Mr. Erçel considers the European financial markets and their implications for Turkish institutions Speech given by the Governor of the Central Bank of the Republic of Turkey, Mr. Gazi Erçel, in Istanbul on 23/10/97.

The EMU will be the most important change in the international monetary system since the creation of the IMF at Bretton Woods. The creation of a new currency, the Euro, is in fact a historical event for the European Union (EU). It marks a new quality in the process of European unification because it is the final point and coronation of efforts since 1958 to create one big market in Europe.

The success of the Euro area will, of course, depend on the future development of the value of the Euro. The Euro, as we all know, has to compete with two strong international currencies: the US dollar and the Japanese yen. According to one school of thought, the Euro will have a stable value. That is because the high stock of assets in Euro, held by official or private foreign holders and which were converted from national currencies, in particular from Deutsche Mark, will not be switched into other currencies.

Besides, once the Euro is introduced, there could be a significant switch of foreign exchange reserves out of US dollars and into Euro. This could give a boost to the exchange rate of the Euro against the US dollar over time. The sheer size of the economy in the monetary union will encourage the use of the Euro instead of the US dollar in trade and foreign exchange transactions. This process would further be accelerated by the fact that the use of a single currency will remove the not negligible cost of transactions. According to a study conducted by the IFO Institute in Munich, "the transaction costs for the inter-European currency management may be in the order of nearly 60 billion ECUs, or nearly 1% the GNP of the European Union".

Also it is likely that central banks will use the Euro rather than the US dollar in foreign exchange interventions. In turn, this will encourage non-EU central banks to switch an increasing proportion of their reserves into the Euro. This process will take time and the Euro will not usurp the role of the US dollar in the short term. However, the trend is likely to be persistent and eventually the current importance of the US dollar in the foreign exchange markets should be replaced by the joint importance of the US dollar and the Euro. One factor which will affect the speed of this change is the outlook for the Euro based on the fundamentals of the monetary policy of the European Central Bank (ECB). Moreover, the creation of a monetary union will prevent exchange rate volatility within the united Europe, the reason being that the Euro area as a whole will be much less dependent on foreign trade. It is estimated that the share of foreign trade of the Euro area will be only about 10% of GNP in comparison to about 30% for Germany today. And over the long term, the Euro should become almost as widely used as the US dollar is today.

One conclusion to be inferred from this is the following: since Turkey has close trade, service and financial links with Europe, and as the only country connected to Europe in a Customs Union (CU), which I hope will evolve over time towards full membership, the EMU will create completely new conditions in Turkey's international and European relations. Therefore what will happen in Europe will be decisive for Turkey in the years ahead. It will be a challenge for the Turkish authorities, as well as for bankers and businessmen.

One of the most important prerequisites for a successful monetary union is a sufficient degree of economic convergence among the potential members. From that standpoint the degree of convergence among the EU countries is remarkable, particularly as regards the convergence criteria; stable prices, stable exchange rates, low long-term interest rates and healthy public finances. In addition to these criteria, the Maastricht Treaty requires that all member countries in the EU must grant independence to their central banks before the Monetary Union and the establishment of the European System of Central Banks (ESCB). The reason behind the requirement of independent national central banks is that fixing exchange rates and unifying currencies requires a common monetary policy.

For a currency union to function “smoothly and in a sustainable way, it is absolutely necessary that all participants agree on either a single common policy or closely coordinated policies”. All costs and benefits of the union must be shared equally. Any member acting with the “free-rider” mentality, and benefiting from the system at the expense of the others, will eventually cause the system to disintegrate. Therefore, a single common currency requires a single monetary policy with a clearly defined target, which is price stability. This basic principle of monetary policy has already been embedded in the Maastricht Treaty. And the European System of Central Banks (ESCB) has been made responsible for achieving it.

In order for the ESCB to fulfil the task assigned to it, it must act in full independence from national governments or from European institutions. The ESCB Governing Council, which is composed of the Board of Management of the ESCB and the governors of the participating central banks, will not be representing respective national interests. Although there are some differences between the two systems, the ESCB is like the Federal Reserve System of the US. For the ESCB to act independently, individual national central banks must already be acting independently of their governments, because the ESCB will be built on individual national central banks. That is why the Maastricht Treaty made it obligatory for the national governments to grant independence to their central banks in the period leading to the formation of the ESCB.

The EMU is an event with far-reaching consequences; in one way or the other all countries will be affected by it. Unlike the effect of a currency area, a customs union or a free trade area, a monetary union can affect in various degrees all countries, irrespective of whether they are in or out. This general fact, together with the signing a Customs Union (CU) Agreement with the EU, make EMU even more important for Turkey than for other countries outside the EMU. Therefore, I believe that the Turkish Central Bank has a predominant role to play in informing and educating all Turkish entities about the choices and implications of EMU.

As you all know, Turkey is one of the potential countries to join the EU. I would say that our country’s ultimate aim is to become a full member of the EU; therefore first we need to adapt to European standards in many areas. The steps Turkey took on the way to the CU are also steps taken to ensure full integration in EMU. After these general remarks I would like to look at the issue from Turkey’s perspective.

So far, the measures taken to support the independence of the Central Bank of Turkey (CBT) are remarkable. Recently, the Central Bank Law was amended and now limits have been set on the so-called “short-term advances” which the Treasury is legally entitled to obtain from the Central Bank. Starting from 1994, the Treasury’s annual use of short-term advances is to be reduced gradually over five years from 15 to 3 percent of each year’s incremental budget appropriations. By 1998, the Treasury will be entitled to short-term advances totalling not more than 3 percent of that year’s incremental budget appropriations over the previous year.

In addition to that, the Treasury and the Central Bank have signed a seven-point protocol to cooperate in fighting inflation. The official aim of this accord is also to give the Central Bank more independence. So, an important development towards the full independence of the Central Bank has been initiated, as required in the Maastricht Treaty.

However, we have been in the process of preparing a new Central Bank law in parallel with the same institutions in the EU. The work has already been done and we are ready to submit it to the government if and when the political environment is appropriate.

On the other hand, in addition to the already installed electronic payments clearing system, the CB has signed a contract to develop and install a modern national securities settlement system. The new system will allow the Bank to increase the efficiency with which government securities can be traded on the capital markets and ensure that the payments system will match the standards of those in the EU and other western nations. The new system will also be capable of being connected to the

TARGET network. At the same time the system will strengthen Turkey's links with the European member countries and will enable it to trade in the same currency as other members, a requirement for participation in the EMU. As far as the technical infrastructure is concerned, Turkey is ready to integrate itself into the EU.

I would like to remind you that Turkey has been pursuing a series of liberalization policies since 1980 which are broadly in line with economic tendencies in the world. A wide range of policy measures were put into effect to achieve the restructuring of the economy. Changes in exchange rate and trade policies were the main instruments in this process. This program has brought a radical change in Turkey's development strategy by increasing its dependence on market forces. In this context, the fixed exchange rate policy was replaced by the flexible one, restrictive control measures on imports were abolished and protection was reduced gradually. Similarly, foreign exchange transactions were thoroughly liberalized, free trade zones were established, foreign investment was further encouraged along with the privatization of public enterprises. As a result of these newly adopted policies, there have been spectacular changes in the Turkish economy, with exports and foreign investments having proved to be responsive to the structural adjustment process; within this process, the Turkish lira has become fully convertible and restrictions on capital movements have been effectively removed.

Even though the liberalization policies were adopted independent of the EU perspective, they helped to facilitate Turkey's attempt to apply for full membership, by providing a solid basis for lasting progress.

On the other hand, member countries of the EU have tried to make some adaptations in their banking regulations to integrate financial systems. Competition among them has increased. A universal banking system is accepted. Banks either have increased their assets or have merged with other banks in order to be strong in a market where competition is intensified. New financial products are created every day. Technology is used intensively in order to reduce costs and serve customers better. In parallel to these developments many reforms have been made in order to develop the Turkish banking system. Some amendments were made to the Banking Law to harmonize it with European standards, and now we are in the process of preparing a new Banking Law. These changes will require some banks to strengthen their financial situation and bring their credit risk and equity participation ratios closer to the EU norms. Within the process of becoming more deeply integrated with the European financial markets, the Turkish banking system will now face new competition. The CU agreement has naturally affected Turkish banks and changed the dimensions of competition. But Turkish banks seem ready in many ways for this new and larger competitive environment. Today banks in Turkey are made more dynamic by a high-technology electronic infrastructure, high-quality services and well-trained manpower. What we need is to integrate the legal and institutional systems in parallel with the EU banks.

With the introduction of the Euro there would arise a number of technical issues which must be immediately tackled. As of today, Turkish banks are allowed to maintain foreign exchange positions in 23 foreign currencies, of which 17, including the ECU, are European currencies. With the Euro the CB and the Turkish banks will no longer have to deal in these currencies, but only in Euro.

Of course, initially there will be some currencies, like the British pound and a few others, which will continue to exist for a while. But within this process, all foreign assets and liabilities in the currencies of the countries participating in the monetary union will need to be converted into the Euro.

Currently, Turkey follows an exchange rate policy based on a basket consisting of the US dollar and the Deutsche Mark. It is assumed that since other European currencies are related to the Deutsche Mark through the European Exchange Rate Mechanism (ERM), the basket also reflects the weight of other European currencies through the Deutsche Mark. With monetary union the share of the Euro area in Turkey's overall trade in goods or services will be more than 50%. But this will not change the picture from the exchange rate policy point of view. Therefore the Euro could easily be substitute for Deutsche Mark in the present basket.

Within the CB's foreign reserves, some positions are being held in the currencies of the countries which are candidates for monetary union membership. These positions consist of securities and money market placements. It is expected that security investments will be converted to the Euro as of January 1st, 1999. Money market placements on the other hand will continue to be transacted in their original currencies until July 1st, 2002. The fixing of the Deutsche Mark rate against Euro, the Euro's value against other currencies in the international money markets and the depth and performance of the Euro bond market will be important factors in terms of our reserve management policy. In the Euro market, there will no longer be any cross-currency risk and cross currency-induced interest rate differential. However, it is possible that the country risk-induced differential will become more pronounced. Therefore investors must pay attention to which country's security they are buying when investing in Euro-denominated securities.

There are also issues which should be considered by the real sector. In particular those firms which are very active in trades across borders are likely to adopt the value of the Euro in their dealings rather quickly, because firms competing in European markets, in order to make comparison possible, should set their prices in Euro.

As I have already mentioned, the CB and the commercial banks have to convert the foreign exchange denominated accounts into the Euro. This is not an easy task and involves changes in accounting systems and data processing. Therefore due attention has to be paid to these infrastructural changes prior to the introduction of the Euro.

The fact that the EU is Turkey's most important trading partner increases the implications of EMU for the Turkish economy. On the other hand, the EU has the largest share in foreign investment in Turkey, and invisible earnings in the Turkish balance of payments have a significant European content. Furthermore, most of our correspondent banks are in the Euro zone. Turkey has close trade, service and financial links with Europe, as the only country connected to Europe in a CU which hopefully will evolve over time towards full membership.

In conclusion, I would like to point out that time is getting short for launching the Euro. The time remaining must therefore be used efficiently. Those who have prepared and are ready will also be those who will also derive the greatest benefits. I do believe that we are heading in the right direction.