Mr. Erçel explains developments in the Turkish economy that help in understanding the country's market opportunites Speech by the Governor of the Central Bank of the Republic of Turkey, Mr. Gazi Erçel, on the occasion of the Conference on "Private provision of infrastructure in Turkey" held at Çiragan Palace in Istanbul on 3/4/97.

For a comprehensive understanding of the opportunities offered by Turkey's market, I should stress the implications of our journey toward liberalisation. In 1980, with world conditions changing and the domestic economy in crisis, Turkey launched a structural adjustment program based on free market principles and an outward-looking economic policy. Since then, a series of liberalisation measures have been taken. The most significant accomplishment of the Turkish liberalisation process is that it has restructured economic relations. Both the financial system and the foreign exchange system have been liberalised. Before discussing Turkey's economic performance, I would like to describe some features of our foreign exchange system and financial system. Let me begin with the foreign exchange system. Efforts to liberalise Turkey's balance of payments go all the way back to the Great Depression, and ever since the 1930's, the issue has been whether to liberalise the current account or the capital account. Now these questions have been settled. Let me summarise the state of the foreign exchange regime under five headings:

1. Residents are permitted to buy, sell, and use foreign exchange freely.

2. Residents are also allowed to purchase, through authorised financial institutions, shares quoted on foreign stock markets, and are permitted to transfer foreign exchange abroad to pay for purchases of such securities.

3. By the same token, non-residents are allowed to buy and sell Turkish securities quoted on the Turkish stock market. They are also allowed to buy and sell Turkish government securities through intermediary institutions operating in Turkey.

4. A substantial part of the controls on capital movements were removed, greatly easing inflows and outflows of credit. Turkey has accepted the provisions of Article VIII of the Articles of Agreement.

5. To avoid excessive risks for the banks, new regulations were adopted governing the foreign exchange position of the commercial banks. The banks are free to set their own rates for buying and selling foreign exchange.

Our foreign exchange system, described above, is very convenient for foreign capital flows. Now let me describe the main characteristics of our financial system. Even though our efforts to liberalise the financial system did not begin until 1980, the Istanbul Exchange Market has existed and operated since 1858. It grew out of the activities of Non-Muslim bankers in the Galata district of Istanbul. These operators, mostly Levantines, Jews, Armenians, and Greeks, used to risk their own capital by extending credit to the government, secured by pledges of future tax collections. Even though during the early years of the Exchange Market's operation in the 1860's, the amount of foreign direct investment in Turkey was negligible, foreign capital was being encouraged to form joint stock companies. Up until the beginning of the 20th century, the Market helped the government find funds to finance its obligations. In 1906, the Istanbul Exchange Market was re-organised and once more became a source of new capital for young private ventures.

Without giving the whole history of the Istanbul Exchange Market, I want to emphasise that Turkey's experience with free markets did not begin in 1980 but goes back more than a century before. What the reforms of 1980 did accomplish was to institutionalise the markets and put them on a solid legal footing.

Besides liberalisation, the structural reforms begun in 1980 included measures providing investment and tax incentives. I would like to review these issues briefly. The aims of these incentives were to encourage activities that would earn foreign exchange on the one hand, and to help foreign sources of capital finance investments in Turkey on the other. It can be said that by liberalising its capital account and introducing structural tax changes to improve investment returns, Turkey issued an invitation to foreign capital. Under these new arrangements, the tax incentives aimed at deepening the securities market and encouraging investment in it are of two kinds:

- Double taxation of dividends was prevented by raising the corporate income tax rate and making it the only tax on dividend income. In addition, the income tax rate for small shareholders was lowered.

- For residents, capital gains on shares became exempt from taxation if the security was listed on an exchange. Capital gains from the sale of through licensed intermediaries were made tax free. Premiums from the issuance of stock are also tax free for stocks listed on a stock exchange that does not distribute dividends to shareholders.

There are also tax facilities for government securities.

Privatization is an important part of our modernisation and liberalisation effort. Turkey embarked on a privatization program in the 1980s. Turkey's telecommunications and energy sectors are great targets for global partnership. Despite extensive exemptions from the program, by 1994 total proceeds derived from privatization since it began in 1986 had reached US$2.4 billion, which is not so bad. Moreover, 25 percent of this total came from sales on the Istanbul Stock Exchange. More than 60 percent of the sales were direct sales to domestic and international buyers. The main purpose of privatization is to get the government out of the business of business and increase the efficiency of the privatised enterprises.

Let me follow this account of the general framework of regulation governing financial investments denominated in foreign exchange with a description of the structure, strengths and weaknesses of our economy. The basic economic features of our country are attractive. A liberal trade and exchange rate regime, a modern and competitive private sector, abundant and vigorous consumer demand, and extremely attractive investment opportunities.

This rosy picture is clouded by three economic problems that can be solved by a firm commitment to macroeconomic discipline. These three problems--high and persistent inflation, high public sector deficits, and large current account imbalances--are interrelated. Persistent high inflation has been Turkey's main economic problem for the last two decades. Its main cause lies in the sizeable public deficit. Its other causes include entrenched inflationary expectations, exchange rate movements, monetary developments, interest rates, and price increases initiated by public enterprises. Under conditions of an open capital account, large public deficits can generate imbalances in the current account. Turkey's current account tends to be volatile. For this reason, what Turkey really needs is to accept fiscal discipline. A sustainable and consistent fiscal policy is evidently the key to solving other economic problems. Achieving fiscal discipline will require political will as well as persistence.

Even though we have economic problems, we unquestionably also have the ability to overcome them. Turkey needs to make use of this potential. I therefore now wish to draw your attention to the considerable strengths of our economy. For purposes of this discussion, I will split our economy in two--the real economy and the financial economy. Let me begin my explanation of the present structure of the economy with **real variables**.

- The Turkish economy is a continuously growing, dynamic economy. Its long-term average annual growth rate is over 4 percent and its average annual productivity increase is around 2 percent. In each of the last two years, GNP has increased by around 7 percent, well above most OECD countries. Along with this rapid growth, the composition of the gross domestic product (GDP) has shifted during the last two decades, toward the industrial and services sectors, while the GDP share of agriculture has greatly declined. The share of the public sector in industrial output has also decreased.

- Spending on investments has been increasing since the first quarter of 1995. Normally, periods of investment aimed at increasing production capacity last for about 20 months, but the increase in investment activity spending remained focused on increasing production capacity throughout 1995 and 1996. The Economic Trend Analysis of the Central Bank of Turkey shows that no earlier period of expectation of rising investments has ever lasted longer.

- Official records show that Turkey's unemployment rate has been holding fairly constant at around 7 or 8 percent, which is very low compared to the other OECD countries. In April 1996, total employment rose by 2.6 percent and unemployment fell to 6.3 percent. The urban and rural unemployment rates were estimated at 9.3 percent and 3.8 percent respectively.

In addition, Turkey was among the top ten countries in terms of improving its score on the United Nations' human resource development index, which is based on a country's literacy rate, per capita income, and life expectancy. Of course, such a nation-wide measurement takes no account of the wide differences between urban and rural conditions. Be that as it may, the strong growth of the working age population, the high degree of urbanisation, and increased numbers of well-educated young workers are all favourable to strong growth in labor productivity.

- Turkey has a strong, dynamic and competitive private sector. The non-agricultural private sector recovered quickly from the financial crises in spite of unsettled political conditions and extremely high interest rates. In addition, it is the private sector that has been mainly responsible for capital formation. ·

- There have been interesting developments connected with Turkey's foreign exchange earnings. Even though the official trade account and current account figures reflect sizeable deficits, I would like to emphasise that the level of merchandise exports is significantly understated due to its omission of rapidly growing but unrecorded "shuttle" trade with neighbouring countries. We are on the verge of being able to include these activities in our balance of payments figures. In addition, there has been serious underreporting of the value of transactions connected with some of Turkey's foreign direct investments, a problem that the Central Bank is working to resolve.

Now let me touch briefly on Turkey's financial system. Turkey's financial sector is still dominated by the banking sector. In other words, most financial savings are channelled through the banking sector. The banking sector's total assets amount to 66 percent of GNP. The reformation of the financial sector had the effect of reinforcing the privileged position of the banks. Turkey has a universal banking system, which is another way of saying that Turkish banks are allowed to participate directly in all forms of financial activity except insurance. The Banking Act of 1985 governs the establishment of banks, their capital structure, branch banking, foreign banking, credits, deposit insurance, and all other activities related to banking. Today our banking sector is highly competitive and efficient. It is integrated with the international financial markets. Its strength is based on an up-to-date technical infrastructure, a well-educated work force and experienced, and a well-qualified management. The banking sector's adaptability, shown by its rapid introduction into the system of new financial instruments, has increased the available range of financing sources. Financial reform has increased the efficiency and competitiveness of our banking sector.

The Istanbul Stock Exchange is one of the best performing of all the emerging markets. Its total market capitalisation is increasing, both in nominal terms and as a percentage of GNP, which indicates that it is playing an increasing role in the transmission of domestic financial savings. The GNP share of market capitalisation has increased to 22 percent, while the GNP share of M2y, which is the total of financial savings held in the banking sector, is around 40 percent. In addition, the return of the Istanbul Stock Exchange, though volatile, increased substantially this year. Market volatility creates liquidity and great trading opportunities.

When I talk about money markets I mean the Turkish lira money market and the foreign exchange cash and deposit market, open market operations, and government securities auction markets. These markets, which were introduced as a part of the financial sector reforms, have increased the effectiveness of the central bank's control over the liquidity in the financial system, and increased the role of market mechanisms in money management. When market mechanisms began to play a larger part in the allocation of resources, the responsibilities and instruments of the central bank also changed, bringing the issue of central bank autonomy onto the agenda of the Turkish economy.

Turkey now has a well established and efficient system of financial markets. The main obstacle at present to the functioning of the financial markets is our large public sector borrowing requirement, which crowds out other demands for financing. The inability of domestic resources to cover the financing needs of the public sector has kept real interest rates very high for over a decade. Bold privatization efforts, broadening the tax base, and reforming the social security system are the best ways to correct this situation, and I may say that they are all under way. Macroeconomic stability and political stability are the keys to achieving sustainable growth in a low inflation environment.