Central Bank of the Republic of Turkey

FINANCIAL SECURITY AND STABILITY

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"Measuring and Fostering the Progress of Societies: The OECD World Forum on Statistics, Knowledge and Policy"
28 June 2007, İstanbul

Dear guests,

I would first like to welcome you all to Istanbul, the city where the two continents meet. And today it is so delightful to see that it is a meeting point for high level delegates from all the continents. In that regard, it is a great pleasure for me to be given the opportunity to share my views on financial stability and security with such a distinguished audience.

Today, I would like to begin my speech by underlining the importance of financial stability, why and how we should keep an eye on the stability of the financial system, including the Turkish perspective. Finally, I will try to emphasize the interrelatedness between financial security and stability.

Importance of financial stability…

As a result of the liberalization and deregulation processes, financial markets became more integrated and underwent radical transformation, starting, in fact, with developed countries in the late 70's and spreading to developing countries in the 80's and 90's. At the same period, capital movements were seen to have accelerated and reached to high levels. This, in turn, led to financial innovation and heavy use of sophisticated instruments.

The degree of sophistication in financial markets urge all market participants to increase their focus on risk management and policy makers to monitor closely the developments and identify risks in these markets. This shift in market participants' perceptions is particularly important, considering the lessons derived from painful experiences of crises, which especially occurred during the last two decades all around the world. These lessons taught us how costly and disruptive financial instability can be and how effective risk management can be to avoid adverse conditions in advance.

Even though there is no consensus on how to define financial stability, its importance is widely accepted. Due to the financial crises experienced on the road to globalization, along with financial liberalization and technological improvements, "financial stability" in line with the target of achieving price stability, has become one of the leading policy issues of central banks. However, I should point out that, although price stability has a commonly accepted and clear definition, I can say that it is much more difficult to define financial stability.

The European Central Bank defines financial stability as the financial system capability to withstand shocks without impairing the transformation of savings to investment opportunities. Another definition draws attention to the absence of crises in the financial system and a robust financial sector. It is also defined as the efficient performance of the financial system in the event of shocks, stress situations and profound structural change.

Policy makers very well recognize that financial instability can harm growth and cause serious disruptions, revealing itself in decreased market liquidity, excessive volatility in asset prices and ending up in banking and currency crises. Therefore, many central banks now consider financial stability as an objective complementing the price stability. In recent years, there has been a noticeable increase in central banks' autonomy in monetary policy, and also a transfer of supervisory and regulatory responsibilities regarding financial institutions to other autonomous bodies. The maintenance of financial stability is, and will remain, a core function for all central banks. In the modern era, central banks' involvement in matters relating to financial stability has become broader and more formalized.

Central banks recognize financial stability as an important and self-contained objective. Central bankers see price stability and financial stability as connected due to the fact that serious disruption in the financial system would affect the implementation and effectiveness of monetary policy, while macroeconomic stability helps reduce risks to financial stability.

Obviously, measurement of financial stability is not as straightforward as price stability since there is no single measure or indicator, which shows if the financial system is stable or not. Considering the substantial developments in innovative financial products including hedge funds and the contagion risk inherent in them, accurate statistical data requirements step forward. Moreover, a thorough assessment of financial stability makes it essential to monitor the risks driven by household and corporate sectors. In this regard, every central bank all around the world is concentrating on developing new tools and stress tests for assessing financial stability. They are reorganizing themselves in order to directly and effectively monitor financial stability and to develop new analysis techniques regardless of whether a central bank is also the supervisory authority or not.

Financial stability from the Turkish perspective…

If we consider the last two decades of the Turkish economy, we can say that Turkey learned its lesson very well by actually going through several crises and economic downturns. Thus, we now are aware of how important it is to have a sound financial system, which is resilient to potential shocks.

The distortions in the banking sector and weak institutional structure of the financial system led to important systemic risks in the Turkish economy making it impossible for the economy to survive without financial sector reforms taking place. Therefore, the restructuring program for the financial sector was launched with the goal of eliminating the distortions in the financial sector, improving its intermediary function and thus enhancing its competitiveness by international standards. Banking Regulation and Supervision Agency has become operational as a separate body to improve the banking supervision. The Banks Act was amended to bring the supervision standards in line with the EU directives and international best practices. Moreover, the Central Bank Law has been amended and instrumental independence of the Central Bank was provided and the primary goal of the Bank was determined to be maintaining the price stability. To support this main goal, the Bank was assigned with the duty of maintaining financial stability, and within this context, the Central Bank continued to assess the main risks and vulnerabilities of the financial system and to develop alternative policies against these risks by monitoring the financial system as a whole. In the last couple of years, Turkey has shown a remarkable progress considering the soundness of the economy and the financial system. Today, we have a stronger banking sector, which forms the basis of macroeconomic stability, as well.

Of course, considering the dynamic nature of the economies, the conditions do not always stay as what they are especially due to the increasingly interlinked global financial markets. In May-June 2006, international developments such as the deterioration in global liquidity conditions and the decrease in risk appetites of foreign investors towards developing countries, and the uncertainty occurring after it, adversely affected developing countries, including Turkey. However, tight monetary and fiscal policies of the current economic program, on-going structural reforms and flexible exchange rate regime have increased the resilience of the system to shocks.

Additionally, the strengthened legal infrastructure and the improved risk culture in the banking sector have alleviated the adverse effects of May-June fluctuations.

I believe nobody in this room would deny the fact that today almost all financial developments will have implications for all decision makers around the world-ranging from investors to policy makers. When a decision is made by the FED, ECB, Bank of Japan or China, it is a concern for most countries. I am sure you will all agree with me when I say, in today's integrated markets when any country catches a cold there will be many others sneezing. In such an environment we are now increasingly aware of contagion risk.

Financial security and financial stability…

Within this framework, I would like to emphasize the close linkage between financial security and financial stability.

In my opinion, financial security can be enhanced by the existence of a smoothly operating infrastructure. This actually is a comprehensive concept and includes the payment system, the technological infrastructure, as well as the regulatory and supervisory framework.

Overseeing the payments system is an essential duty of the central banks. In this respect, a basic continuing responsibility of any central bank is to assure stable and smoothly functioning payment systems. Linked to this is the lender of last resort function of the central banks. Emergency liquidity assistance, perhaps the most traditional function for dealing with financial instability, is a way out provided by central banks. Central banks can have a calming influence on markets in case of a market disruption simply by standing ready to provide liquidity assistance if necessary. It includes both the provision of liquidity to the financial system as a whole through market operations, as well as emergency lending to individual banks. Altogether these two important functions facilitate the security in the system.

Technological infrastructure is another component to secure financial operations. Financial systems continuously need to adapt themselves to the rapidly increasing technological innovations. This also includes new products, necessitating increased awareness by the users and supervisors of the risks and benefits inherent in them. At this stage integrity and accuracy of data comes forward to facilitate risk management by the institutions and effective supervision by the regulators.

The supervisory authorities increasingly need to be proactive and concentrate on consolidated supervision. In my opinion, it is crucial for policy makers to be aware of the dynamics in the highly correlated markets. Creating widespread transparency with regard to their objectives; identifying risks; sharing views with financial market participants to increase their awareness of risks and to act accordingly; starting or promoting initiatives to reduce the financial system's vulnerability to crises and to reinforce financial infrastructure, especially in the field of payment services and securities settlement should be given priority.

International initiatives ease this process by specifying best practices and defining principles. In these international platforms, we find the opportunity to cooperate and exchange information. As we would all agree, although it is highly comprehensive and demands our devotion, Basel II is a significant step towards that end. There is no doubt that the main pillar of Basel II regarding capital adequacy is a core requirement for the financial soundness of institutions. However, I want to point out the importance of its two other pillars. Supervisory Review is very essential to evaluate an institution's risk management. Complementary to this is the effective corporate governance in an institution. And finally, market discipline ensures that the market provides another set of eyes on the soundness of institutions.

In the broader sense, we could conclude that strengthening market discipline within a clear prudential framework can help achieve a better balance between financial system stability and economic efficiency. In that sense, as the Central Bank, we are very well aware of our responsibility in implementing sound and coherent policies and delivering these policies and policy related messages to the markets within the context of maximum transparency and timeliness.

All these components contribute to financial security and in turn enhance the financial stability in the system, accommodating policy makers' further decisions. Actually, financial security and stability are so much interrelated that one could easily argue that the stability is also a prerequisite for the security in the system or vice-versa.

Lastly, financial security and thus, stability contributes to the health of the financial systems, efficient allocation of resources and effective management and distribution of risks in the economy. Maintaining and safeguarding financial stability is a must for the authorities of every country not only to have a sound national financial

system but also to contribute to the overall soundness of the world financial markets. Policy coordination between institutions on international and national levels will certainly be the most important aspect of this dynamic process.

Thank you for your attention.