friendship has lasted for 20 years, and I am very grateful for the Foundation, which keeps us working together. I also wish to thank Mr. Birsen for hosting this meeting.

When I began to think about being in a state of crisis or on the brink of a crisis, I reviewed my own past experiences, and there I discovered some interesting coincidences. It seemed that wherever I have been assigned, or whenever I assumed new responsibilities, there either already existed a crisis environment or one arose shortly thereafter.

When I arrived at the Treasury in 1978, I encountered the Turkish "crisis of 1978-79." When I went to the IMF in Fall 1982, I found the Mexican crisis had just started that August. As soon as I moved to the private sector in 1990, I had to contend with the Gulf crisis of that year. Shortly after I became General Manager of a private bank, we experienced the crisis of 1994. I was appointed Governor of the Central Bank in a relatively calm atmosphere and strong political environment. And although I originally accepted this appointment in the hope of bringing down inflation, for the last three years my job has been complicated by a series of international and political crises.

So I asked myself, Do crises appear just because I happen to be there? Or am I unconsciously attracted to crisis-prone environments? I have not yet been able to decide which hypothesis is more likely correct, but it would certainly be strange if this were the work of pure coincidence.

In any case, let me begin by attempting a brief definition of crisis.

I say "attempting" because defining crisis is problematical. Is there a difference between "crisis" and "mini-crisis," a "bigger one" or a "smaller one?"

In addition, when a crisis has been prevented, it does not exist. For this reason, I believe that our efforts should be directed first of all at crisis prevention. The globalized world economy virtually guarantees that in the future crises or mini-crises will emerge not only in the emerging market countries but also all over the world. We will have to accept this reality and get used to it. Our response should be to develop systematic measures for stopping threatened crises before they start. In other words, we should direct our efforts at crisis prevention.

I expect that many of my listeners have already read a book called titled "Maniacs, Panics and Crisis," written by Charles Kenderberger. It is an interesting book. It recounts the history of crises. We learn that the first known financial crisis occurred in the 18th century and involved a company called the "South Sea Company." This New York-based financial company undertook to sell lands on the Brazilian coast to North American investors against securities it had issued. All went well for the first two years, but then awkward questions arose: "All right, well, but where are the title deeds to these properties on the Brazilian coasts and to whom do they actually belong?" Once investors realized that there was no plausible answer to these questions, they all wanted out at once, and the crisis was off and running. This first known financial crisis was followed by many more of various kinds, down to the present day. A survey of crises from the 1700s to the present day shows them to be occurring most frequently in two main areas, namely the banking sector and foreign exchange, meaning the balance of payments. These crises are mutually reinforcing when they emerge in both areas at once, and a crisis initially confined to either area can easily spread to the other.

It therefore often happens that a crisis which damages both the banking sector and the country's foreign reserve position will cause a decline in GNP. For this reason, the costs of a crisis are often measured in terms of a drop in GNP.

Recent events that started in Asia and by a circuitous route eventually reached Russia show that a crisis affecting both the banking sector and foreign exchange is particularly contagious, whether regionally or globally, which adds a new element to our definition of crisis.

The more recent crises are different from the crises of the past. Those crises were not contagious. For example, at the beginning of 1990s there was a banking crisis in the Scandinavian countries, but it did not spread. Even though this crisis emerged in a region not far from us, we did not feel its effects in any way. The result of the crisis was that many banks in the Scandinavian countries were nationalized, solving the problem.

Obviously crisis prevention means not only that we should prevent the emergence of simultaneous crises in both the banking sector and the foreign exchange reserve position, but also that we should minimize the likelihood that it will be contagious.

Defined in this way, I think that crisis prevention must be our first duty and the main focus of our efforts.

Some of the esteemed participants who have spoken earlier today have already described recent financial developments in Turkey. Output has declined due to the effects of events in the international global arena interacting with inappropriate financial and economic policies in individual countries. Examples are the output declines witnessed in Asia and Russia.

The question thus seems to be, what can we do in such a situation? In my view, our first care should be to prevent this potential crisis from emerging. We should take precautions against the contagion effects of the various international crises available at any given time.

And as I have just finished stating, ensuring the soundness of the banking sector and the balance-of-payments position is the only sure way of avoiding crises.

This is why the draft of a new Banking Act was recently presented to Parliament for approval. It was supposed to have been ratified last week, but wasn't. Our hopes for it are still alive.

If it is approved, the resulting legal measures for the banking sector will provide new policies regarding banking supervision and the establishment of new entities to avoid further complications.

Let me elaborate a bit.

The first requirement for crisis prevention is effective banking supervision. This includes still further refining the culture of risk taking in the banking system, in particular by defining the rules for accepting and managing macroeconomic risk, credit risk, interest rate risk, foreign exchange risk, and liquidity risk, and controlling them as well. We must also take more effective steps in regulating the management of banks. We must adopt the 25 core principles enunciated by the Bank for International Settlements in 1997, and combine them with the banking directives of the European Union. The draft bill sent to Parliament contains all these provisions.

The second element of crisis prevention is to maintain a sound balance-of-payments position that will not give rise to troubles with foreign exchange.

How can this be done? Sound macroeconomic policies, sound foreign exchange policies, and especially great attention to the management of short-term capital movements are the basis of crisis prevention in this area. International developments of the last two years clearly show the importance of capital movements in the genesis of crises.

It will be noted that all the above actions for avoiding crises in the areas of banking and foreign exchange are short-term in nature. But because short-term measures have certain limits, medium-term measures are required as well. These measures have been recommended so many times, in so many contexts, that we all can recite them by hearth. Timely and effective implementation of structural reforms; taking a long-term view of the financial sector, and designing strategies accordingly; and to establish strategies that will ensure that domestic and foreign borrowing is appropriate and prudent. This sounds, and is, fairly simple. The reason for this simplicity is that Turkey's real problems lie not in stock figures but in flow figures.

A look at the Asian countries reveals enormous problems arising from their high debt exposures. For example, they have huge stocks of domestic and foreign debt. Their private firms have exchange rate problems due to their accumulated short positions. In addition, their social problems remain unsolved. The Asian countries must address these problems, and inflows alone cannot resolve their stock problems.

In Turkey, such stock problems do not exist. Turkey's problems have to do with inflows. Specifically, our stock of domestic debts totals nearly US$ 30 billion and we can manage it with inflows of US$ 15 billion. The relative and absolute magnitudes of our stock figures are still relatively low.

This is a good place for me to add two more elements needed for crisis prevention. These are political stability and high credibility. It is absolutely necessary that the crisis avoidance program and he measures that compose it should enjoy high credibility and must be such as to inspire confidence on the part of individuals, firms, and markets.

As Mr. Kavi said earlier, all these measures must be based on a solid social consensus. The experiences of Latin American countries show clearly that this is an essential condition. Our measures cannot have the credibility and confidence that is required to ensure the necessary cooperation unless the social partners are convinced of their rightness. The chances of success are much higher for programs supported by social consensus and solidarity.

You may remember that in October and November last year, speaking as technocrats we repeated many times that a disinflation program was to begin and that the inflation rate would be brought to a level in the range of 50-60 percent. The initial reactions to these statements showed that nobody believed the inflation rate could be lowered that far. All participants in the economy began to plan their behavior based on the assumption that inflation would finish at a level of 70 or 80 percent. When the economic program was launched, positive results were visible in the first quarter, continued in April, and became really noticeable in May, as inflation started to tumble toward 60 percent.

But the behavioral models that would affect the economy for the coming year had been shaped as usual during October, November and December of the preceding year. The usual course of this process is that the pricing policy of the private sector begins to take shape in November. The next year's wages, prices, and expectations about them are always locked in by the end of the year. The markets were prepared for inflation of 80 percent.

What happened next? When we arrived at the middle of the year, we began to see a substantial accumulation of Inventories. At the Central Bank we are able to observe such developments in the real economy quickly by making use of the monthly business trends survey.

At this point, there were two ways of decreasing the inventories: either by reducing the prices of the stockpiled goods, or by exporting them to meet foreign demand. By mid-year, the markets' expectations were such that the method chosen was to export the overstocks, though I expected that some of them could be moved by reducing prices.

All these expectations were upset by the fallout from the Russian crisis. The flow of goods from abroad dried up and financial transactions abruptly ceased. At the same time, the process, which for three or four years had been transforming public sector "crowding out" into "crowding in," suddenly reversed itself as a result of the Russian crisis. The public sector once more began to absorb all available financial resources, leaving nothing for the private sector. When all these elements suddenly materialized at the same time, output fell swiftly. But let me remind you that despite the rapid output decline of the last three months, the surplus that had been accumulated earlier kept 1998's GNP from becoming negative, which you may be sure was for us a crucial indicator.

I can summarize what I have said so far by pointing out that we have been busy with problems and mini-crises, but not with crises. For the present, the crisis in the world has been frozen. Of course we cannot know exactly what will happen in the future. As I have pointed out, in today's global environment where the problems increasingly tend to be cumulative, all we can do is to introduce and pursue macroeconomic measures and reinforce credibility with the help of international institutions. This is our best defense against the contagion effects that lead to worldwide crises.

In such a world environment, it is obvious that the Central Bank's policies have taken on a new importance. Let me explain.

The first concern of the central bank is to preserve financial stability by acting wherever problems and negative expectations are building up. Our efforts to ensure financial stability include immediate actions aimed at reinforcing stability in three areas: financial institutions, financial markets, and especially the payments system. The Turkish central bank has three main policies and principles geared to this aim. First, we implement these actions with the guidance of the Staff Monitored Agreement with the IMF, which runs until the end of 1999. Our policies and the data on which they are based are published on the web-sites of the Central Bank and the Treasury. And developments are followed on a daily basis by all of us.

Of course, it will be noted that this ensures compliance with the monetary targets of the Central Bank and keeps our figures within the target corridors, as they presently are.

Second, we use the interest rate as a sweeper, which is to day an instrument for correcting any imbalances in the market. We do this simply because theory says that only foreign exchange or interest rates can be used as the sweeper, and we could not use foreign exchange for this purpose.

Since foreign exchange rate is an element of our policy, we let the markets determine the interest rates. But the market is presently setting interest rates very high. As the Central Bank we do not want to interfere with market mechanisms but we all know that these high real interest rates cannot be sustained any longer.

This is why despite our reservations about its suitability as a sweeper, we have no choice but to use the interest rate for this purpose.

And third, we calculate the liquidity of the market on a daily basis and supplement it. But it is also known to all of us that failing inflation does not imply a matching fall in demand for money. Money demand clings to its level for a certain time even if the inflation rate falls to the range of 50 to 60 percent. When the economy is demanding a certain amount of money, it takes a certain length of time to reduce that demand. We are taking account of this reality in deciding how to provide liquidity.

To summarize, if inflation comes down slowly, we should not expect money demand to keep pace. In fact, when inflation falls, the behavior of individuals concerning money demand will not change with it. In other words, if inflation drops to 50 percent, it cannot be expected that money demand or monetary aggregates will likewise grow by 50 to 60 percent annually. The growth rate will be nearer to 70 or 80 percent, and will continue for some time. Accordingly, the increments of our monetary aggregates have stood at 70, 80 and 90 percent.

Having said all this, let me leave you with the following conclusion.

We are providing liquidity on a daily basis. Yesterday we injected about TL 1.4 quadrillion into the market. Yesterday's demand for liquidity was higher than normal because it was a payday, and we regulated liquidity taking account of the resulting short supply. In these problematical, hectic, and unpredictable times, we supply liquidity according to short-term developments, in order to build confidence and make stability more durable.

My last point is related to exchange rate policy. As we have stated many times, exchange rate policy takes account of the expected inflation rate and the levels predictable by the markets. The exchange rate, together with the balance of payments, is one of the most powerful tools that we have.

Let me end my remarks by making a last point. In these hectic times of high uncertainty, the Central Bank is trying to monitor developments and seek solutions calmly. We will therefore take whatever measures are required. We cannot at all afford the luxuries of panic and despair.

Thank you very much for listening.