Effects Of The Euro On Emerging Market Economies: The Turkish Case

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The European Union will enter stage three of economic and monetary union in 1999, an event that will signal an enormous change in the international monetary system as the national currencies of several countries are replaced by a single, newly created common currency unit called the Euro. There will be a new exchange rate system based on that common currency, and a new European Central Bank responsible for deciding and executing monetary policy within the Union. This monetary unification will also affect the currency composition of portfolios and the monetary policies of other nations. And obviously the emergence of the Euro as an international currency, its importance, its internalization, and its qualities as a reserve currency will all have a profound influence on financial markets everywhere.

The introduction of the Euro will make its effects felt not only in countries belonging to the European Union but also in countries outside the Union which have close trade or financial ties with Union members. Among the latter, the emerging market countries having close and extensive economic and financial relationships with the European Union will probably be affected most of all.

There are still differences of opinion about the probable growth effects of the monetary union. Some observers fear that because, after monetary unification, the fiscal transfers among regions that are possible in single large economies will no longer exist, the unification may have a recessionary bias for the developed countries of the European Union.

And of course a strong Euro could reduce competitiveness. On the other hand, these possible disadvantages are likely to be offset, however, by increased investment sparked by confidence effects like those that accompanied the creation of the single market in 1992. And to the extent that the Euro is good for European growth, it will also benefit the other economies including emerging market economies that depend heavily on EU market.

Today I will discuss the Euro’s effects on these emerging market economies, focusing my remarks on Turkey as a prime example. In this connection I will sketch the basic economic structure of my country, which maintains close financial and trade relations with the European Union. I will also comment on the Euro’s impact on internal and external economies within the Union.

In order to understand the characteristics of the Euro, we must examine the circumstances leading to the introduction of a multinational monetary system in Europe. I see three main factors behind the Euro.

First, the eleven countries which constitute the vanguard of the European Monetary Union have lived in a stable currency environment for more than ten years. The people of these countries, 170 million in number, have come to appreciate the benefits of a stable currency in an environment of low inflation: they can see that a stable currency is good for their standard of living and quality of life.

Second, the EMU countries are enjoying the advantages of minimizing the differences between their macroeconomic policies. They have realized that the convergence criteria give them an important tool for disciplining their own economies.

And third, despite long-standing differences in cultural traditions and attitudes, two major members of the European Union, Germany and France, have joined in promoting the idea of economic cooperation and monetary union. Germany, in particular, has played a major role in creating the EMU.

All of these factors have combined to provide a sound basis for creating the new reserve currency called the Euro.

To make clear the potential future importance of the Euro, I will give some figures illustrating the comparative importance of the US dollar and the European currencies that now function as international reserve currencies. Today, even though the United States and the countries of the European Union as a whole each account for about 20 percent of world output and 15 percent of world exports, almost half of all trade flows are priced in US dollars, and another third in European Union currencies. More than half -64 percent- of all international reserves are denominated in US dollars. But while the EMU countries hold $389 billion and Japan holds $216 billion of these reserves, the United States holds only $64 billion at the end of 1997. Half of the debt of the developing world is denominated in US dollars, and only 15 percent in EU currencies.

The introduction of the Euro into this situation will affect both the EU countries and other countries, especially those with close ties to the eleven EMU countries.

In the medium term, the efforts of the EMU countries to ensure durable stability for their single currency will produce additional real benefits by creating an environment conducive to stronger growth and higher employment. And for Turkey, as for the world as a whole, the greater stability of the international monetary system and the increase in the potential of its neighbours can have only positive effects.

For the EMU countries, the most important short-term goal is to promote the Euro as an international currency. Crucial to this goal is the acceptance of the new currency by the people of the EMU countries. The more rapidly this acceptance can be realized, the stronger will be the Euro□s status as a currency in the medium and long terms.

It can be expected that both the large economic base of the EMU countries, and the elimination of the transaction costs arising from the multiplicity of European exchange rates, will encourage the use of the new Euro as a unit of account, especially for trade flows. But, I should add that the principal factor that will determine how fast and how thoroughly the Euro becomes internationalized will be its transaction costs in the foreign exchange and securities markets. In other words, if the European Union wants to promote the Euro as an international currency, they must concentrate on making the Euro financial markets more efficient, better integrated and cheaper for participants. In other words, rapid development of Euro financial markets, and ensuring advantageous externalities in the use of the Euro as a medium of exchange, will be keys to successful promotion of the Euro. As Euro markets become deeper and more liquid and transaction costs fall, Euro assets will become more attractive and the use of the Euro as a medium of exchange will expand. Some studies on how the introduction of the Euro is expected to affect the financial markets indicate that the bond markets are likely to be affected faster and more directly than the banking sector.

As regards the effect of Euro securities markets, creating European bond or securities markets will directly affect both private and government debt issues, and borrowing and lending behaviour. The creation of a Euro securities market will involve the redenomination in Euros of all existing debt, the harmonization of market rules and conventions, stable interest rates, informal coordination of government debt issuing procedures, creation of a unified payments system, and the avoidance of unnecessary taxes and other burdens that would make European financial institutions less competitive.

The increasingly harmonized policies and continued resolution of structural issues among the EMU countries will improve the chances for the Euro to become the second most important currency in the world. It is the role and direction of fiscal policies in national economic settings which will be the key to a successful single currency in Europe.

Turning to the effects of the Euro on emerging market economies, it can be said that the magnitude of such effects depends mainly on, first, their share in trade relations; second, the intensity of financial transactions; and third, the size and currency composition of their external debt.

For the short term, the impact of the Euro on the emerging market countries will not be great. But in the medium term, stability in EMU combined with expected large cross-border transactions and increased competition within Europe should present these countries with several opportunities.

An integrated, deeper, more liquid European securities market would be attractive to debt managers and has the potential to strongly affect debt management. The current financing habits of emerging economies make heavier use of the Euro by debt managers likely. If nothing changes, international bond issuers will continue to favour the dollar for large transactions. As a matter of fact, the currency composition of the emerging markets' debt shows a larger share for the US dollar and Japanese yen than for the European currencies. It is plausible to interpret this situation as meaning that the cash market return on U.S. Treasury bonds is larger and the market is more liquid. But if there were a broader, deeper and more liquid European bond market, debt managers outside Europe would be interested in increasing the proportion of their debt denominated in Euros.

The structural changes resulting from the introduction of the Euro will definitely affect Turkey in the medium term, even though Turkish participation in the EMU is not yet an issue. On the other hand, occupying such a strategic location as the bridge between Europe and Central Asia, it is impossible for Turkey to reject integration into the globalized world economy. I believe that this trend toward globalization can give Turkey a good opportunity to obtain a larger share of the international capital flows resulting from the introduction of the Euro.

Let me point out some facts about our close relationships with the EU countries.

- Europe is our largest trading partner. In 1997, 47 percent of Turkish exports and 51 percent of Turkish imports were to and from EU countries, reflecting the increase in trade relations since the Customs Union Agreement came into force at the end of 1995.

- Turkey's external debt totals about US$80 billion. European currencies account for 40 percent of this total, 35 percent in Deutsche Marks.

- Between 1987 and May 1998 Turkey issued $15 billion Euro Bond, which is 70 percent of all bonds issued in DM.

- Fifty percent of Turkish Banking cross-border transactions have been held in EU currencies.

- During the last five years, 70 percent of direct foreign investments came from Europe.

- More than three million Turks are living in Europe, particularly in Germany.

- Forty percent of Turkey's total foreign exchange deposits has consisted of EU currencies.

- Turkish worker savings in the Central Bank of Turkey amounts to DM 21 billion.

- Sixty percent of Turkey's official reserves consist of EU currencies.

- Last but not least, despite the relative slowness of the globalization process in Turkey, our trade accounts of balance of payments has been liberalized since 1980, and our capital accounts since 1990. Turkey's capital accounts are among the most liberalized in the world.

Given these close ties with the European Union, the introduction of the Euro and the creation of a Euro currency area obviously have strong effects on the Turkish economy over the medium and long term.

Provided that the Euro is accepted by international financial markets as a stable reserve currency, the Euro's share in Turkey's financial accounts would increase further. I do believe that it will take less time for the Euro to be accepted in Turkish daily life and financial transaction than in other countries, mainly because of the large numbers of Turkish citizens living in Europe, high value of trade and tourism transactions with Europe, and the observed stability of the Deutsche Mark for over 20 years.

By reducing transaction costs and removing the risk connected with more volatile currencies, the introduction of the Euro will provide incentives for greater reliance on direct financing in European capital markets. A deep, liquid, and efficient Euro bond market will provide an opportunity to Turkish sovereign and private bond issuers. In addition, the volume of transactions in the Euro bond market is expected to be much larger than today.

A larger acceptance of Euros for trade and financial transactions in Turkey, of course in combination with a low inflationary environment, will make direct investment opportunities in Turkey more attractive to European firms. The very small amount of direct foreign investments in Turkey by European investors would surely be encouraged to grow by the disappearance of foreign exchange risks.

Under these circumstances, one can expect an increasing trend for both Turkish and European banks to increase their merger and acquisition activities. As it becomes more deeply integrated with the European financial markets, the Turkish Banking system will face new competition. But the dynamism of Turkish banks, together with their high technology, electronic infrastructure, better quality services and manpower, will be attractive to European counterparts.

In addition, the concept of independent central banks is the core issue in the European monetary system. The countries that belong to the EMU are no longer thinking about independent central banks in this connection. They have completed their structural and legal changes to prepare the unification. A uniform monetary policy will be implemented by independent national central banks. For this reason, independence for the central bank is more important than ever for Turkey. It will become a must for a globalized environment, and particularly important for a healthy relationship with the European Union.

There is one technical issue, related to cross-border payment systems, which we are closely following. This is the Trans-European Automated Real Time Gross Settlement Express Transfer (TARGET) system, developed as part of the EMU process. The Central Bank of Turkey has already begun investigating the possibility and the business feasibility of connecting with this system.

In Turkey, a high value payment system (the Real Time Gross Settlement System, or RTGS) was developed by the Central Bank and has been operational since 1992. This system has been vital to the Turkish banking system since its inauguration, and the number and money volume of transactions has grown very fast in the years since the system was switched on. In 1997, there were around 10.6 million transactions amounting to US$1 trillion. The direct participants in the system are the Turkish banks.

The TARGET System, which is expected to connect with the RTGS systems of member countries to permit Euro transfers starting on 1 January 1999, is not only a payments system, but is expected to be used basically in the implementation of EMU monetary policies.

We believe that connecting the Turkish RTGS system to TARGET by some form of access will enable both parties at either end of the line in the European Union or in Turkey to enjoy better management of their funds with all the advantages of RTGS Systems: minimum risk, reliability, security, and speed. In addition, such a connection will give companies, investors and individuals with financial activities in both areas the benefits of fast cross-border transfer of their funds.

Since payment systems have been made a high priority by other central banks and the Bank for International Settlements, the Central Bank of Turkey is conducting researches and investing in development aimed at improving the infrastructure, for example by establishing hot-stand back-up centers and instructing the banks in the use of the new payment instruments so that they will be ready to provide new, more efficient services to their clients and achieve closer connections with the world markets as they continue the process of globalization.

The last point I wish to make is that the Convergence Criteria of the Maastricht Treaty require the economies that want to join the European Monetary Union to achieve a high degree of proven convergence. As we all know, this includes price stability, low market interest rates, stable exchange rates, and sustainable public finances. And although it is not of immediate importance for Turkey to become a member of EMU, these convergence criteria can also furnish us with an important means of disciplining our economy.

Turkey has two major economic problems. These are inflation and the budget deficit, both of which represent major issues for EMU participation and for sound macroeconomic management. Unless inflation can be reduced and the budget deficit brought below 3 percent of GNP, relations with the EMU cannot be on a healthy footing, whether for Turkey or for the other emerging market economies. Thus, stability in EMU would also bring stability in emerging markets. This is a two-way street.

Those countries that have a solid economic background will take advantage of economic integration. Contrariwise, countries with weak economies are likely to be adversely affected by the new international monetary system.