# Durmuş Yılmaz: Current issues in economic governance

Opening remarks by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the Conference on Current Issues in Economic Governance, organised by Bilkent University, Ankara, 2 April 2008.

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Ministers, Academicians, Bureaucrats and Guests,

Thank you all for accepting the invitation. It is a great pleasure to address such a distinguished audience. I would like to thank Bilkent University for organizing this conference at this juncture. In fact, the timing could not be any better. The recent global financial turbulence has put good governance principles at the center of public debate. I hope, the conference will strengthen our understanding of the subject by building on the lessons derived from the conference last year.

Let me start with reviewing the recent developments in financial markets.

You may have heard about a proverb attributed to the Chinese: “May you live in interesting times!” Here, "interesting" means dangerous or turbulent; therefore, the whole phrase is something of a curse. It turned out that the phrase was not of Chinese origin, but ascribed to them to make it sound wiser. Whatever the origin, it is certain that we are experiencing such a spell right now.

We have been witnessing a global financial turbulence since mid-2007. Its magnitude, measured by the volatility index (VIX), is larger than that of the turbulence in 2006. It was triggered by the falling house prices and subsequent problems in the sub-prime mortgage market and mortgage based securities. Over time, investors have become nervous about the valuations of financial instruments. Banks took large write-downs on mortgage-related assets and other risky securities. Major financial institutions reported huge losses. Some of them even came to on the brink of default and some of the hedge funds liquidated their positions in order to match the increasing withdrawals of the investors. The sharp decline in risk appetite and concerns about the counter-party credit risk has led to a significant deterioration in short-term credit and money markets leading to a major liquidity squeeze. Liquidity problems, coupled with solvency crisis, have tested the resilience of global financial markets, and we are still waiting for the light at the end of the tunnel.

The big losses of financial institutions and deep plunge in consumer confidence due to sharp fall in house prices and declining personal income have increased the possibility of a recession in the US economy, which may have already started as we speak. Deterioration in risk perceptions has increased the risk premia of developing countries, including Turkey. So far, the rise in Turkey’s risk premium was in line with that of other developing countries, although more recently the current political uncertainty has started to put Turkish financial markets under considerable strain. I believe Turkey’s risk premium would be even higher in the absence of improvements in macroeconomic conditions and institutional reforms implemented in recent years.

Dear Guests,

One can label the last two decades as the era of globalization, deregulation, and privatization. It is not a coincidence that this period has overlapped with the rise of attention paid to good governance. One may just look at the number of occurrences of the word “governance” in academic search database (Econ-Lit) over time. It occurred just five times from 1970 to 1979, 100 times in the 80s, 4000 times in 1990s, and more than 10000 times since 2000.

Globalization of economic activity and greater reliance on private sector in economic decisions has created an environment in which the pursuit of efficiency has acquired utmost importance. Globalization has increased the likelihood of international financial crisis in countries where the governments do not function properly. Economic crisis in South Eastern Asia in late 1990s showed that even countries with considerable success in economic development may easily collapse into turmoil if they do not follow good governance practices. Quite paradoxically, as the control of governments over the economy decreases, the quality of governance becomes more critical and decisive. With greater mobility of capital, countries have become more vulnerable to negative assessment of investors.

Today, financial markets are facing the most acute crisis they have experienced since the emergence of globalization. It is not surprising that good governance is once again at the center of public debate at this juncture. The seeds of current problems may be traced to past governance practices of governments, monetary authorities, financial institutions, and corporate sector.

But before that, let me first introduce some conceptual issues. This may help us understand how we ended up here.

It is not easy to give a short and comprehensive definition for economic governance. For the sake of our discussions, let me define it simply as the nature and practice of economic management, regulation and development. Economic governance is in fact part of a larger picture that combines political governance, corporate governance and legal governance, which continuously interact with each other.

The term “economic governance” is explained as “the study of arrangements, and organizations that arise and evolve to govern economic activity.” These institutions underpin economic transactions by protecting property rights, enforcing contracts, and organizing the physical and regulatory infrastructure to facilitate economic activity. Good governance provides a very important set of pillars, which are critical in the design of an economy. The most widely cited ones are transparency, accountability, rule of law and participation.

Let me go over these four principles rather quickly.

Transparency ensures that the necessary information is freely available and directly accessible to those who will be affected by decisions and their enforcement.

Accountability is a mirror image of the authority. It is critical for decision makers to be responsible for the consequences of their decisions and actions to those who will be affected. In democracies, every independent institution or organization is accountable to the public and to its institutional stakeholders.

Participation is the cornerstone of democracies, where every person in the system, in one way or the other, has a voice in the decision-making process.

And last but not least, good governance requires a fair legal framework and impartial enforcement of this legal system that protects property and individual rights and constitutes a strong base for prudent policy-making. The rules need to be preset, predictable and applied equally regardless of whether the parties in dispute are domestic or foreign, individuals or state. Enforcement of rules in speedy and impartial manner would create a self-fulfilling environment, where adhering to contracts voluntarily becomes the norm and there is little need to formally recourse to the legal system.

How can we match governance practices with the current financial turbulence? It is too early to make a judgment about the institutional failures that have led to current financial turbulence, but we have a few clues on what went wrong. Lack of transparency and accountability is at the top of the list. In retrospect there were some important gaps in the U.S. regulatory structure that caused poor underwriting and some fraudulent practices in the sub-prime mortgage sector. Parties in the originate to-distribute chain did not have incentives to generate and provide information on the quality of assets. We can add poor investor due-diligence practices and poor performance of credit rating agencies to that list. Public disclosures required of financial institutions were not enough to shed light to the risks associated with their on- and off-balance sheet exposures. Public authorities were way behind in assessing and regulating the complex financial instruments created by financial engineers.

Of course, accommodating global monetary and financial conditions also contributed to high-risk appetites, high leverage and search for high yields.

At this point we do not know the scale of economic fallout from the ongoing financial turbulence, nor its duration. It is, however, conceivable to expect some regulatory backlash by major industrialized countries. For example, just a few days ago the U.S. Treasury Department announced a new plan to overhaul existing financial regulatory structure to make it compatible with modern financial instruments. This is of course just a beginning and we should not be surprised to witness similar steps by other countries.

Distinguished guests,

Let me turn to the Turkish case and discuss recent developments in Turkey.

As you may remember, throughout 1990s the Turkish economy was shaped by high and chronic fiscal deficits, high inflation rates and a weak institutional environment. The economic crisis in Turkey in 2001 was not only the lowest point of this period, but also a major turning point for our economy. Since then we have witnessed a very ambitious reform agenda taken towards reaching better economic governance. I classify these steps under four main categories: (1) Monetary policy, (2) Fiscal policy, (3) Financial stability and (4) Structural reforms.

Taking into consideration the fact that I am a central banker, I think it will not be surprising if I start with the topic of monetary policy.

Central Bank independence that was granted by Law in 2001 was the key step on the monetary policy side. In the absence of independence, the Central Bank of Turkey would not be able to focus on its primary objective of price stability. Introduction of the free-floating exchange rate regime in 2001 and formal inflation targeting regime in 2006 can be classified as the other two key steps. The inflation targets became the new anchor instead of exchange rates and the Central Bank has started using overnight interest rates as the main policy tool to reach these targets.

Communication tools of the central bank have played a key role in explaining the price developments and the monetary policy outlook to the public and also in managing expectations. The Bank's communication policy has become more effective over time with the introduction of new communication tools, such as the quarterly inflation reports since 2006, the bi-annual financial stability report since 2005 and the monthly price development reports since July 2006. In addition, a summary of Monetary Policy Committee meetings are published on our website within 8 business days following the Committee meeting, simultaneously in English and Turkish. I believe all of these instruments have contributed to a more transparent monetary policy.

After briefly touching upon the main features of the monetary policy in the context of good economic governance, I will continue with the fiscal side.

The prudent fiscal policy that has been implemented since 2002 has made significant contributions to the disinflation process and the economic growth. The ambitious primary surplus targets are at the center of the improvement in fiscal policy. However, I should also underline the progress in institutional and legal framework, such as the introduction of the Public Fiscal Management and Control Law, the Public Procurement Law and the multi-year budgeting framework. Three year inflation targets that are compatible with the three-year budgeting practice are also one of the good examples of coordination between fiscal and monetary policies.

Another pillar of better economic governance is financial stability. A stable and healthy financial system is the key to sustainable growth through allocating savings to the real sector in a country. Law defines financial stability as the auxiliary objective of the Central Bank of Turkey.

Establishment of the Banking Regulation and Supervision Agency, successful implementation of The Banking Sector Restructuring Program and the New Banking Law that brought the legal framework with best international practices were the milestones of legal and institutional reform in the financial sector. No need to say that the improved macroeconomic framework through successful monetary and fiscal policy implementations also contributed much to financial stability. Last but not least, I should say that there is also an effective cooperation among the Central Bank of Turkey, the Banking Regulation and Supervision Agency, the Undersecretariat of Treasury, the Capital Markets Board and other public authorities and also with private sector representatives.

The fourth and the final set of actions that has been undertaken towards better economic governance is structural reforms.

Turkey has achieved significant progress in this front, but today, I would like to put a special emphasis on the role of regulatory and supervisory institutions without getting into details.

Establishment and effective implementations of institutions such as the Banking Regulation and Supervision Agency, the Turkish Competition Authority, the Energy Market Regulatory Authority, the Telecommunications Authority and many others have contributed to the development of a competitive, resilient and efficient economy in Turkey. It is not surprising that manufacturing, retail, energy and financial sectors have attracted the interest from foreign investors in recent years, as witnessed by over 40 billion USD foreign direct investment in the last two years. The good corporate governance practices have also contributed to the overall economic governance in the country.

As a result of the steps taken in the four categories that I have just mentioned, Turkey has shown an impressive economic performance after 2001. The consumer price inflation declined to the single-digit territory. The GDP has continuously grown in the last 24 quarters. This strong growth performance was private sector driven and supported by continuous productivity gains. Along with the high economic growth, openness of the Turkish economy has also increased substantially. Exports increased by more than two-folds since 2001 and reached to USD 107 billion in 2007. The banking sector has strengthened significantly and became resilient to internal and external shocks. Finally, budget deficit and debt stock of the public are no longer sources of vulnerability. Even before recent upward revisions in GDP figures, Turkey easily met the Maastricht criteria for the budget deficit and debt stock.

Turkey has demonstrated significant improvement in the World Bank's Governance Index since 2000. Thanks to better governance practices, competitiveness of Turkish economy has advanced drastically in recent years as well. In the last two years, Turkey moved up a total of 18 steps in the Global Competitiveness Index prepared by the World Economic Forum. Turkey also moved up 34 steps compared to the previous year in the Ease of Doing Business Index of the World Bank.

Distinguished guests,

I tried to highlight some of the important developments in Turkey regarding economic governance in recent years and the resulting improvement in the economic structure. All these led to improvement in the confidence, which was instrumental in further confidence building and credibility for the economic management. These are all key ingredients of good governance.

These achievements, however, are not enough. We still have much to do in terms of reaching price stability and securing sustainable high growth rates. There is still much to be done to improve economic governance and to reach a level compatible with the EU-15 average. As we are going through difficult times both internally and externally, we should not lose the momentum gained in institutional capacity building. It is even more imperative at this juncture to show and utilize the dexterity that we gained from our past experiences. We have to list the things on the reform agenda and share it with the public at large and without sacrificing the long-term benefits for short-term gains. To ensure that the reform agenda is fulfilled in a timely manner, we need to prepare and announce a timetable, thus setting up performance criteria and adhere strictly to its implementation. In case any delay occurs in the execution of the pre-announced timetable, necessary mechanisms should be in place to ensure that policy makers face the public and explain why it was not achieved. By doing so, we will be able to preserve the gains we have brought about and maintain the medium and long-term growth capacity of our economy.

The key word that I would like to underline here is sustainability. Better governance is of great importance for making the gains of recent years permanent and reaching sustainable high growth rates. There is a heavy reform agenda waiting for us. Macroeconomic stability, structural reforms and adherence to good governance principles will unlock Turkey's economic potential and achieve her convergence to European Union. Thank you.