Gazi Erçel: The role of the euro from the Turkish standpoint

Speech by Mr Gazi Erçel, Governor of the Central Bank of the Republic of Turkey, made during the 6th International Financial and Economic Forum, held in Vienna on 9 November 2000.

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Ladies and Gentlemen,

I would like to thank the organizers of this conference for inviting me to share my thoughts on the euro's role as seen from the Turkish point of view.

Of course, the introduction of the euro is affecting not only the economies that are members of the European Union but also non-member economies that have close links with members. These include emerging market economies much of whose trade and financial transactions is with European Union members. Those whose external debt is largely denominated in European Union currencies will be affected the most.

Even though Turkey is not yet a member of the European Union, it has close ties with countries that are. Not only does Turkey carry on a large volume of foreign trade with EU members, it is also the only candidate for membership that has entered into a customs union with the EU, signed at the end of 1995.

Turkey's close relationship with EU countries and the present role of the euro in the Turkish economy are illustrated by the following:

- Europe is Turkey's largest trading partner. In 1999, 54% of Turkish exports - $14.3 billion - and 53% of Turkish imports - $21.4 billion - went to or came from EU countries.
- About 54% of Turkey's official reserves consists of Euro - 11 currencies and the euro itself.
- The foreign exchange deposits belonging to Turkish workers in other countries and held in the Central Bank of Turkey amount to about 11 billion euros, almost 93% of which is in the form of deutsche marks.
- Our external debt totals about US$106 billion, 34% of which consists of Euro - 11 currencies and the euro itself.
- Since 1 January 2000 the Turkish Treasury has borrowed via bond issues in the international capital markets a total US$7.5 billion, 37% of which is denominated in euros.
- During the last five years, 60% of direct foreign investments in Turkey came from Europe.
- Of the 9.3 million foreign tourists who visited Turkey during the first ten months of this year, 5.1 million came from Europe.

Given the breadth and depth of Turkey's relationship with the European Union, it is no wonder that the euro and the creation of a European currency will powerfully affect the Turkish economy from now on.

Assuming that the euro is accepted by the international financial markets as a stable reserve currency, the medium and long term will see the euro's share in Turkey's financial accounts continue to increase. I personally think that acceptance of the euro in daily life and financial transactions will come faster in Turkey than in other countries, for three reasons: the large numbers of Turkish citizens living in Europe, the large volume of trade and tourism transactions with Europe, and the consistent stability of the deutsche mark for 20 years and more. The introduction of the euro has reduced transaction costs and removed the risks connected with more volatile currencies, increasing the incentives for European capital markets to rely more on direct financing. A deep, liquid, and efficient euro bond market will be welcomed by Turkish sovereign and private bond issuers. Moreover, the volume of transactions in the euro bond market is expected to be much larger than today.

Increased acceptance of euros in Turkish trade and financial transactions, of course combined with an environment of low inflation, will make direct investments in Turkey more attractive to European firms. Turkey's presently very small total of direct foreign investments from European investors would surely be encouraged to grow by the disappearance of foreign exchange risks.

Under such circumstances, both Turkish and European banks could be expected to increase their merger and acquisition activities.

For the short term, the most important goal is to promote the euro as an international currency. Success will crucially depend on the new currency's acceptance by the people of the EMU countries and other countries as well. The faster this acceptance can be achieved, the greater will be the euro's strength as a currency in the medium and longer term. Unfortunately, we cannot say this has already happened. Its depreciation against the US dollar has not promoted increased confidence in the euro.

This is probably a good moment **to describe how the fluctuations in the euro/dollar exchange rate have affected the Turkish economy. A low valuation of the euro would affect our economy through two channels:** first, through the euro's role in our new exchange rate system; and second, through the large share of EU countries in our foreign trade.

At the beginning of the year 2000, Turkey launched a comprehensive disinflation program based on a pre-announced path of the Turkish lira against a currency basket consisting of "1 US dollar plus 0.77 Euros." Mainly by taking advantage of the remarkable pass-through of the exchange rate to price levels, this program has brought about a considerable lowering of the inflation rate. Unfortunately, the rapid appreciation of the US dollar against the euro in the international markets has somewhat weakened the effect of the exchange rate basket on inflation. During the first ten months of this year, the Turkish lira depreciated by an average 26.5% against the US dollar, but by an average 6.5% against the euro. The operation of the pass-through mechanism to price indices in Turkey is much stronger for the dollar than it is for the euro, or previously was for the deutsche mark. Turkish inflationary expectations have been following the behavior of the US dollar. Under these circumstances, inflation outcomes have lagged above the targeted level. In addition, due to the preannounced depreciation path of the Turkish lira against the currency basket, the continuous depreciation of the euro against the dollar has resulted in a loss of competitiveness of Turkey vis-à-vis Europe. Due to this chain of events, the total value of Turkey's imports from the EU countries has risen 29.6% in the first half of the year, while the value of Turkey's exports to EU countries has grown by only 3.4%. In other words, the depreciation of the euro has contributed to Turkey's growing trade deficit, which was initially mistaken for a side effect of the disinflation program. In this situation, the correction of the euro's value against other major currencies will have a beneficial effect on Turkey's current account balance, in addition to the offsetting of the negative effects of the weak euro provided by the high productivity of our manufacturing sector and the diversified nature of our exports.

The weak euro has also led to a portfolio shift in the Turkish economy. At the end of September, total foreign exchange deposits in Turkish commercial banks amounted to US$43 billion. Of this 27% consisted of euros, which have decreased in value by 38.5% since the end of 1998. The share of US dollars gradually increased during the same period from 58% to 71%.

At the Central Bank, we have also shifted the currency composition of our reserves from euros to US dollars. The share of euros in our reserves has fallen from 73% to 54%, and there has been a parallel shift in the composition of our foreign exchange liabilities.

Now let me point out two major positive effects of introducing the euro into the Turkish economy.

The first positive effect is that elimination of the transaction costs arising from a multitude of European exchange rates has encouraged the use of the euro as a unit of currency. Between 1994 and 1998, the euro's share in the current account's foreign exchange receipts averaged 37% and in its foreign exchange expenditures averaged 32%. Eighteen months after the introduction of the euro, these figures have barely changed: the respective shares are 40% and 33%.

The second positive effect is that the Convergence Criteria of the Maastricht Treaty, and the Copenhagen Criteria, require economies seeking to join the EU and EMU to become efficient market economies and achieve a high degree of verifiable convergence with the EU. As we all know, the requirements include price stability, low market-based interest rates, stable exchange rates, and sustainable public finances. And whether or not it is considered immediately important for Turkey to become a member of EMU, these convergence criteria can give us an effective means of disciplining our economy.

This is why we have launched a comprehensive disinflation program aimed at reaching single-digit inflation and eliminating macroeconomic imbalances by the end of 2002. Winning for Turkey the possibility of membership in the EU and EMU is one of the main goals of our program.

The ideal of independent central banks is a core issue for the countries of the European Union. We are currently in the process of examining our Banking Law to determine what must be done to bring it up to the standards promulgated by the European System of Central Banks. New modifications are planned to make price stability the principal goal of monetary policy. Debt monetization will no longer be allowed. The new Law will also grant more independence to the Central Bank.

Before ending these remarks, I want to point out that introducing a single currency and reaping the full benefits of doing so is a long-term endeavor. For the time being, Turkish monetary policy is directed towards a single transparent objective, that of price stability. Price stability will serve as a link between the initial expectations about the euro area and the potential economic benefits of a single currency system. The reforms and changes executed up to now will provide a base for ambitious future policies that will broaden the area of integration and encourage the faith of economic agents that the area offers additional benefits such as greater price transparency, improved efficiency, growing investments and economic activity, and a more competitive environment. And no doubt the world economy will also have a share in these benefits.