



**Central Bank of The Republic of Turkey**

**FINANCIAL STABILITY AND IMPLICATIONS OF BASEL II**

16 May 2005, Istanbul

## **FINANCIAL STABILITY**

Minister, Governors, Academicians, Guests etc.,

I would like to welcome you to Istanbul today and thank you all for your participation in this conference. It is an honor for me to host such distinguished speakers and participants in Istanbul.

One of the features of the world economy back in the 90's was the financial liberalization of economies. The ambitious macroeconomic policies of many countries aiming at liberalizing capital accounts, started in fact with developed countries in the late 70's and spread to developing countries in the late 80's and 90's.

Another feature of the world economy in the 90's was the acceleration of capital movements around the world, which I would say is also an outcome of the financial liberalization policies. The comprehensive technological progress in areas of information, communication and computing also highly promoted this active movement of capital across national borders.

This impressive change in the global economic environment since the 80s has resulted in important changes in global financial markets. As the figures indicated, during this period, the global financial sector in general and the banking sector in particular developed much more than the real sector did. New financial instruments that were designed for firms' financing needs provided new opportunities for companies. Hedging markets developed rapidly. All in all, financial engineering emerged as a new area of knowledge.

Dear Guests,

The aggressive capital movements among countries and developments in financial markets generated a number of economic benefits at the global level. When borders between countries have disappeared in favor of capital flows, funds flew to regions where capital had the highest return. So, it has been observed that competitiveness and productivity of capital in global scale increased considerably in the 90s. There has been also a substantial rise in the volume of global merchandise trade.

However, all developments that I mentioned now represent only the front side of the medallion.

The back of the medallion has not been as bright as the front. In the 90's, not only the scope, timing and speed of the financial liberalization varied across countries, but also the consequences of economic policies had various effects on national economies, depending on the initial conditions and country specific factors. Hence, the rapid increase in capital movements among countries shook the financial markets from time to time, led to financial and banking crises in many countries and, even more importantly, caused the crisis in one country to spread to others.

In 2003, Caprio and Klingebiel reported 117 episodes of systemic and highly costly financial crises in developed and emerging market countries since the late 1970's<sup>1</sup>. The resulting costs for economies in terms of fall in GDP have reached even double digits and had a significant impact on the welfare of societies, especially in developing countries, and again especially when banking crises coincided with currency crises.

In addition to high incidence of "traditional" banking crises, the period also saw certain unusual episodes of financial distress with potentially damaging consequences for the real economy operating essentially through capital markets. This has been most evident in the United States, where non-banking intermediation has developed furthest<sup>2</sup>. Starting in the late 80's, examples included the banking crises in Nordic countries, Japan, some Latin countries and East Asia.

Along with excessive capital flows, economic research in recent years has identified a variety of market imperfections such as moral hazard and asymmetric information that, if widespread and significant, can threaten the smooth functioning of financial systems and lead to panic behavior, bank runs, asset price bubbles, excessive leverage, and inadequate risk management.

As Mr. Aninat (Former Deputy Managing Director of IMF) said once, and I'll quote his own words, "Historical experience shows that financial crises are here to stay; and dealing

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<sup>1</sup> Caprio G. and Klingebiel, D. (2003). Episodes of Systemic and Borderline Financial Crises. World Bank Database.

<sup>2</sup> Borio and White. (February 2004). Whither Monetary and Financial Stability? The Implications of Evolving Policy Regimes. BIS Working Papers. No. 147.

with unfolding crises in real time poses perhaps the most demanding and certainly the most stressful challenge to any central banker”<sup>3</sup>.

As a result, it is widely accepted that financial stability is an important issue for policy makers that they basically cannot ignore.

Furthermore, economic literature and experiences of countries also showed that in order to reach sustainable growth and sustainable increase in employment, the key components of the economy are, in addition to indispensable price stability, a sound financial system and a financially stable environment.

Dear Guests,

For the efficient allocation of resources in an economy, financial intermediation should also function efficiently so that firms can find sources to produce more. As we keep dwelling on the banking sector particularly, banks play a vital role in the economy, matching supply of capital with demand, so knowing how a downturn affects these institutions is important in understanding national economies’ dynamics<sup>4</sup>.

Developments in financial markets have two important implications on the global economy and economic policies: Firstly, stronger a country’s fundamentals are, less vulnerable it is to distortions caused by intensive capital movements. Hence, the importance of macroeconomic stability and strong fundamentals.

However, contrary to the general belief, turmoil in global markets in the 90’s also showed that macroeconomic stability in general or price stability in particular does not necessarily guarantee financial stability. As historical evidence suggests, it is possible for financial imbalances to develop even in an environment of stable and low inflation.

Therefore as the second implication, it is impossible to avoid crises without discipline in financial markets. Then it naturally follows that the risk management developed as a distinct banking discipline in the 1990s. New tools and methods to manage the market and credit risk were developed, and brought about a dramatic increase in the volume of capital

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<sup>3</sup> Aninat, Eduardo. (2003). Foreword. Challenges to Central Banking from Globalized Financial Systems. IMF.

<sup>4</sup> Schuerman T. (2004). Why Were Banks Better off in the 2001 Recession? Current Issues in Economics and Finance. FEDNY. Vol. 10. No: 1.

movements in the financial sector and variety of instruments. Efficient supervision became the vital part of this internal discipline.

I should also admit that, as financial engineering contributes to development of new and complex instruments, such instruments also create obstacles to supervisory authorities given their sophisticated structures.

As a result, a long debate started among both academics and policy makers as to whether the objective of price stability or financial stability should take priority for a central bank. I do not want to take sides in this debate. We, central bankers, are responsible for providing a stable economic environment, in which the economy operates efficiently in the long run. And prerequisites for a stable economic environment are both price stability and financial stability. So, there is always a strong reason for keeping financial stability in the central banks' reaction functions.

Therefore, these two objectives are not in conflict in the long run, but are complementary to each other. Accordingly, financial stability has increasingly become an auxiliary objective of central banks to pursue.

In fact, central banks' role in times of financial instability is not a new issue for the economic literature. The term "lender of last resort" originated in the writing of Sir Francis Baring in 1797. In his book, "Observations on the Establishment of the Bank of England", Sir Baring referred to the Bank of England as "the dernier resort" from which all banks could obtain liquidity in times of crises. But the concept of lender of last resort had been described and used in a more comprehensive manner by both Henry Thornton in 1802 and Walter Bagehot in 1873.

Distinguished Guests,

I will add a point to the discussion that the benefit of having a strong financial system in an economy eliminates the ground for conflict in policies between financial stability and price stability. Since a strong financial system increases the efficiency of monetary policy on one side, it also provides elasticity for the economy to overcome external shocks easier on another. On the other hand, it is almost impossible to attain financial stability in the long run without maintaining price stability. Furthermore, price stability attained through

credible monetary policies is an advantage in times of increasing uncertainty in the financial system and financial imbalances.

I should also mention that policies for financial stability not only mean measures taken in times of crises, but also consist of rules for maintaining financial stability in the long run. In the area of prevention of financial instability, perhaps the single most important thing a central bank can do is to foster a macroeconomic environment of low and stable inflation and sustainable economic growth.

Providing price stability is therefore a must but it is definitely not enough in itself to keep financial markets on track. Either central banks or other authorities in charge have to take measures and put harmonized policies into practice to maintain financial stability.

Within this framework, it is possible to mention three main functions for central banks to maintain financial stability: The first one is monitoring the financial system. The second one is running the country's payments system. And the third one is taking necessary measures for crisis resolution. Central banks also publish regular financial stability reports based on innovative in-depth analysis of financial vulnerability.

Dear Participants,

Before proceeding with the Turkish case, I want to address some issues about international cooperation in favor of sustaining financial stability and particularly a strong financial system on a global level. I will, however, not go into so much detail of evolution of the international efforts and criteria formed by international institutions, since many of you here today are not only well informed about the issue, but also largely contributed to these efforts.

The most important result of international efforts aiming at sound financial markets was the approval of modern risk management techniques as a part of regular financial intermediation process.

In this context the Basel II, the new capital adequacy framework, is a very important outcome of the action taken in the international arena. Although, the main aim of the original Basel Accord, which was applying institutionalized and international standards to the global financial system, has not changed in the Basel II Accord, the Basel II puts more emphasis on the risk management aspect of the financial intermediation process. It is

expected that a sound and resilient risk management in the banking sector would also lead to more efficient risk management in the real sector. Therefore, in this way, as the financial system becomes more stable, less pro-cyclical and reinforced against shocks, more sources will be available for the real sector.

However, it should also be considered that healthy and efficient risk management requires more than the three main pillars of the Basel II Accord. A good understanding of the risks that a financial institution might encounter, a clear definition of risk taking procedures, compliance of risk taking decisions with the strategic goals of the institution, ensuring the risks are within the limits that were set by the management and adequate capital for given risk structure are other essential elements for a more significant advance in risk management in financial institutions.

Additionally, the Basel II is also significant due to its effect on the increase in transparency of the banking sector. As you may agree, the more transparency there is in the banking sector, the less probable systemic risk will be.

All these steps will certainly provide a mechanism that is designed to allocate resources effectively, initially financial resources but ultimately real resources. Hence this will contribute to the strength and efficiency of the economy as a whole.

Dear Guests,

Having touched on the notion of financial stability, financial markets and banking sector in the world economy, what I intend to do now is to familiarize you to some extent with the Turkish experience in this area. First of all, I will concentrate on developments in the financial system in Turkey in the 90's. Secondly, I will talk about the 2000-2001 crises. Finally, I will describe the implementation, in terms of financial stability, of the Central Bank of Turkey's monetary policy.

In order to give the appropriate point of view about the development of the Turkish economy and especially the financial sector in the 90s, I'll have to highlight the basic structure of that period in the Turkish economy.

The financial liberalization process that started in the 80s was one of the cornerstones of the Turkish economy. A set of reforms for developing a functioning market economy was put into practice. Interest rates were more and more determined in the markets, and some

measures were taken regarding the supervision of the banking sector. However, before taking the necessary actions for strengthening the domestic financial markets, such as measures for more transparent balance sheets and more careful risk management in the intermediation process, the capital account was liberalized at the end of the 1980s. The Turkish economy with an inefficient banking sector became open to intensive capital movements.

In my view, the Turkish economy turned into an open one before it became strong enough to cope with capital movements that would occur in the 90s. The sequencing of reforms for the Turkish economy in general and its financial system in particular should have been set differently.

What went wrong in the Turkish economy in the 90s? Policies did not concentrate on ensuring and maintaining macroeconomic stability; different priorities, delayed reforms, loose fiscal policy and accommodative monetary policy led to dynamic instability throughout these years. As a result, inflation climbed to 79 percent on average, budget deficit widened so much that the public sector borrowing requirement reached 15.5 percent of the GNP by 1999, the output growth was very low on average and volatile compared to other emerging markets.

So, poor macroeconomic fundamentals and a fully liberalized capital account brought about vulnerability of the economy to external shocks and the Turkish economy faced severe financial crises and turbulences in the 90s.

Such an environment had also important implications on the financial system. Having suffered from the reckless and unstable macroeconomic management together with inefficient supervision, the system deteriorated severely and faced a serious moral hazard problem.

Dear participants,

A closer look at the Turkish financial system would be helpful to characterize its weaknesses and structural problems during that period. First of all, because of the high public sector borrowing requirement, fiscal dominance increased considerably in the financial markets and led the public sector to crowd out the private sector. Hence, the relationship between the banking sector and real sector could not develop as it should



have done. Instead, the relationship between the banking sector and the public sector strengthened year after year.

Secondly, the banking sector as a whole failed to exercise good risk management in its credit allocation. Since financing the public sector budget deficits with high real interest rates was an easy way to make profits, banks did not pay much attention to basic principles of risk management, such as maturity and currency mismatches. Some banks also created considerable amount of connected-loans in their balance sheets. On the public banks side, more specifically, which had a high share in the overall sector, banks were heavily used to support government policies and credits were allocated inefficiently, which resulted in big losses and weakened their capital structure.

Lastly, in the 90s, regulatory and supervisory measures and changes in the structure of the financial system in the Turkish economy were not designed for strengthening the system in the long term, by incorporating elements such as prudent supervision, institutionalization of regulation, etc. Instead, the measures mostly sought daily solutions to the problems. As you know well and the research in the area suggests, *“Actions to deal with crisis can clearly lead to future moral hazard. If any protection provided to banks in a crisis is greater than they expected, this could increase their risk taking and [the possibility of another] crisis in the future.”*<sup>5</sup> As Bagehot also put it, *“any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank.”*

In my opinion, the 100 percent blanket guarantee that was brought as a part of crisis resolution during the 1994 crisis, but kept in effect until very recently is a good example of this. The measures taken during the 1994 crisis unfortunately paved the way for the moral hazard behavior in the banking sector.

All of these distortions in the banking sector and institutional structure of the financial system led to important systemic risks in the Turkish economy. As the 1990s were over, it was impossible for the Turkish economy to operate without reforming its financial sector.

Therefore, the restructuring program for the financial sector was launched as a component of the exchange rate based disinflation program in 2000. The Banking Regulation and Supervision Agency (BRSA) became operational in August 2000 as an autonomous body

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<sup>5</sup> Hoggarth, G. Reidhill, J. Sinclair, P. (2004). *On the Resolution of Banking Crises: Theory and Evidence*. Bank of England Working Paper. No.229.

in order to strengthen the prudential regulations and to improve the quality of banking supervision. The Banks Act was amended to simplify and bring the supervision standards in line with the EU directives, international practices and the core principles stated by the BIS.

However, the reform process was not continued in line with the pre-determined schedule and broke down during the 2000 and the 2001 crises. The process could only be restarted again after the 2001 crisis.

Dear Guests,

If I have to describe the crisis in the Turkish economy in 2000- 2001, I would prefer to describe it as the result of accumulated structural distortions in the economy. These distortions in the economy put pressure on the pegged exchange rate regime and, along with the credibility problem due to the bad track record of policies, resulted in first banking and then currency crises. In other words, the 2001 crisis started as a banking crisis, then it turned into both banking and currency crisis.

Dear Guests,

As I have mentioned several times in my speeches, in Chinese the word crisis also means opportunity. The Turkish economy nowadays is showing signs that, after all those hectic years, opportunity to stabilize it was finally seized.

Policies and measures that were put into practice after the 2001 crisis were not limited to simply practices of crisis management in the short term. Steps were taken in order to remove distortions in the Turkish economy, to renew the financial system and to change the dynamics of the economy with the purpose of achieving price stability, sustainable public finances and sustainable growth in the long run.

First of all, right after the 2001 crisis, economic policies aimed, in the short run, at maintaining financial stability and convincing market participants that sound macroeconomic policies would be put into practice with determination in order to solve the problems of the economy.

In my opinion, the most critical change that came after the 2001 crisis was the amendment to the Central Bank Law. The Central Bank of Turkey has been given independence after

a period of 30 years of high and chronic inflation. The primary objective of the Bank is now defined as achieving and maintaining price stability. It was a turning point in the economy and highly contributed to the changing dynamics in the Turkish financial system.

In addition, it is now explicitly indicated in its law that financial stability is the Central Bank's auxiliary objective, and the Bank gives utmost importance to maintain it.

In the fourth article of the Law, the Bank's responsibility of financial stability is defined within the framework of the functions of central banks that I mentioned before. The fourth article of the Central Bank Law states that the Bank is responsible “ to monitor the financial markets; to regulate the volume and circulation of the Lira, to establish payment and securities transfer and settlement systems and to set forth regulations to ensure the uninterrupted operation and supervision of the existing and future systems and to determine the procedures and conditions of reserve requirements and liquidity requirements by taking into consideration the liabilities of banks and other financial institutions as deemed appropriate by the Bank.”

In this article it is also stated that the Bank will take measures for enhancing the stability in the financial system and take regulatory measures with respect to money and foreign exchange markets as well. Hence, The Bank is equipped to take necessary measures in times of external shocks and in fact proved that during the 9/11 event and also the Iraqi War in 2003.

Distinguished Participants,

After the 2001 crisis, besides amendments in the Central Bank Law, many steps were immediately taken to strengthen the financial sector. At first, the “Banking Sector Restructuring Program” was put into practice in May 2001. The main goal of the program was to eliminate the distortions in the financial sector, improving its intermediary function and thus enhancing its competitiveness by international standards.

Within this framework, restructuring public banks, strengthening private banks, solving the problems of the troubled banks taken over by “Savings and Deposit Insurance Fund” and strengthening the regulation and supervision of the banking sector were among the priorities of the program. And, for improving the asset quality of the system, a debt

restructuring process was put into practice, named as the "Istanbul Approach". The sector increased its capital and decreased foreign exchange open positions to a great extent.

Hence, right after the 2001 crisis, the authorities intervened into the system in order to prevent a total collapse of the system. This operation had cost around 21.7 billions in New Turkish Lira – more than 12 billion Euros at current rates- or in other words, 12.1 percent of GNP. Firstly, the Treasury and the Central Bank have injected liquidity to public banks. Secondly, the Central Bank started foreign exchange sale auctions on a daily basis to provide foreign exchange liquidity in exchange for some of the excess domestic liquidity to the system so that they could close their open positions in foreign exchange. The Central Bank also used open market operations to withdraw the remaining still excessive liquidity from the system to prevent hyperinflation. Thirdly, to provide more room to the banking sector for liquidity management, measures were taken regarding the reserve requirements of the banking sector. The Central Bank started paying interest to banks' required reserves.

The stability of the banking sector has been further strengthened by the ongoing reforms and boosted both mergers and acquisitions and foreign bank participation to the sector. The volume of the banking sectors' credits to non-financial sector rose by more than 70 percent in real terms and the sectors' profits increased by a considerable amount since 2002; capital adequacy and loan quality of the sector also improved.

As of today, efforts towards increasing the consistency of the legal framework with the EU, completion of the restructuring process and then privatization of the public banks and development of modern risk management are on the agenda.

Distinguished Participants,

Today we not only have a stronger banking sector, which forms a basis for macroeconomic stability, but we also see remarkable progress in the Turkish economy in general. With the stabilization program that was launched in May 2001, great progress toward macroeconomic stability was made, especially in the disinflation process and recovery in growth.

As the inflation rate is regarded as a signal of the quality of economic management, the achievement in the inflation front in the Turkish economy is among the most significant

examples of progress toward better macroeconomic fundamentals. Single digit inflation was reached after a period of more than thirty years of high and chronic inflation.

Additionally, as inflation targets were attained in 2002, 2003 and 2004, and thanks to a sound communication policy, the public in general now believes in the determination of the policy makers to fight against inflation. As a result, policies have gained credibility and the inflation target has become a more credible nominal anchor for economic agents. This in turn has strengthened the disinflation policy and ensured its continuity.

As another development, the Turkish economy has been enjoying high rates of growth for three consecutive years in the falling inflation environment. The GNP growth rate was 9.9 percent in 2004. Accordingly, the real growth rate compared to 2001 was 25.5 percent.

However, even more important than achieving high growth rates is that dynamics of growth in the Turkish economy are now changing. Now, growth is mainly driven by the productivity increase, comes from the private sector and increase in exports. This provides confidence regarding achieving sustainable growth rates in the future.

I want to emphasize that, not only recent developments in macroeconomic fundamentals but also the commitment to prudent policies in the medium-term economic program, prospects of EU membership and the new standby agreement with the IMF help the Turkish economy to operate in an equilibrium of good expectations.

Dear Participants,

I want to mention that the Central Bank's commitment to start full fledged inflation targeting in 2006 will deliver extra confidence to economic agents in terms of prudent policies. The full fledged inflation targeting regime will bring more transparency to the actions of the Bank and also enhance the communication policy that the Central Bank put at the center of its policies since the 2001 crisis. As the transparency and institutionalization are critical qualifications of prudent policies to attain a sound macroeconomic environment, the implementation of full fledged inflation targeting will certainly support further macroeconomic and financial stability in the Turkish economy.

Dear Guests,

As a central banker I must confess that conducting monetary policy in an uncertain economic environment is not an easy task and never will be. Distortions in the financial system further increase the uncertainty in the functioning of the economy, and the reform process in the financial system is in fact never-ending to sweep away these uncertainties. Therefore, there will always be steps to be taken toward attaining more transparent and efficient financial markets. And policy coordination between institutions on international and national levels will certainly be the most important aspect of this dynamic process.

Thank you very much.