Durmuş Yılmaz: Access to finance and capital markets development

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the XIIth Euro-Mediterranean Conference on Economic Transition, Bruxelles, 20 February 2008.

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Ladies and Gentlemen,

Over the last two decades, we have witnessed a dramatic shift towards internationally integrated financial markets. In today's world, asset prices and domestic interest rates have become increasingly determined by international developments rather than domestic factors. A sharp expansion in the scale of capital flows is one manifestation of this integration. Another indicator is the pace of financial innovation and corresponding surge in new financial instruments and markets. This rapid growth in financial markets has been accompanied by massive economic and financial deregulation, which has enabled financial institutions to move beyond national borders, making the conduct of monetary policy more complicated.

In this rapidly changing financial environment, the position of a central bank in the financial system has become an important issue to address.

It is generally accepted by many central bankers that the primary objective of the monetary policy should be to achieve and maintain price stability. Here, what is meant by price stability is low and stable inflation.

Most central banks also acknowledge that they have a significant responsibility for ensuring a stable financial environment in which both financial and non-financial institutions operate. Unlike the primary mandate (price stability), the precise meaning of the second mandate is more elusive. Moreover, central banks are not usually alone in fulfilling this mandate. In many countries central banks are in close cooperation with independent regulatory agencies. These agencies have the authority of regulation, supervision and oversight of financial markets and institutions. In the context of Turkish financial system, we have two such agencies: Banking Regulation and Supervision Agency and Capital Markets Board.

At this point, I should emphasize that price stability and financial stability objectives are complementary in nature. Disruptions in financial markets would eventually affect the real economy through their impact on interest rates, exchange rates or asset prices. Thus, it is not far fetched to regard them as two sides of the same coin.

Dear Guests,

Financial stability lies at the core of a well-developed financial system. And the smooth operation of payment and settlement systems is a prerequisite for financial stability.

The Bank for International Settlements defines the oversight of payment and settlement systems as a task left primarily to central banks with the objective of promoting the smooth functioning of payment systems and protecting the financial system from the possible "domino effects" which may occur when one or more participants in the payment system experience credit or liquidity problems.

Central Bank of Turkey has played a leadership role in the development of payment and settlement services in Turkey. Today, the payment system is fully complied with the provisions of the CPSS (Committee on Payment and Settlement Systems) Core Principles for Systemically Important Payments Systems.

Interbank funds and securities transfer are performed via the Interbank Clearing – Real Time Gross Settlement System that is supervised and operated by the Central Bank. This system commenced operation in April 1992. In 2000, the second generation Electronic Fund Transfer System replaced its predecessor. Today, Electronic Fund Transfer System is a real-time gross settlement system in line with best international practice. Payments are settled individually on the accounts and transferred to receiver immediately. Thanks to the infrastructure provided by Electronic Fund Transfer System, institutions and individuals can make any kind of payments in real time through telephone banking or internet banking services free of charge or with minimum cost. A noteworthy feature of the payment system is that it was designed to process both large value and low value transactions.

The Central Bank of Turkey also established Interbank Clearing – Electronic Security Transfer and Settlement System for real time electronic transfer and settlement of government bills and bonds. The system has been taken into operation in 2000 under the supervision of the Central Bank of Turkey. It is fully integrated with the Electronic Fund Transfer System and operates under delivery versus payment principal.

The third pillar of the payment system in Turkish economy is the Interbank Cheque Clearing Houses Center. The Clearing House is a private legal entity that carries out the clearing and settlement of cheques under the supervision of the Central Bank.

Today, we can easily say that payment and settlement system in Turkey is at par with its counterparts in developed countries promoting the efficiency and effectiveness of the financial system.

Distinguished Guests,

Removing market imperfections is essential for the smooth operation of financial system. In this context many central banks have been involved in addressing information problems experienced in credit markets. At this point I will draw your attention for a few minutes to the asymmetric information problem, which can lead to credit rationing.

It is known that obtaining credit information to ensure sound-lending activities is a costly procedure requiring an efficient monitoring process. The lack of adequate information about a borrower's credit solvency and the viability of a project may raise screening and monitoring costs for banks. This situation sometimes leads banks to cut credit supply or make them reluctant to supply loans. Of course, collateral based lending could ease banks' reluctance as it partially reduces the risk involved in lending. However, collateral may play a limited role in the case of small and medium size enterprises since they are less likely to possess appropriate collateral.

In order to improve exchange of information on credit history of a borrower, regulators of many countries have actively involved in setting up public credit bureaus. In Turkey, the Central Bank took the lead in setting up the Risk Center of Turkey in 1951. The Risk Center has been operating within the Central Bank since then. This database enables to prevent extension of credit to a person or legal entity exceeding its payment capacity. Applications are based on data exchange on loan limit and risk information on bank customers, protested bills information, identity information of the customers subject to non-performing consumer loan and credit card, and loan limit and risk information on customers of financial leasing companies and factoring companies. Currently we are at the process of transferring the Risk Center Unit to the Banks Association of Turkey.

A separate and private company was also set up by private banks in 1995 as Credit Bureau to respond to the demands of the financial community. The Credit Bureau promotes the exchange of information among financial institutions about the credit history of potential customers.

I should also emphasize the importance of the new capital accord, the Basel-II. Along with the implementation of Basel-II, the access of small and medium size enterprises to bank credit will depend heavily on their financial and organizational structures. According to the new accord, those enterprises that adhere to sound corporate governance principles will have an advantage in access to cheaper finance through banking sector. They will also have better access to finance if they improve their financial disclosure standards. Hence, it is imperative for small and medium size enterprises to take the necessary steps and prepare themselves for the requirements of the Basel-II without any delay.

At this point, I would like to briefly touch another obstacle that hinders access to capital: Fiscal dominance. Due to high level of public sector borrowing requirements in many emerging market countries, fiscal policy ultimately governs price determination in financial markets. Fiscal dominance reduces the amount of loanable funds available to private sector and disrupts effective credit allocation in the economy. Turkey can be seen as a case study. Years of high real interest rates and budget deficits in the 1990s forced the Turkish banking sector to credit rationing. Banks were not able to perform their intermediary function effectively. Instead, they mostly financed public sector deficits. Fiscal dominance has gradually eased following the reform program enacted after the 2001 crisis. The declining public debt burden and the diminishing fiscal dominance in Turkey put an end to the crowding-out of the real sector. That boosted the supply of loanable funds. Banks have returned to their traditional role of financial intermediation instead of financing government expenditures. Share of public securities in Turkish banking sector assets declined by one-third to 28% in the last 5 years; while share of credits to private sector more than doubled and reached to 49% during the same period. The credits extended to the small and medium enterprises by Turkish banking sector have also increased significantly to USD 95 billion as of 2007. This corresponded to almost 20% of the GDP. As a further note, 32% of these credits were in the category of credits extended to micro enterprises. The ratio of private sector credit used by households and firms to GDP has also rapidly increased, though it is still low in international standards.

Of course, raising the share of private credits in the financial system does not necessarily mean that each and every segment of the population would gain access to financial services. The low-income segment of the society, in particular, may not have access to capital and that would have two principal adverse effects. First, they may not be able to raise the expected value of their income and therefore of consumption and future investment and asset accumulation. Second, due to lack of access to credit, the poor would face high variation in their income and consumption, and the downward risk on income threatens their ability to satisfy basic consumption needs.

Increasing the funds available for entrepreneurs that have micro-scale business plans but do not have access to credit, have merits such as contributing to the production level and unemployment ratio while also strengthening the social structure of a country. Of course, it should be noted here that while the benefits from financing these activities are more or less common, selection of main business areas where these funds should be used obviously depends on country specific circumstances and needs.

Dear Guests,

In the last part of my speech, I would like to share with you my thoughts on the external sources of “access to finance”.

As I touched upon initially, financial innovation and financial integration have led to explosive growth in the international movement of capital. These flows serve as an important catalyst for domestic financial market development, as reflected both in the size of the banking sector and equity markets, as well as the quality of institutions for supervision and regulation.

In recent years, attention has been given on how macroeconomic policies should respond to the unexpectedly big wave of capital flows to many emerging market economies. Regardless of the form or way of these inflows, they create important challenges for policymakers due to their potential to cause overheating of economies.

Emerging market countries have responded to address these concerns in a variety of ways, such as exchange rate alignments, efforts to neutralize the monetary impact of interventions through sterilization, and controls on capital flows. At this point, I should note that coordinated fiscal and monetary policies are necessary to attract high quality capital flows and to manage flows efficiently regardless of their type. Low inflation and prudent fiscal polices signal to investors the extent of government's commitment to achieve macroeconomic stability and adds to the credibility of the government. On the other hand, efforts in the field of financial supervision and regulation, together with policies such as labor and product market reforms are important for the stability and soundness of financial systems in handling capital inflows. Regulatory and supervisory authorities should strengthen prudential and other financial market regulations in order to deepen financial markets and improve investment climate, whereas central banks should focus more on greater currency flexibility and price stability.

In conclusion, as a central banker, I would like to highlight three key messages from the thoughts I have shared with you.

First, to achieve price stability, central banks need to ensure efficiency of financial infrastructure and maintain smooth operation of financial services. An efficient and effective payment and settlement system is at the core of financial infrastructure.

Second, removing market imperfections is essential for the smooth operation of financial systems. Establishment of credit bureaus to improve exchange of information on credit history of economic agents and reducing fiscal dominance are important steps to ensure sound-lending activities. In this context, the role of micro finance in promoting the access of the low-income segment of the society to credit should be supported and encouraged.

Third, the overall level of external financing and its composition is important for domestic access to finance. The benefits of capital inflows to economic growth would be higher with a developed financial sector. Central banks could best support this process through their contribution to macroeconomic stability.

Thank you.