

Remarks by
GAZİ ERÇEL
GOVERNOR
THE CENTRAL BANK OF THE REPUBLIC OF TURKEY
at the
TURKISH AMERICAN BUSINESS COUNCIL MEETING
NEW YORK
NOVEMBER 7, 1996

THE TURKISH ECONOMY, PAST AND FUTURE

It is indeed a great privilege for me to address such a distinguished audience. I would like to thank to the Turkish-American Business Council of Foreign Economic Relations Board and American-Turkish Council for this opportunity to survey the Turkish Economy. The ups and downs of our economy over the last two decades are aptly illuminated by Danish Philosopher Søren Aaby Kierkegaard, who said Life can be understood by looking backward, but it must be lived by looking forward."

Looking at the developments of the last twenty years, one can say that Turkish economy indicates a remarkable improvement after the implementation of program of the structural adjustment and liberalization at the beginning of 1980. The main objective of this program was to increase the role of market mechanism in the allocation of resource by opening up the economy and reducing the state's role in the economic activities.

Now I would like to enumerate **positive and negative aspects of our economy today**. I will begin with the **positive features**:

- In Turkey the long run average growth rate of the economy is above 4 percent.
- The composition of gross domestic product has changed considerably over past two decades. The share of agricultural product has declined while the share of industrial products and service sector in gross domestic products have increased. Moreover, the sum of the shares of service sector and foreign trade in gross national product exceeds 50 percent.
- Structural adjustment programs have led to more efficient use of resources and increased productivity. Productivity has grown at the rate of about two percent a year for the last decade.
- Gross domestic savings as a percentage of GNP have approximately doubled from around 10 percent in 1980s to around 20 percent in 1990s.

- The increased vigour of the private sector has been obvious not only in more developed regions but also in Anatolia. It is the private sector that is mainly responsible for fixed capital formation.
- Unemployment in Turkey has been roughly constant at around 7 to 8 percent since 1970. This rate is consistent with our population growth and general economic conditions. In some OECD countries unemployment rate goes as high 12 percent.
- During the 1980s, foreign trade was the main driving force for the Turkish economy. Turkey's success in foreign trade owes much to incentives and tax reductions for exports. For 1996 export earning are expected to total US \$ 25 billion, while imports will amount to US \$ 45 billion. This clearly shows a high degree of openness of the economy. The share of the external economy in GNP is around 40 percent.
- The composition of our export has also changed in the last 20 years. The total export share of agricultural products has fallen from 57 to 11 percent while that of manufactured goods has risen to 87 percent. And although trade liberalization brought an explosion of imports, Turkey has not suffered chronic current account deficits, which have remained within acceptable level.
- Neither the public sector nor the private sector has ever for a moment considered the possibility of not repaying external obligations. External debt service payments have been made on time, even when there were no significant capital inflow. In 1995, repayments of principal and interest on external debt amounted 25 percent of current account revenues. External debt service payments pose no problem for the balance of payments in external debt service payments because our official reserves equal 17 billion US dollars and international reserve of the system 28 billion dollars.
- In each of the last three years the primary budget showed a surplus of around 2 to 4 percent of GNP. And in every one of the last fifteen years except 1994, public sector revenues have increased at a rate above the inflation rate.
- Since the beginning of 1990s, the structure of public sector borrowing requirement has also changed. The budget deficit and interest payments have displaced the financing needs of the state economic enterprises, which were the dominant element of the PSBR in 1980s.
- The GNP ratio of domestic debt has not been so high. The ratio of domestic debt to GNP is around 20 percent in 1995.
- Some market based financial institutions have been established and others have been put on a market basis. These institutions, which include central bank, financial intermediaries, stock and gold markets, operate in response to free market mechanism. The development of effective financial market instruments has been gradual but steady.
- The Turkish equity market is currently one of the best performing of the emerging markets in the world. Foreign portfolio inflows have made share prices soar. The Turkish equity market's role in financial intermediation is growing rapidly and the GNP share of equity market capitalization is approaching the GNP share of M2Y.
- Turkish financial system is dominated by the banking sector. However the variety of the financial instruments available has increased reflecting Turkey's increasing integration into the international markets. The capital adequacy and non performing loan positions of Turkey's banks are better, thanks to the yields of Turkish Treasury Bills. Our banking system has successfully weathered the financial crises in 1994.

Now that I have summarized the positive aspects of our economy, let me briefly lay out for you the other side of the coin namely the **economic difficulties we need to overcome.**

- Persistent high inflation has been Turkey's main economic problem for the last two decades. The sizeable public deficits and deeply entrenched inflationary expectations feed our inflation.
- For years public sector revenues have fallen short of expenditures, creating public deficits. Before 1994, we even had primary deficits. Since 1995 it has been possible to finance non-interest expenditures of the public sector with public revenues, but debt service payments have to be financed with new borrowing. In other words, the public sector adds its deficit in order to finance its previous deficit, completing the vicious circle known as the "debt trap".
- Turkey's current accounts tend to be volatile. We sometimes have big deficits and sometimes surplus. A stable economy can live with mild deficits or small surplus in the current accounts.
- We are concerned about the deterioration in our social security system. In addition, the financial mismanagement of state-owned social security system is one of the main sources of budget deficits.
- Short termism is a dominant feature of most contracts in the economy. This, as a matter of fact, is a product of high inflation.
- Even though legislation promoting privatization has been passed by the parliament, about half of Turkey's financial sector and about half of such activities of its manufacturing sector as tobacco, shipbuilding, railroad, petrochemical and oil industry are still state owned. Inefficiency in publicly owned enterprises also is a source of economic concern. Inefficiency in public sector contributes to public deficits.
- The quantity of educational services has grown but the quality of education needs to be improved. Because insufficient resources are allocated to education the quality of educational services diminishes with population growth and domestic migration.
- Distribution and quality of health services need to be improved.
- Both the quantity and quality of infrastructure should be improved. The extent of the private sector's involvement in infrastructure investments should be enlarged.
- Domestic interest rates are still high and positive in real terms.
- Inefficient tax collection is another contributor to budget deficits.
- Turkish Financial System does not yet have sufficient breadth and depth to deal with the PSBR.
- Central Bank independence has not yet been unequivocally established.

As I mention each of the major problems facing our economy, I will identify **what measures are needed for its solution**.

Prudent macroeconomic policies should be conducted. Especially with the approach of integration with the European Union macroeconomic policies must be carefully designed not to conflict with the aims of Customs Union. Macroeconomic policy should aim at achieving a sustainable growth with low inflation. Permanent reduction of the public sector deficits and greater efficiency of the public sector --combined with decisive progress with privatization-- will be vital elements of the fight against inflation.

Privatization is one of the first lines of defense against public deficits. Privatization is the key to increased efficiency. Legislation advancing privatization was passed by the parliament last year, and privatization was supposed to be speeded up. This yet to occur, but should now be accomplished very quickly and efficiently.

Experience has shown that stabilization policies have mainly two elements. The first the budgetary discipline in the public sector. The second is monetary discipline by which is meant strict control over the expansion of the net domestic assets of the central bank. A central bank must therefore be granted sufficient autonomy to maintain stability in the financial markets by controlling the volume of currency it issues.

Stabilization efforts have to be supported by structural reforms. Changes in economic relationships can render the institutional infrastructure incapable of expressing them. In that case structural reforms are needed. The institutions must be restored to competence by means of structural reforms. Such reforms are not to be realized overnight: it takes time to accomplish them. Let me now summarize the key elements of a structural reform.

The most important element of these structural reforms consists of measures for reducing public deficits. Reducing public sector's involvement in economic activity, and increasing the efficiency of what public sector activity remains, will help reduce public sector deficits.

Further reductions in public deficits can be achieved by enlarging the tax base and improving tax collection- in other words by a tax reform.

Improving the social security system is another important structural reform which has not yet been accomplished in Turkey.

The financial sector needs to be strengthened by improving the audit system, privatizing state owned banks, and increasing the kinds of financial instruments.

Public sector investments should concentrate on large infrastructure projects and additional financial resources should be allocated to improve education and health services. The private sector should also be encouraged to invest more in these sectors.

All these structural reforms should be supported by exchange and monetary policies that are consistent with sound public finances. If we can manage to avoid monetary financing of public deficits, our monetary control will be both more durable and more credible. There can be no doubt that monetary control is essential to maintain stability in the financial markets.

Now, let me describe to you the **Central Bank's role** in dealing with these problems.

The main duty of central banks should be to prevent inflation. The achievement of price stability is at the heart of an independent central bank's agenda. Independence, as I understand it, means freedom to implement the government's economic program - jointly prepared by the central bank and such other institutions as the State Planning Organization, the Treasury etc. - and to choose the course of the government's financial and economic policies.

The Central Bank of Turkey has taken important steps in these areas. The series monetary programs which has been implemented and has gained continuity in recent years are examples of this. For the Central Bank to extend these programs' reach until they can become the underpinning of medium term economic policies would be a very good idea.

- Central Banks must be trustworthy and respected institutions. They must be transparent.

- Despite the important authority they have to print money they must be responsible and fully aware of the need to exercise this authority wisely.
- Central banks should be at the center of economic stability.
- During the restructuring and operations of the banking sector the central bank's supervisory task must be carried out in the most modern and efficient manner.
- Central Banks should foster constructive and supportive cooperation while being sensitive to the need of intervention. The central bank's relation with the public must also be harmonious.

The future projects and activities of the Central Bank vis-à-vis the Turkish Banking system will conform the principles outlined above. A monetary program will be an essential part of the daily practices of the Central bank. Net domestic assets and other monetary aggregates will be kept under control. The Central Bank will be developing certain practices aimed at the healthy functioning of the banking sector, using such supervisory tools as the foreign exchange risk ratio, provisioning, and capital adequacy ratio. The Bank also intends to carry out its supervisory function in an effective manner with the aid of an early warning system and electronic data processing methods. The ultimate aim is to raise the Turkish Banking System up to the level of world standards.

Before I finish, I would like to emphasize that recent years have seen a **movement towards more interdependent and integrated world**. In the global, and borderless, economy of the twenty-first century, there will be more challenges and more opportunities for every one.

Globalization offers us direct access to the international financial markets. It also provides an incentive to build a more competitive and efficient domestic financial system.

In fact I do not believe that any country, no matter which, can afford not to take advantage of the global markets. But I must also state that developing economies like ours, taking advantage of the opportunities that globalization offers us, must make a much stronger commitment to macroeconomic discipline than have been required in the past.

As they become integrated into the global economy, our domestic economies will be affected much more strongly by events that prior to globalization, had almost no effect on us. Therefore a commitment to monetary stability, to macroeconomic discipline, to an efficient financial system, and to more competitive market mechanisms are essential for any country wishing to adapt to financial integration.

It is also important to note that as borders disappears and economies become globalized monetary policies no longer have their simple, national nature: they acquire international identity. We do not dare allow ourselves to be left out of these trends. The elements mentioned above are the inevitable prerequisites for a contemporary national central bank with- an international identity.

In sum, the challenges facing Turkey in the immediate future are neither too easy nor too difficult. What is needed to meet them is one simple quality: persistence in the pursuit realism. Here let me quote Sydney J. Harris, an American columnist: " An idealist believes the short run does not count. A cynic believes the long run does not matter. A realist believes that what is done or left undone in the short run determines the long run."
